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Double Tax Treaties and Their Interpretation

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I

INTRODUCTION

International double taxation occurs when two or more states impose taxes on the same taxpayer for the same subject matter. Most commonly, double taxation arises because states tax not only domestic assets and transactions but also assets and transactions in other states which benefit resident taxpayers, resulting in the overlap of the states' tax claims. Bilateral double tax treaties address and reduce the extent of this double taxation. The efficacy of the treaty approach, however, depends on common and workable interpretations of the treaty terms.

This Article explores the problems and significant issues which arise when interpreting double tax treaties. Using the various model taxation treaties¹ and in particular an official commentary published by the Organization

† Professor of Law and Director of the Research Unit for Foreign and International Financial and Tax Law, University of Munich. This Article is a revised and adapted version of the introduction to Professor Vogel's commentary on the provisions of the OECD Model Treaty and the treaties of the Federal Republic of Germany concerning the avoidance of double taxation and fiscal evasion. See K. VOGEL, *DOPPELBESTEUERUNGSABKOMMEN, DAS OECD-MUSTER-ABKOMMEN UND DIE DOPPELBESTEUERUNGSABKOMMEN DER BUNDESREPUBLIK DEUTSCHLAND AUF DEM GEBIET DER STEUERN VOM EINKOMMEN UND VERMÖGEN* (1983). The author gratefully acknowledges the extensive assistance of Henry A. Shannon, III in adapting and translating this article.

1. See Organization for Economic Cooperation and Development (OECD), Model Double Taxation Convention on Income and Capital 1977, *reprinted in* 1 *TAX TREATIES* (CCH) ¶ 151 (1980), 3 RHOADES & LANGER, *INCOME TAXATION OF FOREIGN RELATED BUSINESS TRANSACTIONS* §§ 15.01–15.01[30] (1985) [hereinafter cited as OECD Model]; see also United Nations Model Double Taxation Convention Between Developed and Developing Countries, U.N. Sales No. E.80.XVI.3 (1980), *reprinted in* 1 *TAX TREATIES* (CCH) ¶ 171 (1982), 3 RHOADES & LANGER, *INCOME TAXATION OF FOREIGN RELATED BUSINESS TRANSACTIONS* §§ 15.06–15.06[28] (1981) [hereinafter cited as UN Model]; U.S. Department of the Treasury, Model Income Tax Treaty of June 16, 1981, *reprinted in* 1 *TAX TREATIES* (CCH) ¶ 158 (1982) [hereinafter cited as U.S. Model]; also see U.S. Department of the Treasury, Model Income Tax Treaty of May 17, 1977, *reprinted in* 1 *TAX TREATIES* (CCH) ¶ 153 (1978), 31 *BULL. INT'L FISCAL DOC.* 313 (1977). For an article by article comparison of the texts of the OECD Model treaties (1963 and 1977), the UN Model Treaty (1980), and the U.S. Model Treaty (1981), see K. VAN RAAD, *MODEL INCOME TAX TREATIES* (1983). Conventions for the Avoidance of Double Taxation to which Germany is a party are reprinted in English in *INTERNATIONAL BUREAU OF FISCAL DOCUMENTATION, EUR. TAX'N Supplementary Service Section C-5*.

for Economic Cooperation and Development (OECD)² as guides, the Article reviews the tax treaty regimes of the United States and European nations and discusses several particularly troublesome aspects of treaty interpretation. Following a brief outline in Part II of the circumstances giving rise to the need for tax treaties, Part III of the Article describes how tax treaties are concluded and presents a framework from which to analyze the various elements of tax treaties. Part IV outlines the general principles and sources used in double tax treaty interpretation. It distinguishes such interpretation from that of domestic law and suggests the importance of the OECD Model Treaty and parallel tax treaties. Part V illustrates the problem of interpreting a term defined in a treaty by closely examining the internationally-defined term "companies" under the OECD Model Treaty and its consequences for the entitlement to treaty benefits. Part VI presents the complicated problem of qualification which arises when a treaty term is not defined or is inadequately defined in the treaty and the parties attach different interpretations to the term under their domestic laws. In addition, Part VII of the Article discusses the problem of international tax avoidance and outlines several states' solutions, which generally involve restricting the interpretation of a treaty term to exclude transactions or corporate forms lacking economic substance.

II

DOUBLE TAXATION AND THE NEED FOR DOUBLE TAX TREATIES³

A. *Circumstances Giving Rise to Double Taxation*

"The phenomenon of international juridical double taxation can be generally defined as the imposition of comparable taxes in two (or more) States

2. See ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT, REPORT OF THE OECD COMMITTEE ON FISCAL AFFAIRS, MODEL DOUBLE TAXATION CONVENTION ON INCOME AND ON CAPITAL (1977) [hereinafter cited as 1977 Report].

3. See generally G. LIPPERT, HANDBUCH DES INTERNATIONALEN FINANZRECHTS 203 (2d ed. 1928); R. ROSENDORFF & J. HENGGELER, DAS INTERNATIONALE STEUERRECHT DES ERDBALLS (1936); A. SPITALER, DAS DOPPELBESTEUERUNGSPROBLEM BEI DEN DIREKTEN STEUERN (1936); M. UDINA, IL DIRITTO INTERNAZIONALE TRIBUTARIO 250 (1949); O. BÜHLER, PRINZIPIEN DES INTERNATIONALEN STEUERRECHTS 32, 50 (1964); Korn & Debatin, *Systematik I-IV*, in I DOPPELBESTEUERUNG (1985) [hereinafter cited as Korn & Debatin]; A. RÄDLER & A. RAUPACH, DEUTSCHE STEUERN BEI AUSLANDSBEZIEHUNGEN 346 (1966); K. TEICHNER, INTERNATIONALES STEUERRECHT 14, 105 (1967); E. HÖHN & E. DAVID, DOPPELBESTEUERUNGSRECHT (1973) [hereinafter cited as HÖHN & DAVID]; A. KNECHTLE, BASIC PROBLEMS IN INTERNATIONAL FISCAL LAW (1979); A. XAVIER, DIREITO TRIBUTÁRIO INTERNACIONAL DO BRASIL 55, 241 (1977); J. BISCHEL & R. FEINSCHREIBER, FUNDAMENTALS OF INTERNATIONAL TAXATION (2d ed. 1985); G. TIXIER, G. GEST & J. KEROGUES, DROIT FISCAL INTERNATIONAL 153 (2d ed. 1985); 3 R. RHOADES & M. LANGER, INCOME TAXATION OF FOREIGN RELATED BUSINESS TRANSACTIONS (1980); W. RYSER, INTRODUCTION AU DROIT FISCAL INTERNATIONAL DE LA SUISSE (1980); P. MCDANIEL & H. AULT, INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION (2d rev. ed. 1981); K. VOGEL, DOPPELBESTEUERUNGSABKOMMEN (1983); V. KLUGE, DAS INTERNATIONALE STEUERRECHT DER BUNDESREPUBLIK 7, 155 (2d ed. 1983); HANDBUCH DES INTERNATIONALEN STEUERRECHTS DER SCHWEIZ (E. Höhn ed. 1984) [hereinafter cited as HANDBUCH DES

on the same taxpayer in respect of the same subject matter and for identical periods."⁴ Double taxation is widespread today because the vast majority of states, in addition to levying taxes on domestic assets and domestic economic transactions, levy taxes on assets situated and transactions carried out in other countries to the extent that they benefit resident taxpayers. For example, the foreign income or foreign wealth of a resident natural or juridical person is often subject to taxation based on the principle of residence, which implies the taxation of worldwide income or worldwide wealth.

At the same time, since no state unilaterally waives its right to tax transactions or assets of residents and nonresidents within its own territory based on the principle of source,⁵ the tax claims of different states necessarily overlap. Double taxation may also arise when a person is deemed to be a resident simultaneously by two (or more) states, or when source rules overlap because two (or more) states find the same economic transaction or asset to be within their territory. Finally, double taxation may arise because certain states tax the worldwide income of their citizens even when they are residents of another state, as is the case with the United States and Mexico.

In contrast, the term "economic double taxation" is used to describe the situation that arises when the same economic transaction or asset is taxed in two or more states during the same period, but to different taxpayers.⁶ Economic double taxation takes place if assets are attributed to different persons by the domestic law of the states involved. This dichotomy occurs when the tax law of one state attributes the asset to its legal owner while the tax law of the other state attributes it to the person in possession or control.⁷ Further, economic double taxation can result from conflicting rules regarding the inclusion or deduction of positive and negative elements of income and assets such as in cases of transfer pricing.

While the concept and effects of "double taxation" remain the subject of much academic controversy, this brief outline of underlying circumstances serves to provide an understanding of the numerous situations which double tax treaties are intended to address. But the conceptual nature of double taxation carries little practical importance for treaty interpretation itself. It is "international tax law" which provides the rules for the avoidance of double

INTERNATIONALES STEUERRECHTS]; GRUNDFRAGEN DES INTERNATIONALEN STEUERRECHTS (K. Vogel ed. 1985).

For the perspective of the socialist countries, see H. SPILLER, INTERNATIONALES FINANZ- UND WÄHRUNGSRECHT, FINANZ- UND WÄHRUNGSBEZIEHUNGEN ZU NICHTSOZIALISTISCHEN LÄNDERN (1984).

4. 1977 Report, *supra* note 2, at para. 3.

5. The term "territoriality principle" is avoided here because a variety of different meanings have been attributed to it. See K. VOGEL, DER RÄUMLICHE ANWENDUNGSBEREICH DER VERWALTUNGSRECHTSNORM 13, 14 (1965). See also cases cited *infra* note 11.

6. Such double taxation has been described as demonstrating a lack of "subject identity". See O. BÜHLER, *supra* note 3, at 33; Flick, *Das Erfordernis der Subjektidentität bei Doppelbesteuerungsnormen*, 37 STEUER UND WIRTSCHAFT 329 (1960).

7. For example, see the German Fiscal Code, Abgabenordnung [AO] § 39, 1977 BGBl I 269 (W. Ger.).

taxation of which tax treaties constitute a major part. Traditionally, this term has been used to refer to all international as well as domestic tax provisions relating specifically to situations involving the territory of more than one state, or so-called "cross-border situations" (*grenzüberschreitende Sachverhalte*).⁸ Accordingly, an understanding of double taxation law requires a familiarity with aspects of public international law and with the distinctions between international tax law and private international law.⁹

B. Double Taxation and General Rules of International Law¹⁰

International law permits the taxation of foreign economic transactions when a sufficient connection exists between the taxpayer and the taxing state, including residence, habitual abode, citizenship, or situs of assets.¹¹ No territoriality principle of international law prohibits the application of domestic law to situations arising in foreign countries, including the taxation of foreign income for domestic purposes.¹² While a contrary view espoused by Latin American authors and institutions¹³ deserves much respect from the point of view of international comity and policy, such a view cannot represent current international law, as evidenced primarily by actual state practice. In recognition of this situation, Latin American theory has begun to retreat from its

8. O. BÜHLER, *supra* note 3, at 3; Vogel, *Theorie und Praxis im internationalen Steuerrecht*, 6 DEUTSCHES STEUERRECHT 427, 428 (1968); Mössner, *Der Begriff des Internationalen Steuerrechts in der neueren Literatur*, 25 ÖSTERREICHISCHE ZEITSCHRIFT FÜR ÖFFENTLICHES RECHT 255 (1974).

9. See *infra* Part II.D.

10. See A. GARELLI, *IL DIRITTO INTERNAZIONALE TRIBUTARIO* (1899); 1 F. GEYLER, *STEUERLICHE MEHRFACHBELASTUNG UND IHRE NORMATIVE ABWEHR* 169 (1931); E. ISAY, *INTERNATIONALES FINANZRECHT* 22 (1934); M. CHRÉTIEN, *A LA RECHERCHE DU DROIT INTERNATIONAL FISCAL COMMUN* 63, 71 (1955); K. VOGEL, *supra* note 5, at 105, 114, 351; Vogel, *supra* note 8, at 427; Mössner, *supra* note 8, at 260; Rudolf, *Über territoriale Grenzen der Steuergesetze*, *RECHT UND WIRTSCHAFT IN GESCHICHTE UND GEGENWART*, *FESTSCHRIFT J. BÄRMANN ZUM 70. GEBURTSTAG* 769 (1975); R. WEBER-FAS, *GRUNDZÜGE DES ALLGEMEINEN STEUERRECHTS DER BUNDESREPUBLIK DEUTSCHLAND* 61 (1979); Bayer, *Das Völkerrecht in der Rechtsprechung des Bundesfinanzhofs*, 58 *STEUER UND WIRTSCHAFT* 61 (1981).

11. See *RESTATEMENT OF FOREIGN RELATIONS LAW OF THE UNITED STATES* § 411 (Tent. Draft No. 2, 1981). In July 1985, a new, yet unpublished draft was released [hereinafter cited as *TENTATIVE FINAL DRAFT RESTATEMENT*]; this version retains § 411 unchanged. For Germany, see Bundesfinanzhof, [1964] III Bundessteuerblatt [hereinafter *BStBl*] 253, 256; [1965] III *BStBl* 134, 135; 95 *Sammlung der Entscheidungen des Bundesfinanzhofs* [*BFH*] 345, 348 (1969).

12. This statement applies to "substantive territoriality". See K. VOGEL, *supra* note 5, at 114. Concerning "formal territoriality", see *infra* note 18.

13. See, e.g., Palamarchuk, *Plurimposición internacional*, 10 *REVISTA DE LA FACULTAD DE DERECHO Y CIENCIAS SOCIALES, MONTEVIDEO* 949, 987 (1959); Valdes Costa, *Entwicklung und theoretische Fundierung des Territorialitätsprinzips in Lateinamerika*, in M. ENGELSCHALK, *STEUERN AUF AUSLÄNDISCHE EINKÜNFTE* 43 (1983). In addition, see the "Declaration of Principles" adopted by the First Latin American Tax Law Conference (1956) in Montevideo (and several Resolutions of subsequent conferences), *reprinted in* 8 *REVISTA DE LA FACULTAD DE DERECHO Y CIENCIAS SOCIALES, MONTEVIDEO* 9, 19 (1957), and the treaty model adopted by the member states of the Andean Pact, *reprinted in* 28 *BULL. INT'L FISCAL DOC.* 309 (Supp. D 1974).

advocacy of territoriality as a principle of international law. Indeed, Latin American legislation in some countries has adopted a system of taxation on the basis of worldwide income,¹⁴ and the legal systems in general have reflected a lesser adherence to the territoriality principle.¹⁵ It would be unfortunate, however, if the positive aspects of the earlier Latin American view, particularly from a comity and policy perspective, are lost in the wake of such developments.¹⁶

In addition, customary international law does not forbid double taxation.¹⁷ Double taxation, resulting from the interaction of the domestic laws of two (or more) states, will be consistent with international law so long as each individual law is consistent with international law. If the relevant tax provisions of all of the states involved were held to be inapplicable simply because they gave rise to double taxation, a system of loopholes could be created which would be no more acceptable than double taxation. Consequently, international law can decrease the incidence of double taxation only through the introduction of rules establishing when a state must withdraw its tax claim. General international law does not as yet contain such rules. For the most part, only bilateral double tax treaties fulfill this role.

International law is also silent on certain issues where it should not be. For example, in some cases, tax benefits granted by another state are cancelled and made ineffective by higher taxation in the home state. International law does not prohibit such tax laws which have economically disadvantageous results for another state. The development of rules of international law tending to discourage such results would be desirable.

Execution by a state of a sovereign act on a foreign territory is, however, prohibited by international law. This principle of formal territoriality applies especially to acts intended to enforce internal legal provisions abroad. The principle even applies to the process of notification - whether formal or informal - of an administrative act, such as the assessment of tax.¹⁸ Tax audits or other such investigations in a foreign territory without the consent of the

14. A. XAVIER, *supra* note 3, at 3; Valdes Costa, *Foreword to Gnazzo & Piedrabuena, Legislation in Latin American Countries and Criteria Applicable for Taxation of Income*, 34 BULL. INT'L FISCAL DOC. 359, 360 (1980).

15. Gnazzo & Piedrabuena, *Legislation in Latin American Countries and Criteria Applicable for the Taxation of Income*, 34 BULL. INT'L FISCAL DOC. 359 (1980).

16. At its 38th Congress, held in 1984 in Buenos Aires, the International Fiscal Association adopted a resolution stating that "a system of territorial taxation or of exemption of foreign income is preferable (to worldwide taxation) because it is more respectful of the sovereignty of states in tax matters, eliminates distortions of competition in the country where the investment is made, and, therefore, does not impede the free flow of investment." *Resolutions Buenos Aires, IFA Congress 1984*, 38 BULL. INT'L FISCAL DOC. 545 (1984). See the commentary by Coulombe, 1984 I.F.A.Y.B. 75. For a discussion of principles which would be desirable in international tax law, see Vogel, *Taxation of Foreign Income, Principles and Practice*, 39 BULL. INT'L FISCAL DOC. 4, 9 (1985).

17. [1975] II BStBl 497, 498; K. VOGEL, *supra* note 5, at 351.

18. See [1959] III BStBl 181, 182 (delivery through simple letter); 17 Entscheidungen des Reichsfinanzhofs [RFH] 159, 161 (1925) (delivery through registered mail); compare Preussisches Oberverwaltungsgericht, decision of Nov. 13, 1931, reprinted in 61 JURISTISCHE

other state are considered particularly objectionable.¹⁹ Swiss authorities even issued a warrant for the arrest of an official German tax fraud investigator who had performed certain investigations on Swiss territory without Swiss authorization.²⁰ If sovereign acts abroad are necessary, then the internal tax authorities are dependent upon official or legal assistance of the other country involved. Such assistance is available only according to the domestic law of the other state. A state is obligated to provide administrative or judicial assistance only if it has bound itself contractually to do so.²¹

C. Avoidance of Double Taxation, Particularly Through Treaties

1. Unilateral Measures to Avoid Double Taxation

Double taxation can be avoided unilaterally if one of the states involved withdraws its tax claim. On behalf of the state of residence, this unilateral move often is achieved pursuant to a method developed under Anglo-American law whereby the state of residence, to the extent it is not simultaneously the source state, allows a credit for the tax levied in the source state up to an amount equal to its own tax charge.²² In other countries double taxation is avoided unilaterally through the allowance of exemptions: Switzerland exempts income from permanent establishments and real property located abroad; the Netherlands and Australia exempt foreign source income generally if the income is taxed in the source country.²³ As a rule, however, unilateral measures are insufficient to avoid double taxation because they generally

WOCHENSCHRIFT 2329 (1932). The issue of whether international law permits an order to deliver documents held in another state will not be discussed here.

19. R. WEBER-FAS, *supra* note 10, at 63; von Siebenthal, *Der Austausch von Informationen im Rahmen der Abkommen zur Vermeidung der Doppelbesteuerung aus Schweizerischer Sicht*, 1979 STEUER-REVUE 382, 443, 461; K. VOGEL, *supra* note 5, at 347; K. TIPKE & H. KRUSE, KOMMENTAR ZUR ABGABENORDNUNG 1977 § 117, Rz. 1 (1984).

20. von Siebenthal, *supra* note 19, at 463.

21. See OECD Model, *supra* note 1, art. 26.

22. I.R.C. §§ 901-908 (1985) [All references to I.R.C. in this Article are to sections of the Internal Revenue Code of 1954, as amended]; Income and Corporation Taxes Act, 1970, ch. 10, § 418 (unilateral relief). For Germany, see Einkommensteuergesetz [EStG] § 34c (individual income tax); Körperschaftsteuergesetz [KStG] § 26 (corporate income tax); Vermögensteuergesetz [VStG] § 11 (wealth tax); Erbschaftsteuergesetz [ErbStG] § 21 (inheritance tax). For an overview of the corresponding rules in other jurisdictions, see Hundt, *Änderungen des Aussensteuerrechts durch das Gesetz zur Änderung des EStG, des KStG und anderer Gesetze—und Behebung der Doppelbesteuerung in anderen Industriestaaten*, 33 DER BETRIEB, Beilage 17, 1, 4 (1980).

23. For Switzerland, see Höhn, *Funktion, Begriff und Rechtsquellen des internationalen Steuerrechts*, in HANDBUCH DES INTERNATIONALEN STEUERRECHTS, *supra* note 3, at 54, 62 (exemption with progression); W. RYSER, *supra* note 3, at 35; Constantin, *Les mesures unilatérales d'éviter la double imposition* (country report of Switzerland), 66b CAHIERS DE DROIT FISCAL INTERNATIONAL [C.D.F.I.] 449 (1981). For the Netherlands, see Strik, *Tax Avoidance in International Transactions* in NETHERLANDS REPORTS TO THE ELEVENTH CONGRESS OF COMPARATIVE LAW 383 (1982); Overbosch, *Les mesures unilatérales d'éviter la double imposition* (country report of the Netherlands), 66b C.D.F.I. 383, 390 (1981). For Australia, see Mays & Rollo, *Les mesures unilatérales d'éviter la double imposition* (country report of Australia), 66b C.D.F.I. 191, 192 (1981). The most extensive exemption of foreign income is, of course, represented by the territoriality principle as discussed in *supra* Part II.B.

do not cover all situations giving rise to double taxation, and they may apply to double taxation situations inconsistently depending on which state's measures are applied.

2. *The Development of Tax Treaties*

Consequently, individual states have entered bilateral agreements for the avoidance of double taxation.²⁴ At first, only federally related or closely allied states were involved,²⁵ but following World War I an extensive treaty network developed in Central Europe. Germany entered its first double tax agreement with Italy in 1925. At that time Great Britain and the United States were less active.²⁶ The only comprehensive British treaty from the period between the two World Wars was with Ireland in 1922. The United States (following partial treaties with France in 1932 and Canada in 1936) entered its first comprehensive treaties with Sweden and France in 1939.

Efforts of the League of Nations contributed substantially to an assimilation of the existing bilateral treaties and to the development of uniform model treaties. In 1921 the Financial Committee of the League of Nations commissioned four experts on public finance, Bruins (Rotterdam), Einaudi (Turin), Seligman (New York), and Stamp (London), to prepare a report on questions regarding double taxation, which was submitted in final form in 1923.²⁷ Technical experts from seven European countries were called together in 1922 to pursue the same objective. After additional experts were added to the panel, four model treaties were drafted in 1926 and 1927, which were revised

24. See generally the literature cited *supra* note 3. In addition, see Dorn, *Welche Grundsätze empfehlen sich für das internationale Vertragsrecht zur Vermeidung internationaler Doppelbesteuerung bei Einzelpersonen und Körperschaften, insbesondere bei gewerblichen Betrieben?*, 33 VERHANDLUNGEN DES DEUTSCHEN JURISTENTAGES 495, reprinted in 53 JURISTISCHE WOCHENSCHRIFT 1834 (1924); Dorn, *Das Recht der internationalen Doppelbesteuerung*, 1927 VIERTELJAHRSSCHRIFT FÜR STEUER- UND FINANZRECHT 189; Bühler, *Les Accords Internationaux Concernant la Double Imposition et l'Evasion Fiscale*, 55 RECUEIL DES COURS DE L'ACADÉMIE DE DROIT INTERNATIONAL DE LA HAYE 433 (1936); Flick, *Methoden zur Ausschaltung der internationalen Doppelbesteuerung*, 21 FINANZ-ARCHIV 88 (1961); Surrey, *Factors Affecting the U.S. Treasury in Conducting International Tax Treaties*, 28 J. TAX'N 277 (1968); INCOME TAX TREATIES (J. Bischel ed. 1978); Estes, *Tax Treaties*, 14 INT'L LAW. 508 (1980); Rosenbloom, *Current Developments in Regard to Tax Treaties*, 40 INST. ON FED. TAX'N § 31; Gann, *The Concept of an Independent Treaty Foreign Tax Credit*, 38 TAX L. REV. 1 (1982); Claeys Bouaert, *Verdragen tot voorkoming van de internationale dubbele belasting: hoofdtrekken en leemten*, in II LIBER AMICORUM FRÉDÉRIC DUMON 1003 (1983).

25. For example, Prussia and Saxony entered a convention regarding direct taxes on April 16, 1869; Austria and Hungary entered one regarding the taxation of business enterprises on June 21, 1899.

26. In a hearing before the House Ways and Means Committee in 1930, Secretary of the Treasury Andrew W. Mellon observed, "The objections to this method appear to me to be that concessions are more likely to be based on bargaining than on sound principles of taxation" See *International Double Taxation, 1930: Hearings on H.R. 10165 Before the House Comm. on Ways and Means*, 71st Cong., 2d Sess. 5 (1930). Although the objection is well taken, it did not impede the universal development of the treaties. See Brecher, *Relationship of, and Conflicts Between Income Tax Treaties and the Internal Revenue Code*, 24 T. EXEC. 175 (1972); Rosenbloom, *supra* note 24, at § 31.

27. Report on Double Taxation, League of Nations Doc. E.F.S.73.F.19 (1923).

and adopted in 1928 by the representatives of 28 states (some of which were not members of the League of Nations) at a conference called by the General Secretary of the League of Nations.²⁸ To encourage further progress, the Council of the League of Nations appointed a standing committee on taxation in 1928, which in the following year drafted two competing model treaties to replace the 1928 models. A subcommittee, which due to the advent of the Second World War was composed primarily of representatives from Latin American countries, drafted the Model Treaty of Mexico in 1943.²⁹ By 1946, the subcommittee completed the London Model Treaty.³⁰ This time the industrial states participated once again and their views were consequently more strongly represented.

3. *The OECD Model, the U.S. Model, and Other Model Treaties*

The efforts of the Organization of European Economic Cooperation (hereinafter the OEEC) and its successor organization, the Organization for Economic Cooperation and Development (hereinafter the OECD), to develop a system for the avoidance of double taxation picked up where the preparatory research of the League of Nations left off. The Committee on Fiscal Affairs submitted a series of model treaty articles in four interim reports between 1956 and 1961 and a summary report in 1963 to which the complete model treaty (hereinafter the OECD Model) and an official commentary (hereinafter the Commentary) were appended. The Commentary interpreted the OECD Model; to the extent OECD member states did not wish to follow particular recommendations of the model, they entered their reservations in the Commentary. The OECD Model and the Commentary were made the subject of a recommendation of the OECD Council to the member states pursuant to Article 5(b) of its charter.³¹ The Council recommended that member states continue their efforts to enter bilateral double tax agreements, that they adopt as the basis for their negotiations the model submitted by the Fiscal Committee "as interpreted by the Commentaries in the Report,"³² and that they make allowances for the limitations and reservations contained in

28. Report Presented by the Comm. of Technical Experts on Double Taxation and Tax Evasion, League of Nations Doc. C.216.M.85 1927 II (1927).

29. Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion, Report of the Second Regional Tax Conference, League of Nations Doc. C.2.M.2. 1945 II A (1945).

30. Model Bilateral Conventions for the Prevention of International Double Taxation and Fiscal Evasion, League of Nations Doc. C.88.M.88. 1946 II A. (1946). A review of the historical development of treaty models based in part on unpublished documents of the League of Nations was prepared by A. Hemmelrath at the Forschungstelle für ausländisches und Internationales Finanz- und Steuerrecht der Universität München. This review will be published in connection with other results of a larger research project of the Forschungstelle following its completion.

31. See ORGANIZATION OF ECONOMIC COOPERATION AND DEVELOPMENT, REPORT OF THE FISCAL COMMITTEE: DRAFT DOUBLE TAXATION CONVENTION ON INCOME AND CAPITAL 167 (1963).

32. *Id.* at para. 2. The French version reads: "tel qu'il est interprété dans les Commentaires y relatifs."

the Commentary.³³ In the following years the OECD Model and Commentary were revised by the Fiscal Committee based on practical experience. In 1977 the Committee published a new report with a partially revised model and Commentary, which were once again sanctioned by a recommendation of the Council.³⁴ The changes did not affect the model as much as the Commentary, which was made more comprehensive and in which the number of reservations was increased. Aside from the reservations, a number of member states included "observations"; these observations "do not express any disagreement with the text of the Convention, but furnish a useful indication of the way in which those countries will apply the provisions of the Article in question."³⁵

An opposing model, shaped more according to the special interests of developing countries, was concluded in 1971 by the member states of the Andean-Group, an alliance between Bolivia, Chile, Ecuador, Colombia, Peru and — since 1973 — Venezuela. The Andean Model was drafted as an alternative to the OECD Model; it emphasizes the traditional concerns of Latin American countries, especially the source principle.³⁶ Another model treaty intended to serve the interests of developing countries was published by the United Nations in 1980. This treaty is the result of more than ten years of preparation by a group of experts appointed by the United Nations Economic and Social Council. Its structure corresponds to the OECD Model. Its content, however, diverges in some important respects.³⁷

The United States Treasury Department published its own model treaty in 1976 to serve as the basis for U.S. treaty negotiations. A revised model was published in 1977, and in June, 1981 a suggested draft for a further revision was published, followed by an alternative draft of the model's anti-treaty-shopping provision (Article 16) in December of the same year ("June" and "December" versions).³⁸ Though this "U.S. Model" upholds some traditional peculiarities of U.S. treaty practice, it was drafted with the basic aim to adapt this practice as much as possible — and to a greater extent than in

33. *Id.*

34. 1977 Report, *supra* note 2.

35. 1977 Report, *supra* note 2, at para. 27.

36. For the text of the Andean Model, see 28 BULL. INT'L FISCAL DOC. 309 (Supp. D 1974).

37. UN Model, *supra* note 1; see Ritter, *Steuerbeziehungen mit der Dritten Welt*, 17 DEUTSCHES STEUERRECHT 419 (1979); Hundt, *UN-Musterabkommen zur Vermeidung der Doppelbesteuerung zwischen Industriestaaten und Entwicklungsländern*, 1981 RECHT DER INTERNATIONALEN WIRTSCHAFT/AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS 306; S. SURREY, M. WIDMER, H. ROSENBLOOM, L. GRIFFIOEN, F. DORNELLES, N. QUIRESHI, & W. RITTER, UN DRAFT MODEL TAXATION CONVENTION (IFA Congress Seminar Series 1979). Regarding U.S. treaty policy vis-à-vis developing countries, see the articles by Surrey, Estes, and Rosenbloom, *supra* note 24.

38. U.S. Model, *supra* note 1, art. 16 (compare draft of June 16, 1981 with alternative draft of Dec. 23, 1981). See also Patrick, *A Comparison of the United States and OECD Model Income Tax Conventions*, 10 L. & POL'Y INT'L BUS. 613 (1978).

previous U.S. treaties — to the treaty model established by the OECD.³⁹ Tax authorities in other countries as a rule do not have their own model treaties; instead, their negotiations are usually based on the OECD or UN Models. Multilateral treaties on taxation of income and capital include the General Agreement Regarding Fiscal Cooperation of January 29, 1971 of the OCAM,⁴⁰ two agreements within the purview of the Council for Mutual Economic Assistance (COMECON) of May 19, 1978,⁴¹ and a treaty between Denmark, Norway, Sweden, Finland, and Iceland.⁴² As yet no effort has been made to develop a multilateral treaty for the European Economic Community. However, Article 220 of the EEC Agreement⁴³ obligates member states to initiate bilateral negotiations to the extent necessary to ensure the elimination of double taxation within the Community.⁴⁴

D. Double Tax Treaties and Private International Law

If a private transaction or event falls within the scope of the legal orders of several states, conflicts law or “private international law” determines which law applies. There is no uniform system of conflicts law; each state has its own rules so that differing results and imperfect legal relationships (*hinkende Rechtsverhältnisse*) are unavoidable. The norms that determine which law applies are traditionally referred to as conflict rules (*Kollisionsnormen*). To the extent that tax law is based on relationships in private law, the conflicts law of the state in question determines which law applies, even when such questions arise in tax matters (e.g., whether and when a taxpayer has gained ownership of an asset).

39. See *International Tax Treaties: Hearing Before the Senate Comm. on Foreign Relations*, 96th Cong., 1st Sess. 115 (1979) (David C. Lubick, Assistant Secretary of the Treasury for Tax Policy, Responses to Additional Questions for the Record). *Income Tax Treaties: Hearing Before the Subcomm. on Oversight of the House Comm. on Ways and Means*, 96th Cong., 2nd Sess. 71 (1980) (Statement of H. David Rosenbloom, International Tax Counsel, Department of the Treasury).

40. The Organisation Commune Africaine, Malgache et Mauricienne (OCAM) consists of fourteen states. For the text of the OCAM treaty, see 2 AFRICAN TAX SYSTEMS (Int'l Bureau of Fiscal Documentation) § E (1973).

41. For the texts of both COMECON treaties, see 5 EUR. TAX'N 387 (1979). See also Nagy, *Multilateral Tax Agreements and Tax Coordination in the CMEA*, 5 EUR. TAX'N 379 (1979).

42. The Nordic Mutual Assistance Convention has entered into force. See *Bekendtgørelse Nr. 1 af 16 Januar 1984 af Overenskomst af 22 Marts 1983 mellem Danmark, Finland, Island, Norge og Sverige til undgåelse af Dobbeltbeskatning for sa vidt angaar indkomstog Formueskat*, 3 EUR. TAX'N Supp. Ser. Section C. (Denmark). Regarding the importance of the multilateral treaty between the northern states, see Mattson, *Gehört den multilateralen Doppelbesteuerungsabkommen die Zukunft — Einige Bemerkungen im Hinblick auf die Erfahrungen in den nordischen Staaten*, 7 INSTITUT FÜR AUSLÄNDISCHES UND INTERNATIONALES FINANZ- UND STEUERWESEN (1985).

43. Treaty Establishing the European Economic Communities, Mar. 25, 1957, art. 220, 295 U.N.T.S. 2, 126 (German). The official English version is reprinted in 1973 Gr. Brit. T.S. No. 1 (Cmd. 5179-II).

44. See M. LEHNER, *MÖGLICHKEITEN ZUR VERBESSERUNG DES VERSTÄNDIGUNGSVERFAHRENS AUF DER GRUNDLAGE DES EWG-VERTRAGES* (Münchener Schriften zum Internationalen Steuerrecht No. 4 1982).

States levy taxes, however, only on the basis of their own tax laws.⁴⁵ Taxation based on the tax law of another state occurs only in extremely exceptional instances (for example, prior to passage of its own income tax law, the USSR is reported to have taxed foreign enterprises doing business in the USSR according to the domestic laws of the state from which the enterprise came). Tax treaty rules assume that both contracting states tax according to their own law; unlike the rules of private international law, therefore, treaty rules do not lead to the application of foreign law. Rather, treaty rules, to secure the avoidance of double taxation, *limit* the *content* of the tax law of both contracting states in cross-border cases. Treaty requirements apply in addition to domestic law requirements; the legal consequences derived from them *alter* domestic law, either by excluding application of the domestic tax law of one of the states where it otherwise would apply, or by obligating one or both states to allow a credit against their own tax for taxes paid in the other state. Within the scope of a treaty, a tax obligation only exists if and to the extent that, in addition to the domestic tax law requirements, the treaty requirements are also satisfied. Rules of double taxation are not, therefore, conflict rules (*Kollisionsnormen*) similar to those in private international law. Rather, they are “rules of limitation of law” (*Grenznormen*) comparable to those of an “international administrative law” (*Internationales Verwaltungsrecht*) as it has been described and analyzed by Karl Neumeyer.⁴⁶ However, while such rules of limitation ordinarily are embodied in, or closely related to, the substantive rules of the domestic law of the state in question,⁴⁷ the treaty rules are formulated separately from domestic tax law; they therefore have an independent origin and legal foundation.

III

LEGAL FRAMEWORK OF DOUBLE TAX TREATIES

The legal framework of double tax treaties can best be analyzed in three consecutive steps. First, the negotiation and ratification process of a State provides a legislative history for its particular treaties. Second, the substantive elements of a paradigm tax treaty establish the analytical foundation for all tax treaties. Third, the typical organization and content of a tax treaty, as exemplified by the OECD Model, reflect the normal treaty practice of States.

45. Neumeyer, *Internationales Finanzrecht*, 2 ZEITSCHRIFT FÜR INTERNATIONALES RECHT 186 (1914); Neumeyer, *Allgemeiner Teil* in 4 INTERNATIONALES VERWALTUNGSRECHT, 60, 98 (1936); E. ISAY, *supra* note 10, at 6; O. BÜHLER, INTERNATIONALES STEUERRECHT (1960); K. VOGEL, *supra* note 5, at 194, 270, 298; Mössner, *supra* note 8, at 266.

46. Neumeyer, *supra* note 45.

47. See I.R.C. §§ 861, 862, 871, 881; Income and Corporation Taxes Act, 1970, ch. 10, § 418 (relief for unremittable income); EStG §§ 1(3), 49.

A. *Conclusion of Double Tax Treaties and Their Implementation in Domestic Law*

Double tax treaties are international agreements.⁴⁸ Their creation and their consequences are therefore determined according to the rules contained in the Vienna Convention on the Law of Treaties of May 23, 1969⁴⁹. As provided in Article 84, the Convention came into effect on January 27, 1980 with the ratification or accession of the thirty-fifth state. With regard to states which have not ratified the Convention,⁵⁰ it is important to note that the Convention to a great extent merely codifies existing norms of customary international law.⁵¹ To the extent that this is not the case, international practice nevertheless increasingly adheres to the Convention's rules, so that they will probably achieve the status of customary international law in the foreseeable future.⁵²

48. Regarding international agreements generally, see A. MCNAIR, *THE LAW OF TREATIES* (1961); A. VERDROSS, S. VEROSTA & K. ZEMANEK, *VÖLKERRECHT* 158 (5th ed. 1964) [hereinafter cited as A. VERDROSS, S. VEROSTA & K. ZEMANEK]; I. W. WENGLER, *VÖLKERRECHT* 184 (1964); 2 L. CAVARÉ, *LE DROIT INTERNATIONAL PUBLIC POSITIF* 64 (1969); 1 C. ROUSSEAU, *DROIT INTERNATIONAL PUBLIC* 75 (1970); C. DE VISSCHER, *THÉORIES ET RÉALITÉS EN DROIT INTERNATIONAL PUBLIC* 276 (4th ed. 1970); 1 D. O'CONNELL, *INTERNATIONAL LAW* 195 (2d ed. 1970); T. ÖHLINGER, *DER VÖLKERRECHTLICHE VERTRAG IM STAATLICHEN RECHT* (1973); I. BROWNLIE, *PRINCIPLES OF PUBLIC INTERNATIONAL LAW* 582 (2d ed. 1973); Mosler, *The International Society as a Legal Community*, 140 *RECUEIL DES COURS DE L'ACADÉMIE DE DROIT INTERNATIONAL DE LA HAYE* 1 (1974); 1 M. GIULIANO, *DIRITTO INTERNAZIONALE* 341 (1974); 1 E. BERBER, *LEHRBUCH DES VÖLKERRECHTS* 61 (2d ed. 1975); G. SCHWARZENBERGER & E. BROWN, *A MANUAL OF INTERNATIONAL LAW* 121-22 (6th ed. 1976); A. VERDROSS & B. SIMMA, *UNIVERSELLES VÖLKERRECHT* 345 (2d ed. 1981) [hereinafter cited as A. VERDROSS & B. SIMMA]; N. QUOC DINH, P. DAILLER & A. PELLET, *DROIT INTERNATIONAL PUBLIC* (2d ed. 1980); I. VON SEIDL-HOHENVELDERN, *VÖLKERRECHT* 45 (4th ed. 1980).

49. Vienna Convention on the Law of Treaties, U.N. Doc. A/WNF 39/27 289 (1969), reprinted in 8 *I.L.M.* 679 (1969) [hereinafter cited as Vienna Convention]. For a discussion of the Vienna Convention, see S. ROSENNE, *THE LAW OF TREATIES* (1970); A. MARESCA, *IL DIRITTO DEI TRATTATI* (1971); I. SINCLAIR, *THE VIENNA CONVENTION ON THE LAW OF TREATIES* (1984); T. ELIAS, *THE MODERN LAW OF TREATIES* (1974); R. WETZEL & D. RAUSCHNING, *THE VIENNA CONVENTION ON THE LAW OF TREATIES* (Travaux préparatoires) (1978).

50. The United States signed the Vienna Convention in 1970, but unlike Great Britain and, more recently, Germany, has not yet deposited instruments of ratification.

51. *Fothergill v. Monarch Airlines*, 3 *W.L.R.* 209, 224 (1980). The U.S. Department of State has on several occasions stated that it regards particular articles of the Convention as codifying existing international law. *RESTATEMENT OF FOREIGN RELATIONS LAW OF THE UNITED STATES* pt. III, introductory note 2 (Tent. Draft No. 1, 1980) [hereinafter cited as *DRAFT RESTATEMENT*]. In a few instances, however, "the rule of the Convention is at variance with the United States' understanding of customary international law." *Id.*

52. See A. VERDROSS & B. SIMMA, *supra* note 48, at 346; and Mosler, *supra* note 48, at 116.

1. Negotiation

The conclusion of a treaty is preceded by negotiations. In the United States, the Constitution vests treaty-making power in the hands of the President "with advice and consent" of the Senate.⁵³ Although it is unclear what role the framers intended the Senate to play in the actual negotiations of treaties, early practice indicates that the Senate was to advise the President to some extent during the treaty-making process, as well as to consent or withhold consent from the final treaty.⁵⁴ In practice, however, it is widely recognized that the actual negotiation of treaties is within the power of the President as the official channel of communication with other nations.⁵⁵ Negotiations are carried out by parties vested with "full powers" by the President to represent the United States. Normally, this role is carried out by the State Department. In contrast, tax treaties (and protocols) are negotiated by the Office of International Tax Affairs of the Treasury Department with the assistance of Internal Revenue Service personnel. Generally, State Department participation at the negotiation level is peripheral, although the State Department must be consulted prior to the signing of a treaty.⁵⁶ Finally, it has been said that Congress plays a role in treaty negotiations, at least to the extent that it may propose a treaty to the President, provide advice and consent as to the appointment of an Ambassador or Minister to conduct negotiations, consult with the executive branch on treaty terms, and participate in the negotiations as observers or advisers to the U.S. delegation.⁵⁷

In Germany, the Minister of Foreign Affairs is responsible for conducting treaty negotiations. Tax treaties, however, are typically negotiated by the Minister of Finance, represented by a chief negotiator. Representatives of the Foreign Ministry and other Federal Ministries participate in the negotiations to the extent necessary, and in certain cases representatives of one or more of the individual German States may take part.

During the negotiations a treaty text is drafted, initially only in one language. Negotiation results that are deemed less important or that affect only

53. U.S. CONST. art. II, § 2, cl. 2.

54. See SENATE COMM. ON FOREIGN RELATIONS, 98TH CONG., 2D SESS., TREATIES AND OTHER INTERNATIONAL AGREEMENTS: THE ROLE OF THE UNITED STATES SENATE 25-40 (Comm. Print 1984) [hereinafter cited as THE ROLE OF THE SENATE].

55. The President's exclusive power to negotiate treaties arises from various constitutional provisions that establish his role as the chief executive and the sole channel of communication with other nations. The Constitution provides that the President shall "nominate, and by and with the advice and consent of the Senate shall appoint ambassadors, other public ministers and consuls" U.S. CONST. art. II, § 2, cl. 2. The President also "shall have the power, by and with the advice and consent of the Senate, to make treaties, provided two-thirds of the Senators present concur." *Id.* He "shall receive ambassadors and other public ministers." *Id.* at § 3. Finally, the Constitution provides that "[t]he executive power shall be vested in a President" *Id.* at § 1.

56. JT. COMM. ON TAXATION, SENATE COMM. ON FOREIGN RELATIONS, 96TH CONG., 1ST SESS., TAX TREATIES: STEPS IN THE NEGOTIATION AND RATIFICATION OF TAX TREATIES AND STATUS OF PROPOSED TAX TREATIES 1 (Comm. Print 1979).

57. See THE ROLE OF THE SENATE, *supra* note 54, at 89.

one side, or results that should be distinguished from the "main text" of the treaty for other reasons, are often presented separately as an "agreed protocol" or "final protocol" or as an exchange of letters. Legally, however, these additional documents constitute elements of the treaty as such.

At the conclusion of the negotiations, the leaders of both delegations authenticate two copies of the treaty by initialing each page (*Paraphierung*). If necessary, the leaders of both delegations simultaneously sign an exchange of notes or agreed protocol. If the language of negotiation was not the official language of one or both of the treaty partners, the treaty is translated into their respective languages and approved by the treaty partners. Most tax treaties are concluded in the official languages of both treaty partners.⁵⁸ In rare instances, the treaty partners agree that a version in a third language, for example, English or French, will be binding.⁵⁹ If minor modifications to the agreed text subsequently prove necessary, the new pages containing the modifications are initialed and inserted into the text in place of the old pages. Should major modifications be required, negotiation ordinarily must be resumed.

In parliamentary democracies, with Great Britain and the remaining members of the Commonwealth constituting notable exceptions, the executive ordinarily must obtain the consent of parliament to conclude important agreements. The absence of parliamentary consent would constitute a clear and fundamental infraction and would, pursuant to Article 46(2) of the Vienna Convention, cause the treaty to be invalid under international law.

In the United States, the President has the power to make treaties by and with the advice and consent of the Senate, provided two-thirds of the Senators present concur.⁶⁰ After the Secretary of State formally submits a treaty to the President, the President transmits the treaty to the Senate accompanied by a Presidential message consisting of the treaty text, a letter of transmittal requesting advice and consent of the Senate, and the earlier letter of submittal of the Secretary of State, which usually contains a detailed description and analysis of the treaty.⁶¹ The Senate procedure is governed by Rule 30 of the Senate Rules,⁶² although the lengthy and complicated procedural requirements of this rule are usually abbreviated through the procedural mechanism of unanimous consent. The treaty is assigned a number and referred to the

58. See, e.g., Convention for the Avoidance of Double Taxation, June 17, 1980, United States-Denmark, art. 30, — U.S.T. —, T.I.A.S. No. —, reprinted in 1 Tax Treaties (CCH) ¶ 2083 (1981); Convention for the Avoidance of Double Taxation, Mar. 6, 1970, United States-Finland, 22 U.S.T. 164, T.I.A.S. No. 7042.

59. Convention for the Avoidance of Double Taxation, Nov. 17, 1959, Germany-Egypt, art. XXV, 1961 BGBl II 421, 439–40; Agreement for the Avoidance of Double Taxation, June 27, 1975, Germany-Brazil, art. XXI, 1975 BGBl II 2245, 2261; Agreement for the Avoidance of Double Taxation, Apr. 22, 1966, Germany-Japan, art. XXX, 1967 BGBl II 872, 896.

60. U.S. CONST. art. II, § 2, cl. 2.

61. See DRAFT RESTATEMENT, *supra* note 51, at §§ 306, 316; THE ROLE OF THE SENATE, *supra* note 54, at 11.

62. S. DOC. NO. 1, 98th Cong., 1st Sess. 61 (1983).

Senate Committee on Foreign Relations, where it is placed on the Committee calendar. There it remains until it is reported out to the full Senate, ordinarily together with a resolution recommending the Senate to give its advice and consent. The predominant pattern is for the Committee to recommend advice and consent without restrictions. However, the Committee may vote to recommend that the Senate approve a treaty subject to conditions.⁶³ After the treaty is reported to the Senate, the Senate generally approves abbreviation of the Rule 30 procedure, which ordinarily requires consideration of the treaty first by the Senate sitting as Committee of the Whole, and proceeds directly to consideration of the resolution of ratification as reported by the Senate Foreign Relations Committee. After the Senate has given its advice and consent, the treaty is returned through official channels to the President for ratification. Treaties reported by the Committee but not acted upon by the Senate during that legislative period are automatically returned to the Committee calendar at the end of a Congress, and the Committee must report them out again for the Senate's consideration. Treaties may be returned to the President without approval.⁶⁴

In Germany, Article 59(2)(1) of the Federal Constitution (*Grundgesetz*) provides that "agreements that regulate political relations of the federation or affect objects of federal legislation require the consent or cooperation, in the form of a federal law, of the respective corporate bodies that are responsible for federal legislation." These bodies are the Federal Parliament (*Bundestag*) and in certain matters, such as legislation and treaties regarding the more important taxes,⁶⁵ the Federal Council (*Bundesrat*). The Federal Government submits a draft of the implementing legislation to these legislative bodies together with the treaty text, ordinarily in all languages in which the treaty was drafted, as well as any protocols and notes exchanged. As noted above, these documents constitute elements of the treaty and require parliamentary consent as well. The content and any peculiarities of the treaty are explained to the legislators by a memorandum (*Denkschrift*). This memorandum is not an element of the treaty, but rather explains the basis for the agreed provisions. The legislative procedure is determined according to the Rules of Procedure (*Geschäftsordnung*) of the German Parliament.⁶⁶ The implementing legislation is executed by the Federal President (*Bundespräsident*) according to Article 82 of the *Grundgesetz* and published in the *Bundesgesetzblatt*.

63. *Id.* For a brief description of the constitutional background, see Brockway, *Interpretation of Tax Treaties and Their Relationship to Statutory Law, a U.S. Perspective*, in CANADIAN TAX FOUNDATION, REPORTS OF PROCEEDINGS OF THE THIRTY-FIFTH TAX CONFERENCE 619 (1984); see also Brecher, *supra* note 26, at 178; Rosenbloom, *supra* note 24, at § 31.01.

64. Regarding the various actions that the Senate may take, see DRAFT RESTATEMENT, *supra* note 51, § 305 comment and Reporter's notes.

65. GRUNDGESETZ [GG] art. 105(3) (W. Ger.).

66. GG, art. 76; Geschäftsordnung des Deutschen Bundestags § 78, 1980 BGBl I 1237.

2. Ratification

For purposes of international law, a tax treaty comes into existence upon the declaration of consent by both contracting states.⁶⁷ Ordinarily, the head of state is authorized to make the declaration. In the United States, under Article II, section 2, clause 2 of the Constitution, the President, as head of state, declares the consent of the United States to be bound by the treaty under international law. This power is ordinarily delegated to the Secretary of State or a U.S. Ambassador. In Germany the declaration under Article 59(1) of the Grundgesetz is made by the Bundespräsident. Other persons, such as the Federal Chancellor, Federal Ministers, or civil servants, require a certificate of authority from the President.

The method by which the contracting states declare their consent is left up to the contracting parties.⁶⁸ For important treaties, however, it is generally agreed that the conclusion of the treaty should be effected only through an exchange of instruments, or "ratification".⁶⁹ As for multilateral treaties, the declaration of consent is made through the deposit of instruments at a location agreed upon in the treaty by corresponding notification.⁷⁰

Ratification is to be distinguished from parliamentary consent which is frequently incorrectly characterized as "ratification". The OECD Model Treaty⁷¹ provides for ratification of tax treaties, and U.S. and German treaties follow the model without exception in this respect. In the document of ratification, the authorized agent, whether the President in the United States, or the Bundespräsident in Germany, delivers the formal declaration that the constitutional requirements necessary for internal application of the treaty have been fulfilled.

Upon declaration of intent to contract, either through ratification or through other means, the treaty becomes binding under international law (unless the treaty provides for a different date for entry into force). The binding force of the treaty under international law is to be distinguished, however, from its internal applicability. Internal applicability is a consequence only of treaties which, like tax treaties, are designed to be applied by domestic authorities in addition to obligating the states themselves. Such treaties are called self-executing treaties.⁷² In Germany, the internal applicability of the

67. Vienna Convention, *supra* note 49, art. 9(1).

68. Vienna Convention, *supra* note 49, art. 11.

69. Vienna Convention, *supra* note 49, art. 14(1).

70. Vienna Convention, *supra* note 49, arts. 14(1) & 16.

71. OECD Model, *supra* note 1, art. 29.

72. The German Bundesfinanzhof has held the GATT not to be "self-executing". See [1959] III BStBl 166, 167; [1959] III BStBl 486, 489. For the agreement of Germany and France concerning Saarland, see 112 BFH 434, 441 (1974). The opinion prevailing in Germany is criticized in A. BLECKMANN, BEGRIFF UND KRITERIEN DER INNERSTAATLICHEN ANWENDBARKEIT VÖLKERRECHTLICHER VERTRÄGE (1970). Direct internal applicability of GATT has been advocated. See Jackson, *The General Agreement on Tariffs and Trade in United States Domestic Law*, 66 MICH. L. REV. 250 (1967).

treaty generally is achieved through enactment of implementing legislation, as provided under Article 59(2) of the Grundgesetz.⁷³

3. Internal Implementation

In the United States, the Constitution proclaims that, like the Constitution and federal laws, treaties constitute the supreme law of the land.⁷⁴ Thus, in the United States, self-executing treaties automatically obtain equal status with federal laws and are internally applicable. Implementing legislation, as a rule, is therefore unnecessary, although with respect to certain treaties not intended to be self-executing implementing legislation may be required. Such is the case, for example, where appropriations are necessary or where the terms of the treaty itself require additional legislation.

In the United States, however, a peculiarity arises with respect to tax treaties. Although the Constitution requires that all revenue raising measures arise in the House of Representatives,⁷⁵ the fact that the Constitution vests treaty-making power in the President subject to advice and consent of the Senate⁷⁶ means that the House of Representatives as such is not directly involved in the negotiation and conclusion of tax treaties. Consequently, due to constitutional restraints, a tax treaty may not be imposed so as to increase the U.S. tax burden that would exist in absence of a treaty. The result of this constitutional structure is that U.S. tax treaties tend to restrain or reverse legislative action.⁷⁷

Because treaties constitute the "law of the land" under the Supremacy Clause of the U.S. Constitution, treaties also override the laws of the individual states. In the event of a conflict between treaty law and federal law, it is well established that legal primacy is accorded to the measure that is later in time.⁷⁸ U.S. courts, however, like the courts in other countries, attempt to harmonize the domestic and international rules through interpretation wherever possible.

In Great Britain, where parliamentary consent is not necessary for the conclusion of a treaty, the treaty becomes applicable internally only when a special law to this effect is passed by Parliament after the treaty enters into force under international law.⁷⁹ Under Dutch constitutional law, the treaty

73. GG art. 59(2).

74. U.S. CONST. art. VI, cl. 2.

75. U.S. CONST. art. I, § 7.

76. U.S. CONST. art. II, § 2, cl. 2.

77. See Burke, *Report on Proposed United States Model Income Tax Treaty*, 23 HARV. INT'L L.J. 219, 221 (1983); Brockway, *supra* note 63, at 622 (suggesting that this constitutional background may make Congress "somewhat less reluctant" than other states' parliaments to override treaty provisions by subsequent legislation).

78. See *Whitney v. Robertson*, 124 U.S. 190 (1888); Brecher, *supra* note 26, at 179; Langbein, *infra* note 81, at 147; DRAFT RESTATEMENT, *supra* note 61, § 135.

79. A. McNAIR, *supra* note 48, at 81; Oliver, *Double Tax Treaties in United Kingdom Tax Law*, 1970 BRIT. TAX REV. 388.

becomes applicable domestically at the time it enters into force,⁸⁰ reflecting the “monistic” theory of international law.

Traditionally, German theorists labeled the process pursuant to which a treaty acquires the force and effect of domestic law as a “transformation”, that is, as the promulgation of a domestic law parallel to the treaty and corresponding to the treaty text. This theory, however, cannot explain why the treaty, even after parliamentary consent, becomes applicable domestically only when the treaty enters into force under international law, or why it loses its binding force internally when it is rescinded or terminated at the international level. For these reasons the transformation theory has recently been abandoned.⁸¹ Parliamentary consent is now understood as a mandate through which the treaty itself, rather than a corresponding internal legislative provision, becomes applicable within the scope of domestic law.

The point in time at which a treaty enters into force internationally and the point at which it becomes applicable under domestic law must be distinguished from the point in time at which the material consequences of the treaty begin to take effect, or, in other words, the taxable period or the date from which taxation shall be limited by the treaty (the effective date). Usually this “initiation of treaty effects” is established by explicit treaty rules.⁸² Various aspects may be of importance here. For instance, such treaty rules often distinguish between treaty effects on assessed taxes and those on withholding taxes. In general, the material effects of tax treaties apply retroactively, viewed from the date of entry into force under international law; detrimental retroactivity may, however, be prohibited.⁸³

Through the mandate of the legislator, treaties in most states obtain the same authority as internal law. A subsequent law, therefore, can limit a treaty or cause it to be inapplicable domestically.⁸⁴ Of course, such laws violate international law, since they cause a breach of the international obligation represented by the treaty. In France and in the Netherlands, treaties

80. Van Raad, *Interpretatie van belastingverdragen*, 1978 MAANDBLAD BELASTING-BESCHOUWINGEN 49.

81. Regarding the domestic applicability of international agreements in Germany, see PARTSCH, *DIE ANWENDUNG DES VÖLKERRECHTS IM INNERSTAATLICHEN RECHT* (Berichte der Deutschen Gesellschaft für Völkerrecht No. 6, 1964); A. BLECKMANN, *BEGRIFF UND KRITERIEN DER INNERSTAATLICHEN ANWENDBARKEIT VÖLKERRECHTLICHER VERTRÄGE* (1970); A. BLECKMANN, *GRUNDGESETZ UND VÖLKERRECHT* 277 (1975); Langbein, *Double Taxation Agreements: Caught in the Conflict Between National Law and International Law*, 1985 *INTERTAX* 145, 151. For the original German version of this article, see Langbein, *Doppelbesteuerungsabkommen im Spannungsfeld zwischen nationalem Recht und Völkerrecht*, 1984 *RECHT DER INTERNATIONALEN WIRTSCHAFT/AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS* 531.

82. With regard to German treaties, see K. VOGEL, *DOPPELBESTEUERUNGSABKOMMEN* 1413, 1415 (1983).

83. There is no detrimental retroactivity of double tax treaties in Germany. See 30 *Bundesverfassungsgericht* [BVerfG] 272, 284.

84. The international binding effect of the treaty, however, is not affected. See [1973] II *BStBl* 810, 812 (1973); [1977] II *BStBl* 283, 287.

have priority even over subsequent laws. In Switzerland the question is unsettled, although the Swiss Federal Court has denied priority of the treaty.⁸⁵ In Germany, treaties have no priority over domestic law; they are, however, as far as possible, considered to be special provisions, with the result that they are not altered by a subsequent law unless the law expressly contradicts their provisions. The Fiscal Code (*Abgabenordnung*) confirms this principle of German law.⁸⁶ Although this provision appears to grant tax treaties priority over domestic law, it cannot theoretically do so, since the Code is itself merely a general provision of domestic law. Consequently, the provision can only mean that tax agreements are special rules and that in this sense they “precede” tax laws.⁸⁷

B. Analytical Elements of Double Tax Treaties

1. The General Nature of Double Tax Treaties

Tax treaties, unlike conflict rules in private international law, do not choose between applicable domestic and foreign law. Instead, they recognize that each contracting state applies its own law, and then limit the contracting states’ application of that law.⁸⁸ Consequently, designating treaty norms as conflict rules according to the usage of private international law would be misleading. Moreover, treaty rules do not “allocate” jurisdiction to tax to the contracting states.⁸⁹ States have original jurisdiction to tax, and by concluding tax treaties they agree to restrict their substantive tax law reciprocally. In situations in which an overlapping of substantive tax law is expected to occur, states which are parties to tax treaties decide which of them shall be bound to withdraw its tax claim. Tax treaties, in other words, do not just introduce international “source rules”. In addition, they usually establish an independent mechanism to avoid double taxation through the division of tax claims.⁹⁰

85. 59 Entscheidungen des Schweizerischen Bundesgerichts, Amtliche Sammlung [BG] II 331, 337 (1933). *But see infra* note 87.

86. AO § 2.

87. The same rule applies in Switzerland. See 94 BG I 669, 678 (1968). For Austrian treatment, see 18 Österreichischer Verwaltungsgerichtshof, Decisions on Financial Matters, Neue Folge 550, 552; for Great Britain, see *Salomon v. Comm’rs of Customs and Excise*, [1966] 3 W.L.R. 1223, 1233; *Woodend Rubber Co. v. Comm’rs of the Inland Revenue*, [1970] 3 W.L.R. 10 (basically in the same vein, but holding that the tax treaty did not apply in the particular case due to the enactment of a comprehensive tax reform law that did not expressly provide for divergent treatment through application of a treaty). Regarding the termination of domestic applicability of treaty law provisions in Switzerland, see 99 BG Ib 39, 43.

88. See *supra* Part II.D.

89. See Korn & Debatin, *Systematik I*, *supra* note 3, at Rdn. 37.

90. Tax treaties act to waive “tax claims”. See [1972] II BStBl 785, 789. Or, more illustratively, they divide the “tax sources” (*Steuerquellen*), and the “taxable objects” (*Steuergut*) among themselves. See [1965] III BStBl 352, 353 (regarding the German treaty with the Netherlands); [1976] II BStBl (regarding the German treaty with Austria); and Becker, *Die Selbständigkeit der Begriffsbildung im Steuerrecht und ihr Einfluss auf die Auslegung der internationalen Doppelbesteuerungsverträge vom Standpunkt der deutschen Entwicklung aus betrachtet*, 18 STEUER UND WIRTSCHAFT 745, 763–64 (1939).

The limitation by a contracting state of its domestic tax law may consist of the waiver of its tax claim in favor of the other state (exemption method) or of the grant of a credit against its tax for taxes paid in the other state (credit method).⁹¹ In contrast, a tax treaty neither generates a tax claim that does not otherwise exist under domestic law nor expands the scope or alters the character of an existing claim.⁹² To the extent an exemption is chosen, its effect is in principle independent of both whether the other contracting state imposes a tax in the situation to which the exemption applies,⁹³ and of whether that state actually levies the tax.⁹⁴ The treaty thus prevents not only "current" but also "potential" double taxation, which is an effect of some significance when national tax legislation is modified after the conclusion of a treaty. The exempting state ordinarily reserves the right to take the exempted elements (income or property) into account for purposes of calculating the amount of the tax claim under a progressive rate system.

Only in exceptional cases, and only when expressly agreed to by the parties, is the exemption in one contracting state dependent upon whether the income or property is taxable in the other contracting state, or upon whether it is actually taxed there. German treaties recognize four exceptions to this rule. First, two treaties (from a total of about 55) deny the exemption in the source state to the extent that the affected types of income or property are not taxed in the residence state due to application of the territoriality principle.⁹⁵ Because Germany taxes its residents on their worldwide income, this clause is important only with regard to taxation of German source income in the other contracting state. Second, some German treaties provide that where the state of residence of the taxpayer taxes foreign source income only to the extent remitted by the taxpayer according to the "remittance basis principle" the source state exemption shall be limited to the amount of source state income actually remitted.⁹⁶ It should be noted here that a similar exception was provided for by the 1977 U.S. treaty model in Article 4(6), but has not been

91. Regarding the tax credit under U.S. tax treaties, see Gann, *supra* note 24.

92. 1935 RStBl 1399, 1400; 1936 RStBl 1209, 1210; 1939 RStBl 312 (regarding the German treaty with Switzerland). In contrast, at least in the United States, a treaty may operate to expand the scope of a treaty benefit beyond that which is contemplated by domestic law. In the United States, treaties occasionally have granted additional benefits to U.S. taxpayers by allowing deductions for charitable contributions not otherwise available under domestic law. See Rosenbloom, *supra* note 24, at § 31.04[3].

93. 1940 RStBl 532 (regarding the German treaty with Austria); [1973] II BStBl 57, 59 (regarding the German treaty with the Netherlands); [1976] II BStBl 662 (regarding the German treaty with Austria).

94. [1979] II BStBl 61, 62 (regarding the German treaty with the United States). See also 1983-2 Beslissingen in Belastingzaken, Nederlandse Belastingrechtspraak [BNB] 1095 (Hoge Raad).

95. Convention for the Avoidance of Double Taxation, May 17, 1977, Germany-Kenya, Final Protocol, para. 2, 1979 BGBl II 607, 624; Agreement for the Avoidance of Double Taxation, May 30, 1973, Germany-Zambia, Final Protocol, para. 2, 1975 BGBl II 661, 677.

96. Conventions for the Avoidance of Double Taxation: Germany-Indonesia, Sept. 2, 1977, Protocol, para. 3, 1979 BGBl II 188, 205; Germany-Ireland, Oct. 17, 1962, art. II(2), 1964 BGBl II 267, 271-72; Germany-Israel, July 9, 1962, art. II(2), 1966 BGBl II 330, 335; Germany-

included in the 1981 draft. Third, two other German treaties stipulate that the source state exemption applies only if the income in question is effectively "subject to tax" in the state of residence.⁹⁷ Under this clause, treaty relief will be granted if the income is taxable in principle in the state of residence, whether or not the tax is actually paid in a particular case. The treaty between Germany and the United Kingdom combines this "subject to tax principle" and the "remittance basis principle".⁹⁸ In contrast, only very exceptional clauses transfer taxation to the state of residence if income ordinarily taxable in the state of source has not been taxed there.⁹⁹ Finally, other special provisions are meant to prevent treaty abuse: if income is generated by a corporation resident in the other contracting state but controlled from Germany or a third country, then the exemption may depend upon proof in each case that the corporation has actually been taxed in its country of residence according to the general tax law of that country.¹⁰⁰ According to one treaty, a corporation must show in general that the income or property has been taxed in its country of residence.¹⁰¹

2. *The Distributive Rules*

The nature and function of a double tax treaty can best be conceptualized within a three-part analytical framework. The basic distributive rules of treaty law can thus be systematically analyzed for each particular case of treaty interpretation. These three basic elements are: 1) requirements for application of a treaty; 2) requirements of substantive taxation law; and 3)

Jamaica, Oct. 8, 1974, art. 3(3), 1976 BGBI II 1195, 1197; Germany-Malaysia, Apr. 8, 1977, Final Protocol, para. 2, 1978 BGBI II 925, 942; Germany-Malta, Sept. 17, 1974, art. 2(6), 1976 BGBI II 110, 111; Germany-Trinidad and Tobago, Apr. 4, 1973, Protocol, para. 1(a), 1975 BGBI II 679, 697; Germany-Cyprus, May 9, 1974, Final Protocol, para. 2, 1977 BGBI II 488, 505.

97. Agreement for the Avoidance of Double Taxation, Mar. 18, 1959, Germany-India, art. XII(2)(c), 1960 BGBI II 1829, 1837; Agreement for the Avoidance of Double Taxation, Jan. 25, 1973, Germany-South Africa, arts. 7(2)(b), 8(2), 9(1), 12(1) 13(1), 16(1) and 19, 1974 BGBI II 1185, 1194, 1195, 1196, 1198, 1198-99, 1200, 1201.

98. Convention for the Avoidance of Double Taxation, Nov. 26, 1964, Germany-United Kingdom, arts. II(2), VI(1), VII(1), X(1), X(2) and XV, 1971 BGBI II 359, 362, 363, 364, 366, 368.

99. Convention for the Avoidance of Double Taxation, Jan. 30, 1962, Germany-Denmark, arts. 8(4) & 9(5), 1963 BGBI II 1312, 1318-19; Protocol Amending the Convention for the Avoidance of Double Taxation of Nov. 26, 1964, Mar. 23, 1970, Germany-United Kingdom, art. XVIII(2)(a), 1971 BGBI II 46, 50; Convention for the Avoidance of Double Taxation, Apr. 11, 1967, Germany-Belgium, Final Protocol, para. 13(B)(2), 1969 BGBI II 18.

100. Convention for the Avoidance of Double Taxation, Nov. 25, 1970, Germany-Liberia, Final Protocol, para. 4, 1973 BGBI II 1285, 1302-03; Agreement for the Avoidance of Double Taxation, Mar. 15, 1978, Germany-Mauritius, Protocol, para. 1, 1980 BGBI II 1262, 1279; Agreement for the Avoidance of Double Taxation, Feb. 19, 1972, Germany-Singapore, Final Protocol, para. 2, 1973 BGBI II 373, 389; Agreement for the Avoidance of Double Taxation, Apr. 4, 1973, Germany-Trinidad and Tobago, Protocol, para. 1(b), 1975 BGBI II 679, 696.

101. Convention for the Avoidance of Double Taxation, June 7, 1972, Germany-Morocco, Final Protocol, para. 1, 1974 BGBI II 22, 37.

double tax consequences. Such a division of treaty issues into three component parts not only provides a consistent method by which to view the treaties; it also may determine the solution of a particular issue of interpretation, based on that issue's place within the model. This relationship becomes most evident with regard to the question of "qualification".¹⁰²

a. Requirements for Application

The threshold issue of whether a tax treaty applies in a given situation can itself be presented as three questions. First, is the treaty binding on the taxing state? This question could arise, for example, for constituent states of a federation, or for dependent territories of a contracting state. Second, is this particular taxpayer entitled to treaty benefits? Third, does the treaty apply to the tax in question? These two latter questions can usually be answered by reference to the provisions defining the scope of the treaty and the taxes covered.

b. Requirements of Substantive Taxation Law

If the treaty is applicable, the substantive requirements of the distributive rules apply. First, the particular object to which the treaty will apply (the *Objekttatbestand*), such as "income", "profit", or "property", must be designated. Second, the corresponding requirements of the treaty's distributive rule (the *Metatattbestand*) must be determined. Such requirements include both those characteristics of the tax object giving rise to tax liability, such as "income from real property" or "profits of an enterprise", and those characteristics which determine how the amount of tax liability is measured.¹⁰³ Third, a connection between the treaty's substantive requirements and the taxpayer must be established by the "attribution" of the tax object, such as "income which a person receives." A similar "connecting factor" must be established between those requirements and the taxing state, either by a characteristic of the taxpayer, such as residence or citizenship, or by a characteristic of the transaction or event, such as the situs of real property.

Finally, with regard to the procedure for application of a treaty, it is disputed whether treaty law or, for systematic reasons, domestic law should first be examined. The German *Reichsfinanzhof* has expressed the opinion that the tax liability according to domestic law must first be examined.¹⁰⁴

102. See *infra* Part VI.

103. The Swiss refer to this determination as "tax separation" (*Steuerausscheidung*). See E. HÖHN, INTERKANTONALES STEUERRECHT 235, 359 (1983).

104. 1935 RStBl 1399, 1401 (regarding the German treaty with Switzerland); 1938 RStBl 937 (regarding the German treaty with Italy); 1940 RStBl 809, 810 (regarding the German treaty with Switzerland). See also Becker, *supra* note 90, at 762. A limiting interpretation can be found in [1979] II BStBl 64, 65 (only "generally" as a practical rule) (regarding the German treaty with Switzerland)).

Some scholars, however, have supported an approach which would theoretically first look to the treaty,¹⁰⁵ although they often concede that for practical reasons the domestic law must be examined first. Logically, the two methods of procedure are equivalent. Indeed, the treaty is *lex specialis* in relation to national law. The requirements for application of the distributive rules apply, as discussed above, as additional requirements, beyond those of domestic law, for establishing tax liability. In other words, the treaty acts like a stencil that is placed over the pattern of the domestic law and covers certain parts.¹⁰⁶ Whether the stencil or the pattern is examined first, the same conclusion results, so that the order of application can be decided pragmatically case by case.

c. Double Tax Consequences

The application of the treaty's distributive rules will determine how much revenue each state will receive from the taxation of the particular transaction or event. In one of the two contracting states, the substantive tax law will remain unaffected; the tax claim will at most be limited in amount ("primary taxation"). In the other contracting state, relief from double taxation will be provided by the allowance of either an exemption or a credit for the tax paid in the first state ("secondary taxation").

C. Organizational Structure of Double Tax Treaties

1. Treaty Organization by Chapters

The OECD and UN treaty models, as well as many of the tax treaties in force, are organized in seven chapters. Chapters I and II of both models regulate the requirements for application of the treaty ("Scope of the Convention") and determine essential definitions of treaty terms.¹⁰⁷ Chapter III, the most important chapter, contains the distributive rules regarding income taxes,¹⁰⁸ while Chapter IV covers the distributive rules of wealth taxes.¹⁰⁹ Chapter V determines the legal consequences of the rules of Chapters III and IV, as far as such rules do not imply a definitive legal consequence in and of

105. See Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 52–53; Debatin, *Auslegungsmaximen zum internationalen Steuerrecht*, 1969 AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS 477 (discussing a *rechtssystematisch . . . umgekehrte[n] Prüfungsgang*, a legal systematic . . . reversed test procedure).

106. The taxpayer certainly cannot "choose" whether or not the treaty applies to him/her as Brecher assumes. See Brecher, *supra* note 26, at 191. It is true, however, that the U.S. Treasury has at times used language which, though ambiguous, may be understood to corroborate Brecher.

107. OECD Model & UN Model, *supra* note 1, arts. 1–5.

108. *Id.* arts. 6–21.

109. *Id.* art. 22.

themselves, and both the OECD and UN Models provide for a choice between the exemption method and the credit method as two equally valid solutions.¹¹⁰ Chapter VI contains additional provisions regarding non-discrimination,¹¹¹ a mutual agreement procedure for resolving uncertainties, differences of opinion and any remaining cases of double taxation,¹¹² exchanges of information,¹¹³ a reservation for the tax privileges of diplomats and consular officials,¹¹⁴ and a rule for extending the treaty to dependent territories.¹¹⁵ Final provisions in Chapter VI regulate the entry into force and the termination of the treaty.¹¹⁶

In contrast, the U.S. Treasury Model is not formally organized in chapters. Nevertheless, it follows the same pattern as the OECD and UN Models do, except for one anti-treaty-shopping provision introduced in place of what appears as a distributive rule in the two other Models (art. 16).

2. *Distributive Rule Organization*

The distributive rules of Chapter III are organized according to "types of income", and those of Chapter IV are likewise grouped according to "types of wealth". These types of recognized income resemble the types or schedules of income in the domestic tax law of various countries, such as the United Kingdom or Germany.¹¹⁷ Such categories may differ, however, from state to state, and there are countries, such as the United States, which do not even distinguish between income types at all, but rather proceed from a comprehensive definition of income.¹¹⁸ Types of income designated by treaties, therefore, should by no means be confused with those of domestic law, even where they do exist in domestic law: any resemblance that may show up will be superficial and accidental.

In their language, the distributive rules of all current model treaties follow a specific pattern. If a rule provides that a particular type of income "shall be taxed *only* in . . .", then the other state must exempt the income from its tax. If, on the other hand, the rule provides that the income "*may* be taxed in . . ." the state of source, then the consequences in the state of residence are not determined by the rule itself, but by Article 23 of the models, providing for the relief of double taxation. In other words, distributive rules with *complete* legal consequences ("shall . . . only") must be distinguished from rules with *incomplete* or *open* legal consequences ("may"); distributive

110. *Id.* arts. 23A, 23B.

111. *Id.* art. 24.

112. *Id.* art. 25.

113. *Id.* art. 26.

114. *Id.* art. 27.

115. *Id.* art. 28.

116. *Id.* arts. 29-30.

117. Income and Corporation Taxes Act, 1970, ch. 10, §§ 67, 91, 93, 108, 181, 232; ESrG § 2.

118. I.R.C. § 61.

rules with open legal consequences are intended to be completed by application of Article 23.¹¹⁹

Article 23 of the OECD and UN Models provides an alternative for the relief of double taxation: the contracting states in drafting their particular treaty may choose between the exemption and credit methods. The U.S. Model, on the other hand, provides only for the credit method. Because the distributive rules with complete legal consequences ("shall . . . only") always imply exemptions, however, existing tax treaties almost never provide exclusively for a tax credit. Similarly, the exemption method is normally not exclusive. Even where this method is adopted, Article 23A of the models (the exemption article) provides that, with regard to dividend and interest income, double taxation is to be avoided by credit.¹²⁰ A particular feature of U.S. treaty practice is the so-called "saving clause" according to which the United States retains the right to tax its residents and non-resident citizens "as if the Convention had not come into effect."¹²¹ It appears that no other country makes such a reservation. Notwithstanding this provision, there are some exceptional situations in which even the United States, under a "shall . . . only" clause of a tax treaty, exempts foreign income instead of granting a credit.¹²²

The distributive rules of Chapter III are not organized in any systematic way. Rather, their order has been established by tradition. Nevertheless, four general categories can be distinguished, based on the context of various rules:

- (1) rules referring to income from certain activities, including business,¹²³ independent and dependent personal services,¹²⁴ agriculture and forestry;¹²⁵
- (2) rules referring to income from assets, including dividends,¹²⁶ interest,¹²⁷ royalties¹²⁸ and income derived from immovable property;¹²⁹
- (3) rules referring to capital gains,¹³⁰
- (4) a residuary rule covering income not dealt with in the foregoing three categories.¹³¹

119. K. VOGEL, *supra* note 82, at 284.

120. Some continental European treaties entered into in the twenties and early thirties are based exclusively on the exemption method. See Convention for the Avoidance of Double Taxation, Oct. 31, 1925, Germany-Italy, 1925 RGBI II 1145.

121. U.S. Model, *supra* note 1, art. 1(3).

122. For example, in the case of Social Security benefits and other public pensions, see U.S. Model, *supra* note 1, art. 1(3) in connection with art. 18(1)(b).

123. OECD Model & UN Model, *supra* note 1, art. 7.

124. *Id.* arts. 14-15.

125. *Id.* art. 6.

126. *Id.* art. 10.

127. *Id.* art. 11.

128. *Id.* art. 12.

129. *Id.* art. 6(3).

130. *Id.* art. 13.

131. *Id.* art. 21.

A few distributive rules are *leges speciales* within the four categories. For instance, the rule governing shipping¹³² is a special exception to the business profits rule. Similarly, the rule governing entertainers and athletes¹³³ is a special exception to the rules on independent and dependent services, and in some instances even to the rule on business profits as well.¹³⁴ If a given item of income meets the requirements of more than one distributive rule, rules governing income from assets take priority over those governing income from activities.¹³⁵ For example, if the business assets of an enterprise include shares of stock in a corporation, dividends derived from those shares will be treated in general under Article 10 relating to dividends, rather than under Article 7 relating to business profits. The same principle applies if an enterprise has granted a loan or a patent license to a person in the other contracting state, or if it holds immovable property in that state. There is, however, one important exception. If dividends, interest or royalties are received via a permanent establishment in the other contracting state, and if the right in respect of which such payments are made is an asset of that permanent establishment, then their taxation is determined pursuant to Article 7.¹³⁶

3. Other Documents

As previously mentioned, (final) protocols, and in some cases other completing documents frequently are attached to treaties. Such documents elaborate and complete the text of a treaty, sometimes even altering the text; legally they are a part of the treaty, and their binding force is equal to that of the principal treaty text. When applying a tax treaty, therefore, it is necessary carefully to examine these additional documents.

IV

INTERPRETATION OF DOUBLE TAX TREATIES IN GENERAL

The application of a particular tax treaty can pose significant problems of interpretation.¹³⁷ This part explains the fundamental difficulties inherent

132. *Id.* art. 8.

133. *Id.* art. 17.

134. *Id.* art. 7.

135. See OECD Model, *supra* note 1, arts. 6(4) & 7(7); UN Model, *supra* note 1, arts. 6(4) & 7(6).

136. See OECD Model, *supra* note 1, arts. 10(4), 11(4) & 12(3); UN Model, *supra* note 1, arts. 10(4), 11(4) & 12(4).

137. For general literature, see Flick, *Zur Auslegung von Normen des internationalen Steuerrechts*, in VON DER AUSLEGUNG UND ANWENDUNG DER STEUERGESetze 151 (G. Felix ed. 1958); Lenz, *L'interprétation des traités de double imposition* (General Report), 42 C.D.F.I. 281, 294 (1960); J. VAN HOUTTE, AUSLEGUNGSGRUNDsÄTZE IM INTERNEN UND IM INTERNATIONALEN STEUERRECHT (1968); Debatin, *supra* note 105; Kluge, *Die Auslegung von Doppelbesteuerungsabkommen*, 1975 RECHT DER INTERNATIONALEN WIRTSCHAFT/AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS 90; Lang, *Grundsätzliches zur Interpretation völkerrechtlicher Abkommen im Steuerrecht*, 52 STEUER UND WIRTSCHAFT 285 (1975); Ward, *Principles to be Applied in Interpreting Tax Treaties*, 25 CANADIAN TAX J. 263 (1977), reprinted in 34 BULL. INT'L FISCAL DOC. 545 (1980); van Raad, *supra* note 80, at 49; Boidman,

in such interpretation. Section A distinguishes between the interpretation of treaties and the interpretation of domestic statutes, and suggests a relation between the two. Section B delineates the general principles applied in the interpretation of treaties. Finally, Section C presents the necessity for common interpretation among states and identifies two possible sources of a unified approach.

A. Distinctions with Interpretation of Domestic Law

International agreements, like domestic laws, require interpretation. The need for interpretation can arise from a difference of opinion between the contracting states; the agreement will then be interpreted by these states, or, if they have subjected themselves to its jurisdiction in general or for a particular case, by the International Court of Justice. Questions of interpretation with regard to the application of a treaty can also arise, however, before domestic administrative authorities or courts, and in most countries the courts are then authorized to interpret the treaties. France constitutes a major exception to this rule. In cases requiring interpretation of a tax treaty, the French Conseil d'Etat is legally bound to consult the Foreign Ministry, which in turn forwards the inquiry to the Ministry of Finance.¹³⁸ In the United States, and to a certain extent in other states as well, courts often refuse to interpret a treaty to the extent that a political question or an act of state is involved. Apparently, however, no case has yet arisen in which a court has applied this doctrine to a tax issue.

"To interpret" is to unfold a text, to cause it to be understood. Interpretation occurs in poetry as well as in theology. It therefore has been claimed that interpretation is such a general cognitive process that it cannot be regulated through law. That this view is incorrect follows from the existence of different rules of interpretation within the legal systems of various states.¹³⁹

In Great Britain, a judge is bound strictly by statutory language, especially with regard to tax law. In principle he is not permitted to consider the intention of the legislators or the equity of the matter;¹⁴⁰ a teleological interpretation or even a further development of the law would be considered to be

Interpretation of Tax Treaties in Canada, 34 BULL. INT'L FISCAL DOC. 388 (1980); Brockway, *supra* note 63; Osgood, *Interpreting Tax Treaties in Canada, the United States, and the United Kingdom*, 17 CORNELL INT'L L.J. 255 (1984).

138. L. CAVARÉ, *supra* note 48, at 156; C. ROUSSEAU, *supra* note 48, at 255; Rothstein, *Anwendung und Auslegung internationaler Steuerabkommen durch die französischen Gerichte*, 1956 MITTEILUNGSBLATT DER STEUERBERATER 21 (Sonderbeilage zu Heft 1). The authority of the foreign ministry is limited, however, to give a binding interpretation of the treaty provision; it does not take a position with regard to the individual case actually in dispute.

139. Canadian law expressly regulates questions of treaty interpretation. Income Tax Conventions Interpretation Act of Dec. 20, 1984, ch. 48, 1984 Can. Gaz. Part III 1863. See Boidman, *Canada: New Legislation Respecting Treaty Interpretation*, 1983 INTERTAX 383.

140. *Cape Brandy Syndicate v. Comm'r*, [1921] 1 K.B. 64, 71. There is, however, a "new approach" of British courts concerning tax avoidance schemes. See *infra* note 429 and the cases cited therein.

a usurpation of the rights of the legislator.¹⁴¹ In the United States, a somewhat more liberal interpretation of the tax law did not emerge until the 1930s.¹⁴² In Canada, the majority view apparently continues to follow the British view.¹⁴³ According to French and Belgian practice, tax laws are to be interpreted against the fiscal authorities in case of doubt,¹⁴⁴ although in the United States and Germany such a rule has been rejected.¹⁴⁵ These principles regarding the greater or lesser degree to which a judge is bound to statutory language determine the distribution and the balance of power between the legislative and judicial branches of a state, and in this sense they are part of unwritten constitutional law. It is difficult, of course, to formulate these interpretive principles in precise terms. In this regard, they share common characteristics with many other constitutional principles.

The interpretation of international agreements, even by domestic courts, cannot, however, be based on the application of these domestic rules of interpretation. This is clearly the case for treaty interpretation by an international forum, but it also must hold true for treaty interpretation by domestic courts if domestic application of the treaty is not to conflict with the international obligations of the state in question. For the effective interpretation of international treaties, therefore, it is necessary to reconcile the various national methods of interpretation. On one hand, treaty language should be binding to a greater extent than it is in European practice regarding domestic law.¹⁴⁶ On the other hand, treaties should be interpreted more liberally than are statutes in Anglo-American law, a principle which has been confirmed by Anglo-American case law.¹⁴⁷

B. Principles for Interpretation of International Agreements

The extent to which statutory language or statutory purpose should control the interpretation of an international agreement was actively disputed in

141. *Buchanan & Co. v. Babco, Ltd.*, 3 W.L.R. 907, 915 (1977) (Viscount Dilhorne considered such interpretation to be "legislation, pure and simple"); see especially 2 W. FIKENTSCHER, *METHODEN DES RECHTS IN VERGLEICHENDER DARSTELLUNG* 123, 125 (1975).

142. *White v. United States*, 305 U.S. 281, 292 (1938). For a general discussion of the U.S. view regarding treaty interpretation, see *DRAFT RESTATEMENT*, *supra* note 51, §§ 329-335.

143. *Ward*, *supra* note 137, at 546; *Boidman*, *supra* note 137, at 395.

144. Schramek, conclusions to the Judgment of Dec. 4, 1981, Conseil d'Etat, Fr., 1982 *DROIT FISCAL* comm. 397 (req. no. 39.985); 1 J. VAN HOUTTE, *BEGINSELEN VAN HET BELGISCHE BELASTINGRECHT* 204 (1966).

145. *White v. United States*, 305 U.S. 281, 292 (1938); K. TIPKE & H. KRUSE, *supra* note 19 § 4, Rz. 95.

146. R. BERNHARDT, *DIE AUSLEGUNG VÖLKERRECHTLICHER VERTRÄGE* 58 (1963); Bayer, *Auslegung und Ergänzung international vereinheitlichter Normen durch staatliche Gerichte*, 20 *RABELS ZEITSCHRIFT FÜR AUSLÄNDISCHES UND INTERNATIONALES PRIVATRECHT* 603, 633 (1955). For the French sector of Canada, see *Western Electric Co. v. M.N.R.*, 23 D. *TAX* 5204, 5210 (1969).

147. For U.S. treatment, see *Geofroy v. Riggs*, 133 U.S. 248, 271-72 (1889); for Great Britain, see *Stag Line v. Foscolo, Mango & Co. Ltd.*, 1932 A.C. 328, 350; *Buchanan & Co. v. Babco Shipping Ltd.*, 3 W.L.R. 907, 911, 920 (1977).

the older literature on international law.¹⁴⁸ Difference of opinion also existed regarding the meaning of protocols of negotiations and other materials. The most widely-held view was that treaty obligations are to be interpreted restrictively, because parties to a treaty in doubtful cases should only be presumed to have waived their sovereignty to the extent that it is unequivocally apparent from the text of the treaty.¹⁴⁹

1. Interpretation in the Federal Republic of Germany

In Germany, the case law of the *Reichsfinanzhof* (Tax Court of the Reich) and the *Bundesfinanzhof* (Federal Tax Court, since 1949) regarding interpretation of international agreements, especially tax treaties, is ample, but has not indicated a clear direction. In particular, the meaning of statutory language and statutory purpose, and their relation to each other, has been evaluated in different ways. The *Reichsfinanzhof* emphasized the priority of the "fundamental idea" (*Grundgedanke*), or the "meaning and purpose", of an agreement over its language.¹⁵⁰ In contrast, the *Bundesfinanzhof* puts more weight on the language of the treaty; it expresses this by such phrases as "clear language",¹⁵¹ "it can scarcely be expressed more clearly",¹⁵² "not in conflict with their unequivocal language",¹⁵³ and "language and context".¹⁵⁴ The purpose of the treaty is ordinarily referred to only to confirm the linguistic interpretation¹⁵⁵ or to resolve language which is itself equivocal.¹⁵⁶ Furthermore, the *Bundesfinanzhof* declines to conclude from the general purpose of tax treaties that taxpayers receiving foreign income should not suffer disadvantages through their application.¹⁵⁷ In one decision which diverges completely from the general rule, however, the *Bundesfinanzhof* held that the goal of interpretation of international agreements is "to determine the actual intention of the parties".¹⁵⁸ As further

148. For an overview, see Fitzmaurice, *The Law and Procedure of the International Court of Justice, 1951-54: Treaty Interpretation and Other Treaty Points*, 33 BRIT. Y.B. INT'L L. 203 (1957); R. BERNHARDT, *supra* note 146. In the United States the Supreme Court decision in *Maximov* has been of considerable importance. *Maximov v. U.S.*, 373 U.S. 49 (1963).

149. Publications of the Permanent Court of International Justice, Series B 12, 25; A. VERDROSS, S. VEROSTA & K. ZEMANEK, *supra* note 48 at 174; E. BERBER, *supra* note 48, at 482. This point is left open by the *Bundesfinanzhof*. See [1968] II BStBl 797, 800 (regarding the German treaty with the United States).

150. 26 RFH 163, 164 (1930) (regarding the German treaty with Austria); 1937 RStBl 1213 (regarding the Treaty of Versailles); 1934 RStBl 417, 419 (emphasizing the "purpose" of the treaty in the context of the German treaty with Italy); in the same vein, see Becker, *supra* note 90, at 768.

151. [1959] III BStBl 17 (regarding the German treaty with Great Britain).

152. [1973] II BStBl 57, 59 (regarding the German treaty with the Netherlands).

153. [1965] III BStBl 258, 259 (regarding the German treaty with the United States).

154. [1968] II BStBl 797, 800 (regarding the German treaty with the United States).

155. *Bundesfinanzhof*, Decision of Sept. 16, 1960, reprinted in 13 DER BETRIEB 1326 (1960) (regarding the German treaty with Switzerland).

156. [1967] III BStBl 88, 89 (regarding the German treaty with Canada).

157. [1970] II BStBl 569, 571 (regarding the German treaty with Austria).

158. [1972] II BStBl 281, 284 (regarding the German treaty with Italy).

sources for interpretation, the system of the treaty,¹⁵⁹ the history of its negotiation and conclusion,¹⁶⁰ and the principle of treaty effectiveness¹⁶¹ have been employed.

Attempting to summarize this method, the Bundesfinanzhof has referred to "the grammatical interpretation, the systematic interpretation, the teleological interpretation, and the historical interpretation."¹⁶² The Court considers all of these methods of interpretation "allowable", since they are not mutually exclusive, but rather complement each other.¹⁶³ This language, however, is taken from a decision of the German Federal Constitutional Court (*Bundesverfassungsgericht*) involving the interpretation of a provision of domestic, not international, law.

In some cases the Reichsfinanzhof has characterized an interpretation of the Ministry of Finance (*Reichsfinanzminister*) as the "authentic interpretation" of the treaty and therefore as binding.¹⁶⁴ The Bundesfinanzhof confirmed the decision of a lower tax court that based the interpretation of a treaty on a mutual agreement of the contracting states, "because this declaration given by the treaty partners reflects their intention."¹⁶⁵ Similarly, a Canadian court heard the testimony of an official as to the view of the finance administration regarding the interpretation of a treaty provision.¹⁶⁶ In general, the Bundesfinanzhof, however, reacts more cautiously to information of the Federal Ministry of Finance as to what the intentions of the contracting parties may have been: the Court considers it "not allowable to base the interpretation of a treaty solely on the unilateral, subjective view of the German treaty partner."¹⁶⁷ The view of the other treaty partner, of course, will rarely be known.

2. *The Vienna Convention*

The Vienna Convention has rendered earlier differences of opinion with regard to treaty interpretation for the most part obsolete.¹⁶⁸ It is true that the Vienna Convention contains only relatively general rules, and it therefore cannot make allowances for the peculiarities of tax treaties. It has resolved, nevertheless, some of the uncertainties in prior international practice. The

159. Bundesfinanzhof, *supra* note 90.

160. [1966] III BStBl 483, 485 (regarding the German treaty with Sweden).

161. For the so-called "effet utile", see [1979] II BStBl 268, 275 (regarding the German Legal Assistance Treaty with Sweden).

162. [1973] II BStBl 810, 811 (regarding the German treaty with Switzerland).

163. [1975] II BStBl 604, 605 (regarding the German treaty with the United States).

164. See Germany-Hungary Tax Treaty, cited in 10 STEUER UND WIRTSCHAFT 1809, 1810 (1931); 1939 RStBl 878 (regarding the German treaty with Italy).

165. [1963] II BStBl 212, 213 (regarding the German treaty with Switzerland).

166. *Hunter Douglas, Ltd. v. The Queen*, 33 D. TAX 5340, 5344 (1979).

167. [1975] II BStBl 604, 605 (regarding the German treaty with the United States; see also [1975] II BStBl 584, 585 (regarding the German treaty with the Netherlands)).

168. See sources cited *supra* note 49.

relevant provisions of the Vienna Convention regarding the interpretation of treaties are contained in Articles 31 through 33.¹⁶⁹

169. Section 3. Interpretation of Treaties:

Article 31

General rule of interpretation

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
 - (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;
 - (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.
3. There shall be taken into account, together with the context:
 - (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
 - (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
 - (c) any relevant rules of international law applicable in the relations between the parties.
4. A special meaning shall be given to a term if it is established that the parties so intended.

Article 32

Supplementary means of interpretation

- Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:
- (a) leaves the meaning ambiguous or obscure; or
 - (b) leads to a result which is manifestly absurd or unreasonable.

Article 33

Interpretation of treaties authenticated in two or more languages

1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.
2. A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.
3. The terms of the treaty are presumed to have the same meaning in each authentic text.
4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the text, having regard to the object and purpose of the treaty, shall be adopted.

Regarding the particular articles, see Yasseen, *L'interprétation des Traités d'après la Convention de Vienne sur le Droit des Traités*, 3 RECUEIL DES COURS DE L'ACADÉMIE DE DROIT INTERNATIONAL DE LA HAYE 1 (1976); H. KOCK, VERTRAGSINTERPRETATION UND VERTRAGSRECHTKONVENTION (1976). Sections 329–331 of the DRAFT RESTATEMENT, *supra* note 61, correspond to Articles 31–33 of the Vienna Convention. The TENTATIVE FINAL DRAFT, *supra* note 11, § 325, however, adopts only Article 31(1), (3)(a) and (3)(b) of the Vienna Convention.

In interpreting international agreements according to these rules the treaty language is of primary importance, meaning the "usual meaning" of the "terms" in the context of the *entire* agreement. The older view seeking the subjective intent of the treaty parties is therefore rejected.¹⁷⁰ The intent of the parties is only important to the extent that it is found to be expressed in the text.¹⁷¹ This does not mean that subjective elements are excluded, rather they are implied within the purpose of the treaty. The "purpose" referred to by the Vienna Convention, however, is not synonymous with the subjective intention of the contracting states, but refers to the goal of the treaty as a whole. Moreover, such purpose is subordinated to the treaty language, as indicated by the rule of Article 31 that the purpose shall influence interpretation merely by giving "light" to the *terms* of the treaty. In other words, "purpose" is *not* itself an independent means of interpretation.

The "usual meaning" of the terms is not necessarily that of everyday usage. To the extent that an internationally uniform legal usage or a legal usage consistent between the contracting states has developed, or to the extent that a specific technical language has developed in certain specialized areas such as tax law, such meanings are viewed as the "usual" usage within the meaning of Article 31(1) of the Vienna Convention.¹⁷² Paragraph 4 of Article 31 clarifies that the contracting parties can also ascribe a meaning to a term that deviates from the usual meaning.¹⁷³ "Object and purpose," as the preceding paragraph tacitly assumes, is one integral expression.¹⁷⁴ It is used in international case law as such,¹⁷⁵ and there appears to be no reasonable interpretation of "object" separate from "purpose". Under Paragraph 2, the context of the agreement includes any related documents made in connection with the treaty. In the case of tax treaties, these include notes and letters exchanged at the time the treaty is signed. Subsequent agreements and state practice are also to be taken into consideration.¹⁷⁶ It should be remembered, however, that if such subsequent agreements or state practice alter the original agreement, the modifications become effective under domestic law only to the extent that the domestic law requirements for applicability of treaties have been fulfilled.¹⁷⁷ These requirements may be replaced only in exceptional cases by the development of domestic customary law.

170. In the United States, case law has developed in the same direction. See *Sumitomo Shoji America, Inc. v. Aragliano*, 457 U.S. 176 (1982).

171. See van Raad, *supra* note 80 and accompanying text. It should be mentioned here that the U.S. Tax Court has held that "the basic aim of treaty interpretation is to ascertain the intention of the parties." *Estate of Burghardt v. Comm'r*, 80 T.C. 205 (1983). This view is, however, contrary to current international law as expressed by the Vienna Convention.

172. Vienna Convention, *supra* note 49, art. 31(1).

173. *Id.*, art. 31(4).

174. See Yasseen, *supra* note 169, at 55.

175. *Id.*

176. Vienna Convention, *supra* note 49, art. 31(3).

177. See *supra* Part III.A.

In contrast, Article 32 of the Vienna Convention states that accompanying material relating to a treaty may only be referred to as a supplementary source in cases of doubt. This rule was included to take into account multi-lateral conventions, which usually are drafted in difficult and protracted negotiations; states that later enter such a treaty, especially small and/or newly formed states, are often unaware of the voluminous materials that may accompany the treaty. Moreover, they cannot be expected to study all of these materials before entering the agreement. The "Technical Explanations," usually published by the United States Department of the Treasury in connection with the publication of a treaty text, and the Reports of the Senate Foreign Relations Committee regarding a particular treaty, do not constitute "materials" in this sense; nor does the memorandum which the German Federal Government submits to the legislature with the draft of the implementing legislation for a tax treaty.¹⁷⁸ These items reflect only the subjective interpretations of one of the treaty partners,¹⁷⁹ and they therefore cannot represent authoritative sources for interpretation. Only to the extent that these items reproduce the content of notes or exchanged letters between initialing and final signature do they constitute accompanying materials of the treaty in the sense of Article 32.

With respect to bilingual or multilingual agreements, Article 33 of the Vienna Convention provides (as did customary international law prior to the Vienna Convention) that the original versions in each language are equally binding.¹⁸⁰ Tax treaties generally are entered in the languages of both contracting states,¹⁸¹ if those states do not share the same language and if they do not agree that a version in a third language - usually English or French - will be binding. A domestic judge, therefore, when interpreting treaties, cannot and may not limit himself to the version of the treaty written in his mother tongue; the judge must always refer to the foreign version as well.¹⁸² If the contracting states have agreed that in cases of doubt a version in a third language shall be decisive, the judge must also take this version into consideration. In such cases, the third version, of course, must also have been approved through the applicable constitutional procedure and must be applicable under domestic law.

It is inevitable in the case of such bilingual or multilingual treaties that discrepancies in meaning between the various linguistic versions will arise. According to the Vienna Convention,¹⁸³ in such cases that interpretation is to be chosen which best harmonizes both (or all) texts. If the two (or more)

178. See *supra* Part III.A.

179. A contrary view is expressed in Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 130.

180. Mössner, *Die Auslegung mehrsprachiger Staatsverträge*, 1971-72 ARCHIV DES VÖLKERRECHTS 273; M. HILF, *DIE AUSLEGUNG MEHRSPRACHIGER VERTRÄGE* (1973).

181. See *supra* Part III.A.

182. For numerous arguments, see M. HILF, *supra* note 180 and accompanying text.

183. Vienna Convention, *supra* note 49, art. 33(4).

versions are irreconcilable - which can result, for example, from a drafting error - the interpretation is to be guided by the Vienna Convention, that is, by considering the object and purpose of the treaty, its context, and any supplementary means of interpretation.¹⁸⁴ If this approach is not possible, the treaty is defective due to the contradiction, and the case is not governed by the treaty provision in question.¹⁸⁵

C. *The Principle of Common Interpretation, the Importance of the OECD Model Treaty and of Parallel Treaties*

In order for tax treaties to be applied efficiently and fairly, courts of different countries must strive to interpret treaty provisions consistently. This principle of common interpretation is already well-established in many jurisdictions. Moreover, the OECD Model treaty provides a foundation for an actual common interpretation of particular provisions by different states. Finally, parallel treaties of a given state may also provide some guidance in the interpretation of other treaties of that state.

1. *Common Interpretation*

Tax treaties are meant to allocate tax claims equally between the contracting states. This goal can only be achieved if the treaty is applied consistently by the authorities and courts of both contracting states. In interpreting tax treaties, therefore, an interpretation should be sought which is most likely to be accepted in both contracting states.¹⁸⁶ This precept of "common interpretation" is also recognized in private international law with regard to the interpretation of conflict rules.¹⁸⁷ It is further recognized for the interpretation of numerous international agreements concerning the standardization of such areas of private law as the law of commercial paper, the international law of sales, and private international highway, air and sea transport law, as well as for the provisions of domestic law that affect these treaties.¹⁸⁸

184. *Id.*, arts. 31, 32; for an example taken from the tax treaties between Germany and Great Britain, see *infra* Part V.C.

185. According to Article 5(3) of the Convention for the Avoidance of Double Taxation, Oct. 31, 1925, Germany-Italy, 1925 RGBl, II 1146, 1148, the German version of the rules covering dividends also apply to income from other "securities" ("Wertpapiere") "that are substantially equivalent to stock" ("die in ihrem Wesen der Aktie entsprechen"). This does not include shares of a German limited liability company (GmbH). See 1935 RStBl 1160; 1936 RStBl 1209 (regarding the German treaty with Switzerland). The Italian version would include GmbH shares, but because of the contradiction between the two versions the provision is not valid as far as it refers to "valori mobiliari" which are not "Wertpapiere". Consequently, the treaty provisions concerning business activities apply.

186. Flick, *supra* note 137, at 151.

187. P. NEUHAUS, DIE GRUNDBEGRIFFE DES INTERNATIONALEN PRIVATRECHTS 49 (2d ed. 1976); G. KEGEL, INTERNATIONALES PRIVATRECHT 55 (4th ed. 1977).

188. Bayer, *supra* note 146, at 611 (and case law cited therein); J. KROPHOLLER, INTERNATIONALES EINHEITSRECHT 277, 281 (1975); Munday, *The Uniform Interpretation of International Conventions*, 27 INT'L & COMP. L. Q. 450, 458 (1978); Buchanan & Co. v. Babco Shipping Ltd., [1977] 2 W.L.R. 107, 112, [1977] 3 W.L.R. 907, 912; Fothergill v. Monarch Airlines, [1980] 3 W.L.R. 209, 218.

In interpreting the tax treaty between the United States and Canada, for example, Canadian courts have referred to decisions of authorities and courts in the United States, noting that these decisions, although not binding on Canada, are nevertheless persuasive.¹⁸⁹ The Canadian courts have emphasized that inconsistencies with the U.S. decisions should be avoided because they can result in double taxation.¹⁹⁰ The courts of the United States have responded similarly, creating a productive dialogue.¹⁹¹

In Germany, the Reichsfinanzhof and the Bundesfinanzhof have applied the principle of common interpretation in cases involving international model agreements,¹⁹² regulations acknowledged by authorities of another state,¹⁹³ parallel treaty provisions,¹⁹⁴ and decisions of a foreign court.¹⁹⁵ The concept of common interpretation is also embodied in Article 33, paragraph 4, of the Vienna Convention regarding the interpretation of treaties negotiated in multiple languages.¹⁹⁶

"Common interpretation" does not mean that the case law of the other state must be accepted without review. In *Corocraft v. Pan American Airways*,¹⁹⁷ it is true, Lord Denning did support the following of foreign decisions as if they were binding, stating "even if I disagreed, I would follow them in a matter which is of international concern. The courts of all the countries should interpret this convention in the same way."¹⁹⁸ But this statement, while certainly impressive, goes too far. Decisions of foreign courts can be very inconsistent, as is shown, for example, in *Ulster Swift, Ltd. v. Taunton Meat Haulage Ltd.*¹⁹⁹ In addition, even a majority or uniform legal view of foreign courts cannot be considered binding.²⁰⁰ A good example of common interpretation is the decision of the House of Lords in *Fothergill v. Monarch*

189. Number 630 v. M.N.R., 59 D. TAX 300, 303 (1959).

190. Canadian Pacific Ltd. v. The Queen, 76 D. TAX 6120, 6135 (1976).

191. Donroy, Ltd. v. United States, 301 F.2d 200 (9th Cir. 1962). See also United States v. A.L. Burbank & Co., Ltd., 525 F.2d 9 (2d Cir. 1975), cert. denied, 426 U.S. 934 (1976) (Second Circuit Court of Appeals reached a conclusion different from the Canadian case law). See S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NON-RESIDENT ALIENS IX/7 C (Practicing Law Institute 1971).

192. See *infra* Part IV.C.2.

193. [1969] II BStBl 579, 581 (regarding the German treaty with the United States).

194. 1938 RStBl 188, 189 (regarding the German treaty with Czechoslovakia); [1972] II BStBl 281, 283 (regarding the German treaty with Italy). For a further comparison, see Flick, *supra* note 137, at 160.

195. See [1970] II BStBl 660 (regarding the Austrian Constitutional and Administrative Court).

196. See text of the Vienna Convention, *supra* note 169, art. 33(4).

197. *Corocraft Ltd. v. Pan American Airways Inc.*, [1968] 3 W.L.R. 1273, 1283 (opinion of Lord Denning).

198. *Id.*

199. *Ulster-Swift, Ltd. v. Taunton Meat Haulage Ltd.*, [1977] 1 W.L.R. 625, 631.

200. See P. WERY, DE AUTONOMIE VAN HET EENVORMIGE PRIVAATRECHT 24 (1971); cf. J. KROPHOLLER, *supra* note 188, at 281.

Airlines.²⁰¹ In this case, the House of Lords thoroughly discusses and evaluates the foreign case law and commentary,²⁰² while emphasizing that the persuasive value of a decision depends, among other things, on the reputation and rank of the foreign court in question.²⁰³ The situation, in other words, is similar to that in which a court considers the decisions of another court of equal competence within the same state.

Common interpretation is also a rule of interpretation in domestic law: a judge is expected to examine the decisions of other courts and evaluate their reasoning. Rather than adhering stubbornly to a unique personal view, he must choose the interpretation most likely to find general acceptance by courts. The same is true with regard to courts in other countries. As Lord Scarman quite correctly observed: "Our courts will have to develop their jurisprudence in company with the courts of other countries from case to case"²⁰⁴

A significant problem which arises regarding common interpretation is the practical one of information. A judge is obliged to consider decisions of foreign courts, at least those regarding the treaty in question that are brought to his attention by the parties. If he cannot read the foreign language, he must have the decisions translated. Naturally, he will make allowance for the fact that the parties will attempt to provide him primarily with decisions that are most favorable to their positions. In addition, the judge must use all available means to find relevant cases of foreign courts on his own.

This duty to conduct research is subject, however, to a limitation of reasonableness, and in view of the limited possibilities currently existing in most countries to research foreign case law, the boundary of reasonableness will often be reached rather quickly. Nevertheless, exceptions do exist. The decisions of English-speaking courts are available as a rule to British and American judges without great difficulty, as are those of the Austrian Administrative Court and the Swiss Federal Court to the German judge.

2. *The OECD Model Treaty and Its Commentary*

The OECD Model and its Commentary are very important for the interpretation of tax treaties in that they provide a source from which courts of different states can seek a common interpretation.²⁰⁵ As early as 1934 the German Minister of Finance, to support an interpretation of the Reichsfinanzhof, referred to the models and the explanations submitted at the

201. *Fothergill v. Monarch Airlines*, [1980] 3 W.L.R. 209.

202. *Id.* at 217.

203. *Id.* at 225.

204. *Id.* at 234 (opinion of Lord Scarman).

205. For a discussion of this subject, see Avery Jones, *The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model* (pt. 2), 1984 BRIT. TAX REV. 90, 100. See also G. TIXIER, *DRÖIT FISCAL INTERNATIONAL*, ¶¶ 424, 429-431 (1979).

League of Nations Double Taxation Conference in 1928.²⁰⁶ The Second Circuit Court of Appeals in *United States v. Burbank*,²⁰⁷ the Dutch *Hoge Raad* and the Swiss *Bundesgericht*²⁰⁸ have all relied on the OECD Model in interpreting treaties.²⁰⁹ Similarly, the *Bundesfinanzhof* in one instance has even referred to the OECD Model with respect to a treaty which entered into force prior to publication of the model and which, therefore, was not based on the model.²¹⁰ It has not, however, made reference to the model in interpreting the treaty with Italy, because that treaty was already entered into in 1925.²¹¹

Such interpretation by reference to the OECD Model is not inconsistent with the Vienna Convention. The “preparatory work” within the meaning of Article 32 refers to the materials of an individual treaty, not to the OECD Model or Commentary. In contrast to the preparatory work applicable to an actual agreement, the OECD Model and the Commentary are generally known and easily obtainable. No reason exists, therefore, to refer to these sources only as secondary means of interpretation, as is the case for “preparatory work” within the meaning of Article 32.

The significance of the OECD Model and the Commentary for treaty interpretation, however, is not limited to their use in the interpretation of individual treaties. They were, in addition, the objects of two important recommendations of the OECD Council of July 30, 1963 and April 11, 1977, in which the Council recommended that the governments of the member states follow the model “when concluding new bilateral conventions or revising existing bilateral conventions between them, to conform to the Model Convention . . . as interpreted by the Commentaries thereto” Under Article 18(c) of the procedural rules of the OECD, a Council recommendation obligates the member states to examine whether the recommended measures are appropriate or opportune.²¹² In OECD practice, the legal importance of recommendations is even greater,²¹³ as evidenced by the fact that states often have filed “reservations” or included “observations” regarding their particular interpretation of a recommendation when filing their general consent to the commentary. Such an affirmative action would have been unnecessary if

206. 1934 RStBl 417, 419 (regarding the German treaty with Italy).

207. *United States v. A.L. Burbank & Co., Ltd.*, 525 F.2d 9, 15-17 (2d Cir. 1975), cert. denied, 426 U.S. 934 (1976) (regarding the United States treaty with Canada from 1942).

208. 1976 BNB 121 (regarding the Germany/Netherlands treaty); 102 BG Ib 264, 269 (1976) (regarding the Swiss Treaty with Spain).

209. See Korn & Debatin, *Systematik III*, supra note 3, at Rdn. 131; see generally Ward, supra note 137, at 268-70.

210. [1966] III BStBl 24, 27; [1966] III BStBl 463, 464 (regarding the German treaty with Switzerland).

211. [1972] II BStBl 281, 283.

212. H. HAHN & A. WEBER, DIE OECD-ORGANISATION FÜR WIRTSCHAFTLICHE ZUSAMMENARBEIT UND ENTWICKLUNG 99 (1976); Guillaume, *L'Organisation de Coopération et de Développement Economiques et l'Évaluation récente de ses Moyens d'Action*, 1979 ANNUAIRE FRANÇAIS DE DROIT INTERNATIONAL 75.

213. See Guillaume, supra note 212.

a recommendation merely obligated the states to examine whether the recommendation was appropriate. At least some form of a "soft" obligation must therefore be derived from the recommendation regarding the OECD Model. The model must be applied unless the member state has entered original reservations or unless material reasons, such as peculiarities of the domestic law of the contracting state, weigh against the adoption of the model with regard to a particular treaty provision. The recommendation, in other words, generates "a loose legal duty, but a legal duty nonetheless."²¹⁴

a. Tax Treaties Between OECD Countries

As far as the interpretation of tax treaties between OECD countries is concerned, the following general points can be observed.

First, if the text of the OECD Model has been adopted unchanged, it is to be assumed that the contracting states intended to conform to the Council's recommendation. It follows that when interpreting such treaties, whether or not official versions are drafted in one or more languages, the model in both its original language versions (English and French) must be considered in addition to the individual treaty text(s). Moreover, the particular versions of the Commentary which applied at the time the treaty was entered must be considered. Consequently, the 1977 Commentary is important in principle only for treaties entering into force after April 11, 1977 and only as far as the treaty negotiations were based on the 1977 Model. Both the 1977 Model and the 1977 Commentary contain various formulations, however, that are intended only to clarify what in the opinion of the OECD Committee on Fiscal Affairs already applied under the 1963 OECD Model. In addition, paragraph 30 of the 1977 Report expresses an expectation that states will interpret treaties based on the 1963 model in the spirit of the 1977 Commentaries, and that states should clarify their intentions in this regard by means of an exchange of letters between competent authorities in accordance with the mutual agreement procedure. This OECD statement, of course, does not eliminate the need for examining in each individual case whether the new version in fact only "clarifies" treaty law or whether it is an attempt to change it. While the Commentary is, of course, an important source of interpretation, it expresses only an individual view and is not binding on its own. Some treaties, it is true, expressly support interpretation by reference to the Commentary. The negotiating protocol for the tax treaty between Germany

214. Dahm, *Die völkerrechtliche Verbindlichkeit von Empfehlungen internationaler Organisationen*, 1959 DIE ÖFFENTLICHE VERWALTUNG 363, 364. The United States has been reluctant to conform to the OECD Model. Rosenbloom explains this as a consequence of the relatively late and detached participation of the United States in drafting the model which resulted in the predominant application of European terminology and practice. See Rosenbloom *supra* note 24, at § 31.04[2]. However understandable this attitude may be, it does not alter the fact that the United States did have the opportunity to file reservations to the OECD Model. As has been mentioned before, however, the publication of the U.S. Model was an important step towards a better assimilation of U.S. treaty practice to the OECD Model.

and Switzerland of 1971, for example, requires the contracting parties to interpret the treaty according to the standards of the OECD Commentary. Obviously this reference applies directly only to the 1963 Commentary. It is clear, on the other hand, that the Commentary cannot be applied to the extent that contracting states have indicated a divergent view by entering a reservation or an observation.

Second, if (a) the language of the OECD Model is not adopted literally, but a formulation is adopted that permits an interpretation consistent with the model, or (b) a provision was adopted literally, but a related provision that differs from the OECD Model suggests a different interpretation of the literally adopted provision, a presumption arises, nevertheless, that an interpretation consistent with the OECD Model should apply.

It is only if (a) and (b) above occur simultaneously, in other words, if a model provision is not adopted literally and the context suggests an interpretation diverging from the model, that the OECD Model and Commentary may be disregarded in determining the proper interpretation of the provision.

b. Tax Treaties with Non-OECD Countries

In contrast, with regard to the interpretation of treaties with non-OECD States, the OECD Model and Commentary are less important. An intention by the contracting parties to adopt a provision within the meaning of the OECD Model can be presumed only where (1) the language of the provision coincides with the OECD Model and (2) its context suggests no other interpretation. The weight to be given the Commentary in such cases cannot be stated generally, but rather must be determined according to the circumstances of the individual case. With regard to recent treaties with developing countries, the UN Model must be considered as well, but since both models coincide for the most part, the OECD Model and Commentary can be helpful for these treaties, too.

3. Parallel Treaties

Even where the treaties of a particular state deviate from the model on which they are based, such deviations are often relatively consistent.²¹⁵ Negotiators tend to incorporate formulations developed in prior negotiations into subsequent treaties. This may result from the particular interests of the state for which they are acting; it may also result, however, from demands of a new treaty partner. It often occurs, for example, that concessions made once to a treaty partner (for example, to a developing country) are demanded subsequently by similarly situated partners and are difficult to deny to them. Thus, each state develops its own standard formulations, and incorporates them, parallel to those of the OECD and UN Models, in its negotiations.

215. See Vogel, *Abkommensvergleich als Methode bei der Auslegung von Doppelbesteuerungsabkommen*, 1983-84 *STEUERBERATER-JAHRBUCH* 373.

They are carried forward as needed into subsequent treaties, and, therefore, even if they are not summarized in an independent treaty model (like the US Model), they produce an additional level of continuity in the tax treaties of the respective state.

On the other hand, the use of such standard formulations, as well as of model treaties, should never eclipse the fact that each individual treaty is autonomous, that it concerns important and conflicting interests of the two contracting states, and that a coordination of these interests will usually be reached only after difficult and protracted negotiations. One need only listen on those rare occasions, usually at a very late hour, when former tax treaty negotiators relate their war stories: stories of delaying negotiation on important issues until the airplane for the return trip is ready to take off, so that the other party is forced to make additional concessions if the negotiations are to be concluded in the current round; stories of the famous night negotiations, in which the physically robust have the advantage; stories of the host delegation that promised to serve an evening buffet after conclusion of the negotiations, and even arranged the food in an adjacent room in view of the delegation, only to prolong the negotiations mercilessly into the night (according to rumor, the hosts were able to sneak out individually for snacks during the negotiations). Even if ninety percent of these stories may be simply "negotiator stories", comparable to stories told by sailors or hunters, enough remain to demonstrate that treaties very often result from stubborn and wily battles in which the negotiating parties are ready, willing and able to make use of every possible advantage. This fact cannot be neglected when interpreting tax treaties.

In interpreting an individual treaty, inferences from other treaties into which a contracting state has entered can therefore be drawn only with extreme caution. Differences in express language do not necessarily imply that substantive differences are intended. In particular, the absence from one treaty of a rule expressly contained in another treaty does not determine conclusively that this rule does not apply (no *argumentum e contrario*). It is entirely conceivable that a contracting state in one instance desired a clarification not deemed necessary by the parties to other treaties. It even occurs occasionally that a particular rule is expressly negotiated out of the treaty, but then nevertheless applies through the application of another provision of the same treaty. For instance, it may be intended that particular items of income be excluded from taxation in the country of residence and that the provision referring to them is therefore omitted, but that, by means of a catchall clause corresponding to Article 21 of the OECD, UN, and U.S. Models, the income is still allocated to the residence country in the end. Such discrepancies can be a result of the tenacity of negotiators on both sides.

Furthermore, the fact that a state's treaty practice does not forever remain unchanged must be taken into consideration, too, when referring to parallel treaties. It is clear that treaty policy changes, as do the particular

formulations of treaty provisions used by a state. The meaning of a rule can be derived by reference to a similar or divergent rule in another treaty only if both treaties are considered in light of the prior and subsequent treaties of both contracting states. In addition, it should be noted that the influence of one treaty on another does not depend on the order in which the treaties enter into force, but rather on the order in which they are negotiated. This order, of course, is often difficult to determine. Occasionally, it may also be necessary to distinguish between various types of treaties negotiated simultaneously by a particular state. For example, with regard to German practice between 1954 and the early 1960s, three types of treaties can be distinguished: 1) those entered into with neighboring European countries; 2) those entered into during the same period with Anglo-American countries, including the treaty with Egypt and, for unknown reasons, the treaty with Greece; and 3) the treaty entered into with France, which follows a pattern of its own. Currently, although their differences are less radical, German treaties can be divided into those with Western industrial nations, those with developing countries, and those with communist countries. The category of a particular treaty may be a determining factor in the interpretation of a provision.

V

TREATY SUBJECTS: "PERSONS" AND "COMPANIES"

Treaty interpretation often involves interpreting a term which has been defined internationally in the tax treaty itself. In other words, it must often be determined whether a particular fact situation falls within a category delineated by the treaty. This Part examines such interpretation by focusing on the issue of treaty entitlement under the OECD Model. Since the treaty applies to "persons who are residents of one or both of the Contracting States," it is critical to decide which parties qualify as "persons". While many different types of entities could be considered "persons", this Part deals only with one category, that of "companies", in order to illustrate how treaty interpretation plays a role in determining who is entitled to benefit from treaty provisions.

A. Model Treaty Terms

Under Article 1 of the OECD Model, all "persons who are residents of one or both Contracting States" but only they are entitled to treaty protection.²¹⁶ Furthermore, Article 3(1)(a) provides that "companies" are persons for purposes of the OECD Model Treaty. The concept of "person" is at the heart of all of the model provisions, whether the person be the recipient of income, the owner of property, the object of procedural provisions, or the beneficiary of treaty entitlements. A party's characterization as a "person"

216. OECD Model, *supra* note 1, art. 1. The term "resident of a contracting state" is defined in art. 4; the terms "person" and "company" are defined in art. 3(1)(a) and (b).

("treaty subject"), if "residence" under Article 4 is established, confers on that party the authority to claim rights under the treaty, as well as the obligation to accept its less desirable consequences. This authority and obligation is referred to in German as *Abkommensberechtigung* ("treaty entitlement").

While "companies" in general are treated as persons under the OECD and UN model treaties,²¹⁷ "partnerships" are not specifically singled out.²¹⁸ A uniform treatment of partnerships has been extremely difficult to achieve, given the significant differences in their treatment under domestic law.²¹⁹ For example, although not attributed legal personality, partnerships and their corresponding foreign counterparts are often subject to, or can elect to be subject to, corporate level taxation in continental European countries; their "distributions" are then taxed as dividends. In the United States, on the other hand, partnership tax liability, both individual and corporate, is determined by special tax criteria that differ from those in civil law jurisdictions.²²⁰ In Greece, even income of a German limited liability company (GmbH),²²¹ a juridical person, is treated as income of its shareholders for tax purposes, and they are taxed in the same way as are partners of a German general partnership (oHG).²²² Due to these differences, the Committee on Fiscal Affairs of the OECD did not feel that it was in a position to suggest a uniform rule for partnerships and similar forms of business organization.²²³

The taxation of a particular business organization often raises a series of issues under the OECD Model, particularly the following:

- (1) whether the business organization is a "person", e.g., a treaty subject;
- (2) whether (under treaty law) the income it generates is considered that of the business unit or that of its members or shareholders;
- (3) how to separate these items of income from other income of the members or shareholders, especially with respect to items of income derived from individual business relationships between these parties and the enterprise; and
- (4) whether profit distributions are dividends under Article 10 of the OECD Model.

217. Commentaries on the Articles of the Model Convention, art. 3, comment 2 in 1977 Report, *supra* note 2, at 51, reprinted in 3 R. RHOADES & M. LANGER, *INCOME TAXATION OF FOREIGN RELATED BUSINESS TRANSACTIONS* § 15.05-15.05[29] (1980) [hereinafter cited as OECD Commentary].

218. They are included in the U.S. Model, *supra* note 1, art. 3(1)(a). Article 4(1)(b), however, partly revokes this by providing that that partnerships can qualify as residents in the other contracting state only if they are taxable there as such. In the United States, and in contracting states with similar legislation, partnerships are residents only to the extent that their partners are.

219. For an overview, see Philipp, *Partnerships and Joint Enterprises in International Tax Law* (General Report), 58b C.D.F.I., 59 (1973); D. PILTZ, *PERSONENGESELLSCHAFTEN IM INTERNATIONALEN STEUERRECHT DER BUNDESREPUBLIK DEUTSCHLAND* 52 (1981).

220. Treas. Reg. § 301.7701-2 (1960), as amended by T.D. 6797 (1965), T.D. 7515 (1977), T.D. 7889 (1983).

221. Gesellschaft mit beschränkter Haftung (GmbH).

222. Offene Handelsgesellschaft (oHG).

223. OECD Commentary, *supra* note 217, art. 1, comment 2.

Similar questions arise with regard to other bodies of persons or to capital funds treated partially or totally as independent entities for tax purposes, where the members or beneficiaries assume the role of shareholders.

While all four issues are of significance, this Part will deal only with the first, that is, whether a particular entity constitutes a "person" thereby qualifying as a treaty subject.²²⁴ This Part thus examines in detail the interpretation of a particular term which has been defined at the international level by the treaty itself.

B. Model Treaty Rules for "Person" and "Company"

1. Main Features

Article 3(1) of the OECD Model defines the terms "person" and "company" within the context of a catalog of general definitions. In this respect, the Article adopts a treaty practice developed by Anglo-American countries.²²⁵ The first treaty containing such a definitional catalog as well as a general rule of interpretation comparable to Article 3(2) of the OECD Model was the treaty between the United Kingdom and the United States of April 16, 1945.²²⁶ Thereafter, the United Kingdom adopted the pattern in almost all of its treaties. Other states in the Commonwealth followed gradually, and beginning in 1948 the United States adopted the pattern too. Such a development may imply that the provision was drafted originally by British lawyers.²²⁷

Both paragraphs of Article 3 of the OECD Model are limited by the clause "unless the context otherwise requires." The same reservation, typical of Anglo-American treaty technique, is also found in the 1945 treaty between the United Kingdom and the United States. The strict adherence of English judges to statutory language²²⁸ requires as counterweight that definitions,

224. For the possibility of deriving the type of income involved from the fact that the person or entity is entitled to treaty protection, see *infra* Part VI.D.1.

225. The model treaties of the League of Nations, *supra* note 29, did not contain such a "definitions article"; nor did they contain the rule of interpretation of art. 3(2) of the OECD Model, *supra* note 1. To the extent that treaties entered prior to World War II contain a catalogue of definitions, they were embodied in final protocols.

226. Avery Jones points out that a 1940 Treasury Regulation under the US-Sweden treaty (1939), T.D. 4975, 1940-2 C.B. 43, 52, refers to domestic law as far as there are no definitions in the treaty, but without the clause crucial to art. 3(2) of the OECD Model, "unless the context otherwise requires." Avery Jones, *The Interpretation of Tax Treaties With Particular Reference to Article 3(2) of the OECD Model* (pt. 1), 1984 BRIT. TAX REV. 14, 18 n.14.

227. The Committee on Fiscal Affairs of the OECD drafted Article 3 only in the last phase of its work on the OECD Model following its fourth report to the council in 1961.

228. See *supra* Part III.C.1.

however precise, be drafted with flexibility.²²⁹ Such flexibility may be accomplished by leaving the definition expressly open²³⁰ or by reserving a divergent interpretation from the context.²³¹ In other words, the reservation in both paragraphs of Article 3 has no other function in Anglo-American law than to provide the judge with a degree of freedom in interpretation, which the continental judge enjoys in any event without express reservation.²³²

2. Requirements in Detail

Under Article 3(1)(a) of the OECD Model "persons" specifically include:

- (1) individuals;
- (2) companies, which under Article 3(1)(b) includes:
 - bodies corporate;
 - entities that are treated as bodies corporate for tax purposes; and
- (3) all other bodies of persons.

"Individuals" are natural persons. Whether an individual legally exists and, therefore, can be subject to taxation is determined by the domestic tax law of the state applying the treaty,²³³ which ordinarily refers to private law. Thus, under German private law, and consequently under German tax law, legal capacity begins at birth;²³⁴ in contrast, under French law, a newborn child obtains legal capacity only if it is viable.²³⁵ Under common law the question appears unclear.

Reference to private law includes reference to the private international law (conflicts law) of the state applying the treaty. Thus, for example, the provision of the German Civil Code which refers to legal capacity,²³⁶ applies only to German citizens. A child born in Germany which would be a French citizen if it had legal capacity, but which is not viable, would fail to obtain legal capacity and, thus would not be treated as a "person" for tax purposes. A German child, however, in a similar case could obtain legal capacity, acquire property, and consequently incur tax liability.

229. Noteworthy is Paragraph II(c) of the Final Protocol of the German treaty with Australia, where it was deemed important to emphasize that terms in the singular include the plural and terms in the plural, the singular "unless the context otherwise requires."

230. For example, in *Beswick v. Beswick*, [1967] 3 W.L.R. 932, 940, 942, and 946, the House of Lords relied on the formulation "unless the context otherwise requires" to correct an apparent editing mistake. For a discussion of the possible importance of the term "context" in Article 3(2) see *infra* Part VI.C. For an example of an interpretation according to the context contrary to the language of Article 3(1), see the opinion of the Finanzgericht Hamburg in 1978 Entscheidungen der Finanzgerichte 10 (regarding the term "Gesellschaft" (company) in the German treaty with Switzerland).

231. This formula (the same as in art. 3(1) and (2) of the OECD Model) can be found, for example, in the British Income and Corporation Taxes Act, 1970, ch. 10 §§ 90 and 527.

232. For example, in *Beswick v. Beswick*, [1967] 3 W.L.R. 932, 940, 942, and 946, the House of Lords relied on the formulation "unless the context otherwise requires" to correct an apparent editing mistake. For a discussion of the possible importance of the term "context" in Article 3(2) see *infra* Part VI.C. For an example of an interpretation according to the context contrary to the language of Article 3(1), see the opinion of the Finanzgericht Hamburg in 1978 Entscheidungen der Finanzgerichte 10 (regarding the term "Gesellschaft" (company) in the German treaty with Switzerland).

233. See *infra* Part VI.B.

234. BÜRGERLICHES GESETZBUCH [BGB] § 7.

235. CODE CIVIL [C. CIV.] art. 725.

236. BGB § 7.

As a subset of “companies”, “bodies corporate” are entities to which the legal system attributes legal capacity to the same general extent that it does to individuals, with the exception of legal relationships that from their very nature are restricted to natural persons, such as family relationships. Even though not expressly stated, the OECD Model proceeds from the assumption that bodies corporate are subject to tax under the law of the contracting states as are individuals. For treaty purposes, however, they would still remain “persons” even if they were not taxable in one of the states.

Foreign states, their political subdivisions and local authorities are bodies corporate, and thus “companies.” Partial legal persons (*Teilrechtspersonen*) to which only partial legal capacity within the legal system is granted, are not bodies corporate within the meaning of the provision; they are therefore “persons” under treaty law only when the requirements of the second alternative of Article 3(1)(b) are fulfilled.²³⁷

In contrast to Article 24(2)(b) of the OECD Model, Article 3 is not limited to bodies corporate organized under the law of one of the contracting states. As a practical matter, however, because under Article 1 only persons resident in the contracting states are covered by the treaty, only those bodies corporate that are recognized as taxable entities under the law of at least one of the contracting states are involved.²³⁸ Entities that are treated as bodies corporate for tax purposes are, in other words, entities that are taxed as such according to the law of the state in which they are resident. They are entities, the income and property of which is not attributed to their beneficial owners or interested parties.

It is not necessary, however, that the state in which the entity is a resident tax distributions from such entities in the same manner as it taxes dividends. Therefore, foundations lacking legal capacity are also included in the definition of bodies corporate.²³⁹ As a rule, Anglo-American law includes trusts²⁴⁰ and undivided estates in this category to the extent that they are treated as taxable entities in the state of their residence. In Germany, *Vereine* (clubs), *Anstalten* (institutions), *Stiftungen* (foundations) and other *Zweckvermögen* (special purpose funds) that do not have legal capacity are included,²⁴¹ as are foreign corporations, bodies of persons and funds, to the extent that they have income in Germany.²⁴²

237. In addition they could be “bodies of persons” within the meaning of art. 3(1)(a).

238. Another issue is whether under substantive domestic tax law even those bodies of persons that are not recognized as legal entities can be subject to limited tax liability; see A. RAUPACH, *DER DURCHGRIFF IM STEUERRECHT* 143 (1968).

239. OECD Commentary, *supra* note 217, art. 3, comment 2.

240. The U.S. Model now expressly includes trusts in its definition of a “person”, see *supra* note 1, art. 3(1)(a).

241. KStG § 1(1)(5).

242. KStG § 2(1).

The reference to the rules of a foreign legal structure under the terminology of domestic income or corporate tax law is not a question of treaty application. While such analysis is often referred to misleadingly as *qualification*,²⁴³ it would be better to call it "substitution" or "classification" (*Einordnung*) as does the German Bundesfinanzhof.²⁴⁴ According to the law of many countries, a foreign legal characterization is not controlling, nor is the foreign tax treatment of a particular entity. On the contrary, it must be determined whether the foreign entity, by its legal structure and economic position, is more comparable under domestic law to an entity that is subject to corporate taxation or to a body of persons such as a partnership.²⁴⁵ In the United States, this approach follows from the characteristics of a corporation, as established by Treasury Regulation.²⁴⁶ It has been the law and practice in Germany for many years, and a proposed diverging view and administrative practice have not been accepted in German practice.²⁴⁷ According to these same principles, a *sociedad de responsabilidad limitada* under Chilean law has been held to correspond to the German limited liability company (GmbH).²⁴⁸ Similarly, the IRS has treated a Brazilian *limitada* as a corporation under U.S. income tax laws.²⁴⁹ Austria also determines the characterization of foreign legal entities primarily according to these principles.²⁵⁰

Finally, according to Article 3(1)(a) of the OECD Model, other bodies of persons constitute "persons" for treaty purposes, too. The formulation of this category in both original versions of the model is as broad as conceivable: "tous autres groupements des personnes" or "any other body of persons". The definition relates back to certain British treaties from the period between the First and Second World Wars regarding the mutual exemption of business profits, in which "person" is defined as "any body of persons, corporate

243. See, e.g., Arendt, *Zum Qualifikationsproblem, (II): Anwendung deutscher Sachnormen auf ausländische Privatrechtsinstitute*, 37 *STEUER UND WIRTSCHAFT* 350 (1960).

244. For a further discussion of the terminology, see *infra* Part VI.A.

245. The fundamental decision in this area was 1930 RSStBl 444 (regarding a limited partnership under Venezuelan law). See Arendt, *supra* note 243; A. RAUPACH, *supra* note 238, at 135. Similarly with regard to the German business tax (*Gewerbesteuer*), see [1983] II BStBl 77.

246. Treas. Reg. §§ 301.7701-2, *supra* note 220. See New York State Bar Assoc., *Report on Foreign Entity Characterization for Federal Income Tax Purposes*, 35 *TAX L. REV.* 169 (1980).

247. For this diverging view, see Hintzen, *Zur Qualifikation ausländischer körperschaftsteuerpflichtiger Personengesellschaften*, 51 *STEUER UND WIRTSCHAFT* 319 (1974); Coordinated State Decree, 1973 *FINANZRUNDSCHAU* 216, which was subsequently withdrawn. Compare Streck, *Eine Verwaltungsentscheidung zur Qualifikation ausländischer Personengesellschaften*, 1973 *FINANZRUNDSCHAU* 537; Krabbe, *Qualifikationskonflikte bei ausländischen Personengesellschaften*, 1976 *RECHT DER INTERNATIONALEN WIRTSCHAFT/AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS* 135; Kluge, *Die Anerkennung ausländischer Gesellschaften im deutschen Steuerrecht*, 14 *DEUTSCHES STEUERRECHT* 365 (1976); Wurster, *Die Anerkennung ausländischer Körperschaften im deutschen Ertragsteuerrecht*, 1950 *FINANZRUNDSCHAU* 588.

248. Letter from the Bundesminister der Finanzen (December 1, 1980), *reprinted in* 1980 *FINANZRUNDSCHAU* 70.

249. See I.R.S. Private Letter Ruling 8401001 (June 16, 1983).

250. Philipp, *supra* note 219, at 63. For the Swiss view, see K. ALIG, *PERSONENGESELLSCHAFTEN IM INTERKANTONALEN UND INTERNATIONALEN STEUERRECHT* 347 (1980).

or not corporate”.²⁵¹ Because bodies corporate and other entities that are taxed as bodies corporate are already included as “companies” under Article 3(1)(b), only structures that neither have independent legal capacity nor are independently taxable can constitute “other bodies of persons”. For instance, this category could refer to clubs that lack legal capacity (*nicht rechtsfähige Vereine*), where they are not taxable under foreign law.

Moreover, a convincing Swiss view includes partnerships in this category, too.²⁵² The broadly drafted language of both the French and English versions clearly allows the inclusion of partnerships.²⁵³ Moreover, the history of the definition, as well as the 1963 Commentary, support such an interpretation.²⁵⁴ Although the Commentary to Article 3²⁵⁵ proceeds from an apparently different view, this cannot support an interpretation of Article 3 which would be contrary to its express language. It is of interest in this context that the German tax treaty with Switzerland omits the formulation “any body of persons”, at the request of the German negotiators, precisely because partnerships are not taxable in both countries.²⁵⁶

3. Treaty Entitlement of Bodies of Persons

Characterization as a “person” establishes the individual or entity as a treaty subject; it does not yet establish, however, that the person is entitled to treaty protection. For this purpose, Article 1 requires that the “person” be “resident” in a contracting state. Article 4 of the OECD Model determines residence by examining whether a person in a contracting state “is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.” Regarding tax liability of partnerships and other “bodies of persons” several broad categories of factual situations can be distinguished:

a. Tax Liability in Both Contracting States

As a first case, it shall be assumed that an organization is deemed liable to taxation in both contracting states. This situation would arise, for

251. Agreement for the Reciprocal Exemption from Income Tax on Certain Profits or Gains Arising through an Agency, Sept. 17, 1936, United Kingdom-Greece, art. 3, 176 L.N.T.S. 185, 188.

252. K. LOCHER, W. MEIER & R. VON SIEBENTHAL, *DOPPELBESTEUERUNGSABKOMMEN SCHWEIZ-DEUTSCHLAND 1971 UND 1978* B. 3.1.2. (Oct. 1979).

253. Apparently, it has been asserted in the OECD Committee on Fiscal Affairs that the term “body of persons” has a specific meaning according to English and Irish law that does not include partnerships and companies. Even if this is the case, this formulation does not apply in all English speaking legal systems. For example, the U.S. Model, *supra* note 1, art. 3(1)(a), provides, “the term ‘person’ includes an individual, a *partnership*, a company, an estate, a trust, and *any other* body of persons” (emphasis added). To be sure, the legal consequences that would follow from this language are eliminated by art. 4(1)(b). Regarding the U.S. Model, see *supra* Part II.C.

254. OECD Commentary, *supra* note 217, art. 3, comment 3.

255. OECD Commentary, *supra* note 217, art. 3, comment 2.

256. K. LOCHER, W. MEIER & R. VON SIEBENTHAL, *supra* note 252.

instance, if the organization is liable to tax by reason of its domicile or residence in one contracting state and liable to tax on its domestic source income in the other contracting state. In such a case, the company is a "person" according to Article 3(1)(a) and (b) and is "resident" in the first mentioned contracting state according to Article 4(1). Its entitlement to treaty protection is beyond doubt.

Similarly, the organization can be liable to tax by reason of its domicile or residence in both contracting states. In such a case, Article 4(3) of the OECD Model determines in which of the two states the organization is "resident" within the meaning of the treaty, and the organization is entitled to treaty benefits. Or, on the other hand, the organization can be liable to tax only on its domestic source income in both contracting states. In such a case, the organization is not deemed to be "resident" in either contracting state, and therefore it is not entitled to treaty protection.

b. Tax Liability in One Contracting State

Alternatively, the organization may be liable to tax as such in only one of the two contracting states. Many situations can bring about this result, and the treaty consequences of such cases are difficult to determine and widely disputed.

First, the organization can be liable to tax in the state in question by reason of its domicile or residence. In this case, the organization is a "person" according to Article 3(1)(a) and (b) and "resident" in that state according to Article 4(1); it is thus entitled to treaty protection. The tax consequences remain unclear, however, with respect to the other contracting state, if that state does not tax the organization itself, but rather the persons or entities owning interests in the organization. It is sometimes maintained that in such cases in the last mentioned contracting state — the source state — the treaty entitlement of the organization does not justify application of the treaty, but rather the treaty entitlement of the persons or entities owning interests in the organization (which normally fails, if they are not residents of the state in question). Such an argument is supported by the principle of subject identity, as well as by Article 3(2) of the OECD Model Treaty.²⁵⁷

Under this interpretation, however, the treaty entitlement of the organization would be legally meaningless, since the country of source could deny treaty protection simply by subjecting the shareholders to tax liability rather than the organization. Furthermore, such a treaty interpretation is unconvincing, since it is contrary to the purpose and object of the treaty.²⁵⁸ Rather, it must be assumed in such a case that the right of the organization to claim treaty protection "passes through" to its shareholders. In other words,

257. Diehl, *Qualifikationskonflikte im Aussensteuerrecht*, 1978 FINANZRUNDSCHAU 517, 521; Kluge, *supra* note 247, at 367; H. BECKENRATH, *DER DURCHGRIFF IM DEUTSCHEN AUSSENSTEUERRECHT* 108 (1978).

258. Vienna Convention, *supra* note 49, art. 31(1); *see supra* Part II.B.

treaty protection should apply to them even if they are not resident in the state in which the organization is taxed as an entity, and thus are not personally entitled to treaty protection.²⁵⁹ The income of such an organization is, therefore, primarily taxable in the state of residence of the organization, to the extent the source state is not entitled to tax those profits on the basis of Article 7 or some other treaty distributive rule.²⁶⁰ This solution poses difficulties, to be sure, if the shareholder is resident in a state that also has its own treaty with the source state. Here it may be assumed that the provisions more favorable to the taxpayer will apply.

A second situation giving rise to tax in only one of the contracting states occurs when the organization is liable to tax in its own capacity only in the country of source or as a result of its domestic source income. The organization then is a "person" within the meaning of the model treaty.²⁶¹ However, it is not liable to tax in such capacity in the state in which it is organized or managed. According to the language of Article 4(1) of the OECD Model, the organization in such a case would not be resident in that state (because it is not liable to tax therein "by reason of . . . its place of management or any other criterion of a similar nature") and, therefore, not entitled to treaty protection.²⁶² This interpretation is supported by the German Ministry of Finance.²⁶³ The language of Article 4(1) itself also supports this point of view. Moreover, the alteration of the heading of Article 4 from "Fiscal Domicile" under the 1963 Model, to "Resident" under the 1977 OECD Model could be viewed as supporting the same conclusion.²⁶⁴ The interpretation, however, could lead to a valuation conflict between Article 3 and Article 4 of the OECD Model to the extent that the characterization as "person" under Article 3 would be legally meaningless if the internal tax law of the state in which the seat of the organization is located does not treat the person as a tax subject.

For systematic reasons, therefore, a different interpretation is preferable. Article 4 is intended to establish a physical connection. To define "residence" it refers to those criteria that establish residence according to the domestic law of the contracting state. It is not the purpose of Article 4, however, to deny treaty protection "through the back door", if a person within the meaning of the treaty happens not to be a person, i.e., a tax subject, according to the requirements of domestic tax law. A person who is not liable to tax in the country in which its residence or its seat is located, because it has no income

259. See Korn & Debatin, *Systematik IV*, *supra* note 3, at Rdn. 135; Debatin, *supra* note 105, at 481; D. PILTZ, *supra* note 219, at 134.

260. Regarding the problems that arise in such cases, see *infra* Part VI.D & E.

261. See, e.g., as a "body of persons" under the OECD Model, *supra* note 1, art. 3(1)(a).

262. D. PILTZ, *supra* note 219, at 130.

263. See, e.g., with regard to Spanish partnerships, Letter from the Bundesminister der Finanzen (Mar. 19, 1976), reprinted in 1976 RECHT DER INTERNATIONALEN WIRTSCHAFT/AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS 305.

264. OECD Model, *supra* note 1, art. 4.

or property or because it is exempt from tax can nevertheless be "resident" there and thus be entitled to treaty protection. Similarly, if a "person" within the meaning of Article 3 of the OECD Model is not taxable as such, it should not be treated differently.²⁶⁵ It should be considered a "resident" if its physical connection to the contracting state meets those criteria which, if a tax liability existed, would cause the entity to be taxable as a resident. In the source state, which treats it as an independently taxable entity, the organization should consequently be able to claim treaty protection.

A third case in this category is posed when an organization is liable to tax in the source country on its domestic source income, but is not, however, a "person" within the meaning of the treaty, perhaps because the actual provisions of the treaty do not expressly include partnerships or, more generally, bodies of persons under the definition of "persons". In this situation, the requirements of Article 1 of the OECD Model are not satisfied.²⁶⁶ Nevertheless, it would be unsatisfactory to deny the organization treaty protection. This protection cannot be replaced by the entitlement of its members or shareholders, which may be residents in different states and, therefore, subject to different treaties or to no treaty at all. The residence of the members or shareholders can be determined, of course, but the source state will usually lack rules to allocate the profit of the entity taxable to the shareholders for treaty purposes, since the organization is an independent taxable entity under that state's law. In the United States, it is true, the rules of subchapter S might be applicable to such a situation.²⁶⁷ However, if, for example, the profit of a German limited liability company (GmbH) was taxable with respect to the various backgrounds of the shareholders, nothing in German law could justify the application of partnership rules of profit allocation.

One satisfactory solution to this problem would be to apply a prohibition of contradictory behavior (*venire contra factum proprium*) within the context of Article 1 of the OECD Model as a complementary rule. As a "general legal principle of civilized nations" within the meaning of Article 38(1)(c) of the Statute of the International Court of Justice,²⁶⁸ this principle is a rule of international law in its own right. The source state that treats the organization as a taxable entity, and thus as a "person", would violate this rule if it denied the entity treaty protection based on the divergent law in the country of residence of the entity.²⁶⁹ Such a prohibition, however, cannot obligate the state in which the seat of the organization is located to allow treaty benefits that do not exist according to its own legal standpoint.

265. Article 4(4)(b) of the U.S. Model, *supra* note 1, expressly provides for an exception to this rule.

266. D. PILTZ, *supra* note 219, at 222.

267. I.R.C. §§ 1361-1379.

268. See generally A. VERDROSS & B. SIMMA, *supra* note 48, at 62, 317.

269. For a discussion consistent with this conclusion, see Debatin, *Aussensteuerrechtliche und internationale Behandlung von Rechtsträgern und daran bestehenden Beteiligungen*, 30 DER BETRIEB 1, 4 (Supp. 13, 1977).

c. *No Tax Liability in Either State*

Finally, an organization may not be taxable in either contracting state. According to the preceding model treaty analysis, the organization is entitled to treaty protection if it is a “person”, and in relation to a contracting state the criteria may be present that establish residence, such as unlimited tax liability in Germany. Its right to claim treaty protection, however, remains legally meaningless because it is not taxed in either contracting state, and thus the question of treaty protection does not arise. Moreover, in view of the consistent treatment in both contracting states, there is no occasion to allow the shareholders or members treaty protection if they do not themselves fulfill the requirements of Article 1 of the OECD Model.

4. *Triangular Relationships*

Lacunae in treaty protection with respect to partnerships and similarly treated entities result frequently where more than two states are involved in their taxation (so-called “triangular relationships”).²⁷⁰ Problems of triangular relationships can be grouped into two categories of cases. First, inconsistent tax rules in the two contracting states regarding partnerships and similar entities can pose this particular problem. Second, insufficient drafting of a treaty can result in such gaps in treaty coverage.

a. *Inconsistent Tax Rules*

The first type results when the partnership is treated as a non-taxable unit in one country (that is to say that only the partners are taxed) and as a separate taxable entity in the other country. If a taxpayer *T* resident in a state *R* participates in a partnership in state *P* that has permanent establishments in states *P* and *S*, and if *P* treats the partnership as a legal person but *R* does not, the question arises whether, in addition to *T*'s share of the profit from *P*, *R* must also exempt *T*'s profit arising in *S*.²⁷¹ Assuming a treaty between *R* and *P* similar to the model treaties, the following interpretation could result: the partnership is a “person”²⁷² “resident” in *P*²⁷³ and its enterprise is “an enterprise of state *P*”.²⁷⁴ As a partner, *T* is entitled to rely on the treaty entitlement of the partnership; the treaty entitlement “passes through” to him. Consequently, he can rely on the fact that under Article 7(1) of the OECD Model the business profits of the partnership are to be taxed only in *P*, unless they are attributable to a permanent establishment in *R*. Taxation of the business profits of the partnership, therefore, is reserved for *P*. If Article 7 were held not to apply, the same conclusion would result from application of Article 21(1) of the OECD Model. This “triangularity”

270. For an extensive discussion, see Philipp, *supra* note 219, at 71.

271. *Id.* at 72-73.

272. OECD Model, *supra* note 1, art. 3(1)(a) & (b).

273. *Id.* art. 4(1).

274. *Id.* art. 3(1)(c).

problem is therefore solvable. In fact, several recent treaties contain special rules to solve such problems.²⁷⁵

b. *Treaty Gaps*

The second type of case arises because treaties are not drafted adequately to deal with triangular relationships. Assume, for instance, that *T* in state *R* participates in a partnership in *P* that receives income arising in *S*, and that such income consists of dividends subject to withholding at source. Assume, also, for purposes of simplification that all three states do not tax partnerships, but tax only the partners, and that tax treaties corresponding to the OECD Model²⁷⁶ exist between all three states. In this situation, *T* cannot claim a credit in *P* for the portion of the source tax in *S* attributable to his interest, because he has no rights under the *P/S* tax treaty. Nor can *T* claim a credit in *R*, because Article 7, together with Article 23A of the OECD Model, provides that no creditable tax is levied against the profit's interest in the partnership there. Such a triangular relationship arises not only with respect to partnerships. It would result as well if the taxpayer as sole proprietor received the dividends through a permanent establishment in *P*. Therefore, an appropriate solution under treaty law would only be obtained if all domestic permanent establishments were granted treaty protection. In the absence of such a rule, however, treaty protection granted to the partnership itself could help under certain circumstances. If *P* unilaterally provided a credit to taxpayers subject to tax on their worldwide income, *T* could claim the same treatment under Article 24(4) of the OECD Model.²⁷⁷

c. *Special Rules in the Treaties of the Federal Republic of Germany*

One group of German treaties expressly states that "partnerships" are "persons" within the meaning of the treaty, and that they are therefore entitled to treaty protection. The treaty with Belgium, for instance, includes *offene Handelsgesellschaften* (partnerships), *Kommanditgesellschaften* (limited partnerships) and *Partenreedereien* (shipowning partnerships) under German law as "companies" because these entities are taxed as independent legal entities under Belgian law.²⁷⁸ They also are defined expressly in Article 4(1) as "resident persons".²⁷⁹ Similarly, partnerships, although not considered

275. See, e.g., Convention for the Avoidance of Double Taxation, July 5, 1979, Germany-Finland, Final Protocol, para. 1, 1981 BGBl II 1165, 1180.

276. OECD Model, *supra* note 1, art. 23A.

277. Section 50(6) of the German individual income tax law (EStG), therefore, now grants a credit to the owners of domestic permanent establishments for their income from third countries.

278. Convention for the Avoidance of Double Taxation, Apr. 11, 1967, Germany-Belgium, art. 3(1)(4), 1969 BGBl II 18, 20.

279. *Id.* art. 4(1), 1969 BGBl II at 21.

“companies”, are treated as “persons” in the recent tax treaty with Finland²⁸⁰ as well as in the treaties with Iceland²⁸¹ and Liberia.²⁸² Here treatment as treaty subjects is established unequivocally even where partnerships are not subject to tax themselves. The tax treaty with Japan expressly states in Article 7(7) that the German *offene Handelsgesellschaften* and *Kommanditgesellschaften* are to be treated as treaty subjects for the area of business profits; if the term “bodies of persons” in Article 3(1)(e) of the treaty is not to be meaningless, similar treatment must apply to other business forms.²⁸³

The treaty with Egypt completes “bodies of persons” by adding “not possessing legal capacity.”²⁸⁴ However, this addition does not lead to an interpretation different from that of the OECD Model, since bodies of persons possessing legal capacity according to the treaty are “companies”. The tax treaty with India contains a circular definition for “company”, namely, “any entity which is treated as a body corporate or as a company for tax purposes.”²⁸⁵ If this definition is not to be meaningless, it must be assumed that the provision refers to “company” as that term is defined under domestic law (in Germany that would include a partnership).

The treaty with the United Kingdom and the former treaty with Ceylon contain two divergent definitions.²⁸⁶ In the English version, the definition is open; according to that version the term “person” includes “any body of persons, corporate or not corporate.” The corresponding German definition is formulated more narrowly; it provides, “*Personen jeder Art, natürliche und juristische Personen*,” (“any kind of person, natural and legal persons”), thus excluding bodies of persons not possessing legal capacity. Apparently, the English text, which corresponds to British treaty tradition and to the content of the OECD Model, has been translated inadequately into German. According to the principles of interpretation of international agreements,²⁸⁷ the English text is to be given preference because it better corresponds to the object and purpose of the treaty.

280. Convention for the Avoidance of Double Taxation, Germany-Finland, *supra* note 275, art. 3(1)(b), 1981 BGBl II at 1166.

281. Convention for the Avoidance of Double Taxation, Mar. 18, 1971, Germany-Iceland, art. 3(1)(d), 1973 BGBl II 358, 359.

282. Convention for the Avoidance of Double Taxation, Nov. 25, 1970, Germany-Liberia, Final Protocol, para. 5, 1973 BGBl II 1285, 1303.

283. For a different view, see Korn & Debatin, Comment 3 to Article 7 of the Agreement for the Avoidance of Double Taxation, Apr. 22, 1966, Germany-Japan, in II *DOPPELBESTEUERUNG* 148 (1982).

284. Convention for the Avoidance of Double Taxation, Nov. 17, 1959, Germany-Egypt, art. II(1)(e), 1961 BGBl II 421, 423..

285. Convention for the Avoidance of Double Taxation, Mar. 18, 1959, Germany-India, art. II(1)(e), 1960 BGBl II 1829, 1830.

286. Convention for the Avoidance of Double Taxation, Nov. 26, 1964, Germany-United Kingdom, art. II(1)(f), 1966 BGBl II 359, 360; Convention for the Avoidance of Double Taxation, July 4, 1962, Germany-Ceylon, art. III(1)(f), 1964 BGBl II 790, 791.

287. Vienna Convention, *supra* note 49, art. 33.

Numerous German treaties strike the term "bodies of persons" from the treaty definition of "person", thus denying treaty protection to bodies of persons to the extent they are not taxed as legal persons.²⁸⁸ In some cases "all other legal entities that are subject to tax as such" are included as "persons," instead of "bodies of persons".²⁸⁹ Because the independently taxable entities, however, are already considered to be "companies," and therefore "persons" under all of the previously mentioned treaties, the formulation is meaningless in this context. It is meaningful, however, in some older treaties that do not define the term "company" but include only individuals, legal persons and legal entities that are taxed as such as "persons" within the meaning of the treaty.²⁹⁰ This formulation has the same effect as in the previously mentioned treaties.

Only a few treaties, in contrast, expressly regulate the specific issues posed by partnership taxation.²⁹¹ It was suggested above that the treaty entitlement of a company that is taxed as such in one state and the partners of

288. See the following Conventions for the Avoidance of Double Taxation: Germany-Argentina, July 13, 1978, art. 3(1)(b), 1979 BGBl II 587, 588; Germany-Brazil, June 27, 1975, art. 3(1)(c), 1975 BGBl II 245, 246; Germany-Greece, Apr. 18, 1966, 1967 BGBl II 853; Germany-Sri Lanka, Sept. 13, 1969, art. 3(1)(c), 1981 BGBl II 631, 632. In the treaty with Greece, moreover, only bodies corporate are "companies" and consequently "persons" under the treaty, art. II(1)(3), 1967 BGBl II at 854. See also the following Conventions for the Avoidance of Double Taxation: Germany-Israel, July 9, 1962, art. 2(1)(3), 1966 BGBl II 330, 331; Germany-Kenya, May 17, 1977, art. 3(1)(c), 1979 BGBl II 607, 608; Germany-Korea, Dec. 14, 1976, art. 3(1)(d), 1978 BGBl II 191, 193; Germany-Malta, Sept. 17, 1974, art. 3(1)(d), 1976 BGBl II 110, 111; Germany-Morocco, June 7, 1972, art. 3(1)(4), 1974 BGBl II 22, 23; Germany-Mauritius, Mar. 15, 1978, art. 3(1)(b), 1980 BGBl II 1262, 1263; Germany-Poland, Dec. 18, 1972, art. 3(1)(b), 1975 BGBl II 646, 647; Germany-Romania, June 29, 1973, art. 3(1)(b), 1975 BGBl II 601, 603; Germany-Switzerland, Aug. 11, 1971, art. 3(1)(d), 1972 BGBl II 1022; Germany-Zambia, May 30, 1973, art. 3(1)(d), 1975 BGBl II 661, 663; Germany-Thailand, July 10, 1967, art. 3(1)(e), 1968 BGBl II 590, 592. Subparagraph (f) clarifies that "company" includes "groups of persons" that are taxed as such. See Convention for the Avoidance of Double Taxation, Dec. 23, 1975, Germany-Tunisia, art. 3(1)(c), 1976 BGBl II 1654, 1655; Convention for the Avoidance of Double Taxation, July 18, 1977, Germany-Hungary, art. 3(1)(c), 1979 BGBl II 627, 628.

289. See the following Conventions for the Avoidance of Double Taxation: Germany-Australia, Nov. 24, 1972, art. 3(1)(d), 1974 BGBl II 338, 339; Germany-Cyprus, May 9, 1974, art. 3(1)(d), 1977 BGBl II 488, 490; Germany-Indonesia, Sept. 2, 1977, art. 3(1)(d), 1979 BGBl II 188, 190; Germany-Ireland, Oct. 17, 1962, art. II(1)(b), 1964 BGBl II 267, 268; Germany-Jamaica, Oct. 8, 1974, art. 3(1)(d), 1976 BGBl II 1195, 1196; Germany-Malaysia, Apr. 8, 1977, art. 3(1)(f), 1978 BGBl II 925, 927; Germany-New Zealand, Oct. 28, 1978, art. 3(1)(c), 1980 BGBl II 1223, 1224; Germany-Singapore, Feb. 19, 1972, art. 3(1)(d), 1973 BGBl II 373, 375; and Supplementary Convention for the Avoidance of Double Taxation, Jan. 27, 1970, Germany-Pakistan, art. II(1)(e), 1971 BGBl II 33, 33-34.

290. Convention for the Avoidance of Double Taxation, Jan. 30, 1962, Germany-Denmark, art. 2(1)(1), 1963 BGBl II 1312, 1315; Additional Protocol to the Convention for the Avoidance of Double Taxation, June 9, 1969, Germany-France, art. 2(1)(3), 1970 BGBl II 719, 719-20; Convention for the Avoidance of Double Taxation, Oct. 4, 1954, Germany-Austria, Final Protocol, para. 1(1), 1955 BGBl II 750, 753; Convention for the Avoidance of Double Taxation, Nov. 11, 1958, Germany-Norway, art. 2(1)(1), 1959 BGBl II 1281, 1282; Convention for the Avoidance of Double Taxation, Apr. 17, 1959, Germany-Sweden, art. 1(2), 1960 BGBl II 1815. The Convention for the Avoidance of Double Taxation, June 16, 1959, Germany-Netherlands, art. 2(1)(1), 1960 BGBl II 1782, 1783, also includes in this provision the Dutch equivalent of the German *Kommanditgesellschaft auf Aktien* (KGaA).

291. See *supra* Parts V.B.3 & V.B.4.

which are taxed in the other state “passes through” to the shareholders. This solution is provided in the Final Protocol to the treaty with Belgium: both for the shareholders of a German *offene Handelsgesellschaft*, *Kommanditgesellschaft*, or *Partenreederei* that receive income from Belgium, whether these shareholders are residents of Belgium or a third country, not independently entitled to treaty protection, and for the shareholders of a Belgian *offene Handelsgesellschaft* or *Kommanditgesellschaft* who are German residents (the remaining shareholders would not be subject to tax on their worldwide income in Germany in any case).²⁹² The 1979 treaty with Finland also allows the treaty rights of the company to “pass through”,²⁹³ although because of the special distributive rules contained in Paragraph 1 of the Final Protocol²⁹⁴ the rule remains merely theoretical in that treaty. The treaties with Portugal and Spain follow a somewhat different path that leads, however, to the same legal result. For purposes of taxation of their distributional shares of partnership income and loss and their portion of partnership property, these treaties treat the parties owning interests in the partnership as resident in the state in which the place of management of the partnership is located, thus granting them entitlement to treaty protection in their own right, independent of their state of residence.²⁹⁵

The treaty with Switzerland treats shareholders of a German *offene Handelsgesellschaft* or *Kommanditgesellschaft* from Switzerland, who are not resident in Germany, similarly.²⁹⁶ In contrast, the Agreed Minutes with Switzerland dated June 18, 1978 provide for the assertion of corporate rights through the entity: a partnership formed under the laws of a contracting state with its place of management in that state can claim the reductions in tax liability of the other contracting state provided in the treaty, if at least three-fourths of the profits of the partnership are attributable to persons who are resident in the state in which the partnership has its place of management.²⁹⁷

Commentators have occasionally attempted to apply the rules outlined above to confirm their own interpretations of those treaties that contain no special rules for partnerships or to refute a particular view through reverse argumentation.²⁹⁸ The rules, however, are too diverse for this purpose, since

292. Convention for the Avoidance of Double Taxation, Apr. 11, 1967, Germany-Belgium, Final Protocol, para. 12(1), 1969 BGBl II 18, 49.

293. Convention for the Avoidance of Double Taxation, Germany-Finland, *supra* note 275, art. 23(6), 1981 BGBl II 1177.

294. *Id.*, Final Protocol, para. 1, 1981 BGBl II at 1180.

295. Convention for the Avoidance of Double Taxation, July 15, 1980, Germany-Portugal, art. 4(4), 1982 BGBl II 130, 132-33; Convention for the Avoidance of Double Taxation, Dec. 5, 1966, Germany-Spain, art. 4(4), 1968 BGBl II 10, 13.

296. Convention for the Avoidance of Double Taxation, Germany-Switzerland, *supra* note 288, art. 24(1)(3), 1972 BGBl II at 1029-30.

297. *Id.* arts. 10-12, 1972 BGBl II at 1025-27.

298. See Diehl, *supra* note 257, at 521; Kluge, *supra* note 247, at 367.

they do not indicate a uniform trend. Arguments for a particular interpretation of other treaties, therefore, cannot be won in this way.²⁹⁹

For purposes of completeness, a few other peculiarities in German tax treaties should be noted. The treaty with South Africa adopts the term "company" as used in the OECD Model.³⁰⁰ However, it characterizes as "persons" only individuals and bodies of persons.³⁰¹ The treaty with Romania expressly includes as "companies" the "mixed companies under Romanian law".³⁰² The treaty with Malaysia includes "greater Hindu families".³⁰³ Finally, the terms "person" and "company" are not defined in the treaty with Italy³⁰⁴ or in the treaty between Germany and the United States.³⁰⁵

VI

QUALIFICATION AND RELATED PROBLEMS

When a treaty term is not defined in the treaty itself, or when it is inadequately defined, an issue of qualification often arises. Qualification refers to the situation in which the contracting states attach different interpretations to the term under their domestic law. This Part will present and analyze some of the approaches to the problems of qualification which have been suggested by commentators. In particular, it discusses the solution of the OECD Model treaty, which refers to the parties' domestic law, thereby accepting remaining double taxation or double non-taxation as its result. Finally, it will briefly describe some special problems which arise when contracting states afford different treatment to the payments of partnerships and other non-corporate entities to their partners or beneficiaries.

A. *The Concept of Qualification*

Special problems arise when a treaty uses legal terms that simultaneously are terms of the substantive law of the contracting states. To refer to these problems, the expression "qualification" has come into use as a term borrowed from private international law (conflicts law).³⁰⁶ Tax treaties, however, do not contain conflicts of law rules. They do not provide whether a

299. See D. PILTZ, *supra* note 219, at 132.

300. Agreement for the Avoidance of Double Taxation, Jan. 25, 1973, Germany-South Africa, art. 3(1)(f), 1974 BGBl II 1185, 1188.

301. *Id.* art. 3(1)(e), 1974 BGBl II at 1188.

302. Convention for the Avoidance of Double Taxation, Germany-Romania, *supra* note 288, art. 3(1)(c), 1975 BGBl II at 603.

303. Agreement for the Avoidance of Double Taxation, Germany-Malaysia, *supra* note 289, art. 3(1)(f), 1978 BGBl II at 927.

304. Convention for the Avoidance of Double Taxation, Oct. 31, 1925, Germany-Italy, 1925 RGBl II 1146.

305. Convention for the Avoidance of Double Taxation, July 22, 1954, United States-Germany, 5 U.S.T. 2768, T.I.A.S. 3133.

306. See Herzfeld, *Probleme des internationalen Steuerrechts unter besonderer Berücksichtigung des Territorialitätsproblems und des Qualifikationsproblems*, 1932 VIERTELJAHRESCHRIFT FÜR STEUER-UND FINANZRECHT 422, 465. See also W. WENGLER, BEITRÄGE ZUM

state must apply domestic or foreign law, but rather impose their own distributive rules in addition to the laws of the contracting states.³⁰⁷ Consequently, the problems arising when a treaty rule uses terms of domestic substantive law are structurally quite different from the problem of "qualification" as known in conflicts law, and the two should not be confused. Admittedly, tax treaty problems comparable to "qualification" might arise with respect to the determination of the taxes to which the treaty applies.³⁰⁸ This question, however, is resolved for the most part today through the express listing of these taxes in the treaty itself as in Article 2(3) of the OECD Model.

Nevertheless, the term "qualification", as well as the different theories developed to resolve this problem in conflicts law such as the rules of *lex fori*, *lex causae* or *autonomous qualification*, have been adopted, though incorrectly, by literature on international tax law. The expression, therefore, cannot be discarded. But one should be careful at least to use it consistently and in reference to only one specific type of problem. For use in international tax law, the term qualification should be confined to the problems arising when a tax treaty uses terms derived from domestic law, especially when those terms have a different meaning in the domestic laws of both contracting states. Such terms can be understood according to the law of state *A* or of state *B*, or a third interpretation can be applied. In contrast, the issue of how a foreign legal act or a legal institution (of state *B*) will be treated under domestic law (of state *A*) is a problem of a different logical structure and is therefore not, strictly speaking, a qualification problem in the international tax context. For example, the issue of whether a Venezuelan general or limited partnership, which is a legal person under Venezuelan law, is taxable under the provisions of the German individual or corporate income tax should not be incorrectly labelled a problem of qualification.³⁰⁹ Such problems are often called "substitution" in private international law,³¹⁰ and the same term could be applied in international tax law, too.³¹¹ Alternatively, the language of the German Bundesfinanzhof could be adopted, which speaks of *Einordnung*, or "classification" under domestic law.³¹²

PROBLEM DER INTERNATIONALEN DOPPELBESTEuerung 12 (1935); Arendt, *Zum Qualifikationsproblem im deutschen internationalen Steuerrecht*, 38 STEUER UND WIRTSCHAFT 381 (1959); K. VOGEL, *supra* note 5, at 279, 311, 325; A. RAUPACH, *DER DURCHGRIF IM STEUERRECHT* 153 (1968); Kluge, *supra* note 212, at 365; Vogel, *Aktuelle Fragen bei der Auslegung von Doppelbesteuerungsabkommen*, 1978 DER BETRIEBSBERATER 1021 [hereinafter cited as Vogel, *Aktuelle Fragen*]; Vogel, *La clause de renvoi de l'article 3, par 2. Modèle de Convention de l'OCDE*, in: RÉFLEXIONS OFFERTES À PAUL SIBILLE 957 (1981) [hereinafter cited as Vogel, *Interprétation de l'article 3*]; Avery Jones, *supra* note 205.

307. See *supra* Part II.D.

308. K. VOGEL, *supra* note 5, at 330.

309. 1930 RStBl 444.

310. Lewald, *Règles Générales des Conflits des Lois*, Basel 69 RECUEIL DES COURS DE L'ACADÉMIE DE DROIT INTERNATIONAL DE LA HAYE 1, 130-36 (1939); P. NEUHAUS, *GRUNDBEGRIFFE DES INTERNATIONALEN PRIVATRECHTS* 351 (2d ed. 1976).

311. K. VOGEL, *supra* note 5, at 330; B. GROSSFELD, *BASISGESELLSCHAFTEN IM INTERNATIONALEN STEUERRECHT* 62 (1974).

312. 1973 RStBl 440, 442.

Other issues sometimes mistakenly called "qualification" can be identified. For instance, no problem of qualification exists if a treaty term requires the interpretation of a term that is not a legal term in the law of the contracting states.³¹³ Contrary to what has been suggested,³¹⁴ exercise of a discretionary power reserved in the treaty is not a problem of qualification, either. Finally, no problem of qualification exists to the extent that economic transactions or items of property are doubly taxed or exempted because the substantive prerequisites that establish tax liability are defined differently in the two countries involved. This latter case presents a problem of "economic double taxation",³¹⁵ which is sometimes referred to as a "conflict in attribution" (*Zurechnungskonflikt*).³¹⁶

Some examples of the qualification problems addressed in the case law may help to define this difficult concept. The following situations raise qualification issues:

- (i) whether remuneration paid to an orchestra conductor for recordings is a "royalty" under Article 12 of the OECD Model and other treaty models (according to the view of the German Ministry of Finance) or compensation for personal services under Article 14 (according to the U.S. Tax Court);³¹⁷
- (ii) whether interest paid by a partnership to its partners constitutes business profits of the partners under Article 7 (according to the German view)³¹⁸ or interest under Article 11 of the OECD Model Treaty (according to the Swiss view);³¹⁹
- (iii) whether severance payments paid upon dissolution of an employment relationship constitute income from dependent personal services under Article 15³²⁰ or income not dealt with otherwise in the tax treaty under Article 21 (as may be the case in Switzerland);³²¹
- (iv) whether a commission agent or trading agent carries on a business within the meaning of Article 7 (as under German Law)³²² or has income from independent personal services under Article 14 (as under Spanish law);³²³
- (v) whether participation in a real property holding company (*Grundstücks-AG*) constitutes immovable property within the meaning of Model Treaty Articles 6, 13(1) and 22(1) or capital assets (as according to the German view);
- (vi) whether shares of stock issued without payment of consideration, such as stock dividends, constitute "income from shares" according to the OECD Model Treaty³²⁴ (as in Austria and Switzerland) or whether they do not constitute taxable income at all (as according to German law).³²⁵

313. For example, "athlete" in the OECD and UN Models, *supra* note 1, art. 17.

314. *But see* W. WENGLER, *supra* note 306, at 13; Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 137.

315. *See supra* Part II.A.

316. *See* 51 Archiv für Schweizerisches Abgaberecht 497 (Bundesgericht 1983).

317. Pierre Boulez, 83 T.C. 508 (1984).

318. EStG § 15(1)(2).

319. 1939 RStBl 544 (regarding the German treaty with Switzerland).

320. EStG §§ 19, 24(2).

321. [1973] II BStBl 757, 758.

322. HANDELSGESETZBUCH [HGB] §§ 1(2), (6), and (7) (W. Ger.).

323. Vogel, *Aktuelle Fragen*, *supra* note 306, at 1022.

324. *See* OECD Model, *supra* note 1, art. 10(3).

325. *See* the Statute of August 10, 1967, 1967 BGBl I 889.

These examples are by no means exhaustive, but merely serve to illustrate the problem of qualification. The literature on double taxation has attempted to systematize problems of qualification by various different methods,³²⁶ but these attempts have not been particularly successful.

B. Solutions to the Qualification Problem

1. Alternative Solutions

The problem of qualification can be solved by the treaty itself, if the treaty defines the particular term expressly³²⁷ or if the treaty refers to the qualification of one of the contracting states.³²⁸ To the extent that the treaty fails to provide an express definition, proposed solutions to the qualification problem are numerous and varied. Commentators, in strong reliance on the theories developed in private international law, and adopting the terminology of that field, have discussed three possible solutions:

(1) *Lex fori* qualification: each state applying the treaty qualifies the treaty terms according to the requirements of its own domestic law.

(2) Source country qualification: both states qualify treaty terms consistently according to the law of the state in which the income arises. This solution is sometimes erroneously referred to as *lex causae*. According to the terminology of private international law, however, *lex causae* is the legal system that applies to the particular case; so that in tax law the *lex causae* is identical with the *lex fori*;

(3) Autonomous qualification: both states seek to establish a consistent qualification from the context of the treaty.

A fourth possible solution, not relevant in private international law and until now not discussed in tax literature, might be residence country qualification: both states would qualify treaty terms consistently according to the law of the state of residence of the taxpayer.

A partial regulation of the qualification problem is provided by the OECD Model.³²⁹ This solution, however, raises its own problems. According to Article 3(2), each state shall apply treaty terms as it would according to its own tax law for the taxes to which the treaty applies.³³⁰ If the term is defined only in tax laws not covered by the treaty, in administrative law, or in commercial law, Article 3(2) of the OECD Model does not apply. In such cases, as well as for treaties that do not contain a provision corresponding to Article 3(2) of the OECD Model Treaty, a general solution independent of Article 3(2) must be found.

326. See W. WENGLER, *supra* note 306, at 12; A. SPITALER, *supra* note 3, at 555; Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 137.

327. See, e.g., "interest" in the OECD Model & UN Model, *supra* note 1, art. 11(3); and "royalties" in the OECD Model, *supra* note 1, art. 12(2); UN Model, *supra* note 1, art. 10(3).

328. See OECD Model & UN Model, *supra* note 1, arts. 3(2) & 6(2).

329. OECD Model, *supra* note 1, art. 3(2).

330. See *infra* Part VI.C.

In formulating this general solution, one should begin by noting, as did the German Bundesfinanzhof, that "the domestic law on the one hand and the law of double taxation on the other are two mutually independent legal spheres that have their own boundaries and definitions."³³¹ To the extent that an interpretation from the context of the treaty, the "autonomous" qualification, can be derived, such an interpretation should be given priority if the treaty itself does not define the term. In an early case in which an autonomous interpretation could not be reached, the German Reichsfinanzhof adopted the qualification of the source country, Italy.³³² In a 1938 decision, however, the same Court gave priority to a qualification according to German domestic law, that is, according to the law of the state applying the treaty.³³³ The German Bundesfinanzhof, successor of the Reichsfinanzhof, has followed this practice for the most part.³³⁴

2. Analysis

a. *Lex fori* Qualification

One reason to favor a qualification according to the law of the state applying the treaty (*lex fori*) is the pragmatic consideration that the authorities and the courts quite naturally understand their own law best. In addition, the old rule of international law that contracting parties intend to waive their sovereignty only to the extent that this is clearly evidenced in the treaty text also supports the *lex fori* approach. There is, however, a strong argument against an interpretation according to the law of the state applying the treaty: under this solution the contracting states will apply the treaty differently where the qualifications according to their domestic laws differ. This can lead to retaining certain types of taxation that the treaty intended to eliminate, or it can lead to the opposite result in which neither of the contracting states is allowed to tax a particular event or transaction.³³⁵

331. 101 BFH 536, 539, 580 (1971), [1971] II BStBl 379, 380; 110 BFH 187,190 (1973), [1973] II BStBl 810, 811 (regarding the German treaty with Switzerland); see also 1934 RStBl 38, 40; 1934 RStBl 417, 420 (regarding the German treaty with Italy); [1966] III BStBl 483, 484 (regarding the German treaty with Sweden).

332. Regarding whether an equity interest or an interest as a creditor is involved, see 1934 RStBl 38, 40 (regarding the German treaty with Italy). With respect to the term *gewerbliche Einkünfte* (income from a trade or business), see 1934 RStBl 902, 904 (regarding the German treaty with Italy); 1938 RStBl 851, 852 (regarding the German treaties with Czechoslovakia and Austria). See also [1964] III BStBl 165, 166 (regarding the German treaty with the United States, and, to some extent, discussing whether a subsequent payment is "income from personal services"); [1972] II BStBl 459, 460 (regarding the German treaty with Switzerland).

333. For the allocation to the types of income, see 1938 RStBl 852, 853 (regarding the German treaty with Italy).

334. See [1965] III BStBl 258 (regarding the German treaty with Switzerland). Concerning *freiberufliche Tätigkeit* (professional services) see [1967] III BStBl 392, 394 (regarding the German treaty with Switzerland). Regarding the terms *selbständige/nichtselbständige Arbeit* (independent/dependent personal services), see [1972] II BStBl 88, 89 (regarding the German treaty with Austria). Concerning the term *Einkünfte aus Arbeit* (income from services), see [1973] III BStBl 757, 758 (regarding the German treaty with Switzerland).

335. Lenz, *supra* note 137, at 297.

For example, double taxation has actually resulted where a "golden handshake" paid by a German company to its former manager who was resident in Switzerland constituted "income from services" according to the German view and consequently was taxable in Germany, but constituted "other income" under the Swiss view and consequently was taxable there.³³⁶ If the company (a German GmbH) had been a Swiss company and the manager a German resident, neither Germany nor Switzerland would have been entitled to tax the income.³³⁷ The latter result is especially disturbing, because residuary double taxation can be eliminated through the mutual agreement procedure³³⁸ while "double non-taxation" cannot.

b. Source Country Qualification

To avoid these undesirable results, Avery Jones and his coauthors have argued for qualification according to the law of the source country,³³⁹ and they have attempted to support this approach by an interpretation of Article 3(2). Qualification according to the law of the source country is provided for in Article 6(2) of the model treaties covering immovable property and, to a limited extent, in Article 10(3) of the models covering dividends. The method does in fact lead to a uniform application of the treaty in both states, provided the state of residence is bound by the qualification. It guarantees, however, that the state applying the broadest definition to the qualified term will always have the advantage.³⁴⁰

For example, in both variations of the case discussed above of a German company with a Swiss manager or a Swiss company with a German manager, Germany would be entitled to taxation according to the model treaties. If Germany is the source country, it is entitled to tax under Article 15, and if Switzerland is the source country, Germany is entitled to tax under Article 21. Similarly, the rule of Article 6(2) necessarily leads to taxation in Switzerland of sales proceeds, both with respect to a Swiss real property holding company³⁴¹ with German shareholders (if it is assumed that a cantonal qualification of the interests as real property is controlling under the treaty)³⁴² and

336. [1973] II BStBl 757, 758 (regarding the German treaty with Switzerland). Treatment of the issue is different with regard to subsequent income. See [1972] II BStBl 459, 460 (regarding the German treaty with Switzerland). See also OECD Model, *supra* note 1, art. 21.

337. K. VOGEL, *supra* note 5, at 521.

338. OECD Model & UN Model, *supra* note 1, art. 25.

339. Avery Jones, *supra* note 205, at 48.

340. Raupach, *Korreferat*, JAHRBUCH DER FACHANWÄLTE FÜR STEUERRECHT 354, 356 (1978/79).

341. See *supra* case (v) in Part VI.A.

342. According to the German-Swiss treaty in force between 1931 and 1955, the treaty parties pursuant to the mutual agreement procedure agreed in one case to reduce by one half the tax as calculated according to the domestic law of each state. Convention for the Avoidance of Double Taxation, Sept. 15, 1931, Germany-Switzerland, 1934 RGBl II 38. Switzerland has recognized with regard to its Convention for the Avoidance of Double Taxation, Aug. 11, 1971, Germany-Switzerland, 1972 BGBl II 1022, that, consistent with the view set forth in OECD Commentary, *supra* note 217, art. 13, comment 23, profits from the sale of real estate companies

with respect to a German real property holding company with Swiss shareholders. In the former instance, Switzerland would be entitled to tax under Article 13(1), and in the latter under Article 13(4). This advantage to the state applying the broader definition conflicts with one of the purposes of the treaty, which is to distribute taxable events between contracting states equally, and therefore source country qualification does not seem suitable as a general solution to the problem of qualification. Furthermore, it is unlikely that tax authorities or courts would be willing to adopt this approach.

c. Residence Country Qualification

As mentioned above, qualification according to the law of the state of residence has not previously been discussed. One argument in favor of such a rule, however, is that according to the traditional, systematic approach of tax treaties, especially the OECD and U.S. models, taxation in the state of residence is the rule, while taxation in the country of source is the exception.³⁴³ On the other hand, the possibility of double residence, which cannot be eliminated in all cases even through application of Article 4(2) of the model treaties, remains, and in such a case the contracting parties must rely on the mutual agreement procedure. Therefore, a residence country rule also fails to provide an appropriate means for resolving qualification conflicts.

d. Autonomous Qualification

Given the failings of the above three possible approaches, autonomous qualification seems to be the only supportable solution. In fact, it best conforms to the character of the treaty as an independent rule that applies to both states, since only autonomous qualification can guarantee the desired common interpretation of treaty terms.³⁴⁴

An autonomous definition in a treaty, however, must use undefined terms, which can in turn be subject to qualification. This is illustrated quite clearly in *Pierre Boulez*.³⁴⁵ Although the treaty between Germany and the United States defines "royalties" in Article VIII(3), this autonomous definition was interpreted differently by the German and the U.S. authorities, and double taxation was therefore not eliminated. If, on the contrary, it had been the German authorities who had assumed the payments to be income from personal services, and if the IRS had considered them to be royalties, petitioner Boulez would have paid no tax at all. Moreover, states seek to avoid

are not covered by art. 13, apparently a case of "autonomous" qualification. Decrees (Einkommensteuereinführungsvorordnungen) of Oct. 18, 1972 and of Sept. 26, 1975 cited in K. LOCHER, W. MEIER & R. VON SIEBENTHAL, *supra* note 252, at B. 13.1 No. 3; Wetzel in DOPPELBESTEUERUNGSABKOMMEN DEUTSCHLAND-SCHWEIZ Art. 3, Erläuterung 3 (H. Meyer-Marsilius & D. Hangarter eds.).

343. See OECD Model, *supra* note 3, art. 21.

344. See *supra* Part IV.C.1.

345. See *supra* note 317.

autonomous definitions, in particular because such definitions subsequently restrict their discretion in applying the treaty.

Where a term is not defined, an autonomous qualification must be derived through interpretation. This is a difficult task, however, because sufficient criteria for such a qualification often will be sought in vain. What does the context of the treaty provide for determining whether severance payments constitute income from the rendering of services, or whether the activity of a commissioned agent constitutes business activity or independent personal services? The more diverse the legal systems of the contracting states are, the more desirable autonomous definitions become, but the more difficult they are to achieve. Even the supporters of autonomous qualification, therefore, favor reference to the law of the state applying the treaty in the end, at least as a final interpretation resource (in German: *Auslegungsbehelf*³⁴⁶ or *letzte Auslegungshilfe*³⁴⁷).

3. Summary

It follows that none of the methods described above is convincing alone. Instead, a combination of approaches may work best, with the choice of method dependent upon the purpose for which the interpretation is sought. In this light, the levels on which problems of qualification can arise for a distributive rule should be distinguished.³⁴⁸

The different elements of the paradigm distributive rule³⁴⁹ may warrant the application of different rules of qualification. For instance, the objections that were raised above against qualification according to *lex fori* are fully valid on only one of these levels. Within the context of the requirements for the application of a distributive rule,³⁵⁰ that is, the question whether a person is entitled to treaty protection, diverse qualification can only lead to the result that the treaty would not apply in one of the two states, and thus that double taxation would not be eliminated. In contrast, double non-taxation cannot occur. Residuary double taxation, however, can often, if not always, be eliminated through the mutual agreement procedure. Therefore, significant advantages of practicability and legal certainty³⁵¹ support a rule of qualification according to the law of the state applying the treaty in case of interpretation at the level of treaty entitlement.

346. A. SPITALER, *supra* note 3, at 563.

347. Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 126; Debatin, *supra* note 105, at 480.

348. Regarding these levels, see *supra* Part III.B.

349. See *supra* Part III.B.2.

350. See *supra* Part III.B.2.a.

351. See Spitaler, *L'interprétation des traités de double imposition* (country report of Germany), 42 C.D.F.I. 165, 165-66 (1960).

The same arguments can be made at the level of the legal *consequences* of the distributive rule.³⁵² Again, it is unlikely that a *lex fori* qualification approach could lead to double non-taxation. Furthermore, the characterization of the substantive-legal taxable object to which the rule applies (the *Objektatbestand*, such as "income", "profit", or "property") is even less likely to be based on anything other than the law of the state applying the treaty.³⁵³ Reference to Article 3(2) of the OECD Model is superfluous here,³⁵⁴ and the same applies for the question of which legal subject the object of taxation is to be attributed.³⁵⁵

Only within the scope of the *requirements* for the distributive rule,³⁵⁶ its *Metatbestand*, is it plausible to argue that a qualification according to *lex fori* can lead to double taxation or double non-taxation.³⁵⁷ In this case, all possibilities of deriving an autonomous qualification should therefore be exhausted before applying a *lex fori* rule. In addition to the context of the particular treaty, treaty practice, the development of treaty terminology, and the OECD and UN models and Commentaries must be referred to.³⁵⁸ "In company with the courts of other countries," an autonomous qualification appropriate to the treaty is to be developed step by step "from case to case",³⁵⁹ in a "mutual approach to reconcile carefully and gradually affected legal systems and their judicature."³⁶⁰ Until this goal is attained it will be unavoidable, in certain cases at least, to refer back as a last "interpretation resource"³⁶¹ to the law of the state by which the treaty is applied (the *lex fori*).

At this particular level, dealing with the *requirements* for a distributive rule, a ruling that may prove helpful is the one which has been included in the Final Protocol of the German-Canadian treaty, and which the German Ministry of Finance plans to insert into the treaty between Germany and Sweden which is currently being renegotiated. According to Paragraph 13 of that

352. See *supra* Part III.B.2.c.

353. See [1970] II BStBl 569, 571 (regarding the German treaty with Austria). The same applies with respect to Switzerland. See 1971/72 Archiv für Schweizerisches Abgaberecht 259 (Bundesgericht) (regarding the German treaty with Switzerland); Philipp, *Probleme der Doppelbesteuerung auf Grund der Verschiedenheit der Steuersysteme der Vertragsstaaten und der Verschiedenheit von Vertragstypen*, 1967 DEUTSCHE STEUERZEITUNG AUSGABE A 245, 246. See also Debatin, *supra* note 105, at 483.

354. Cf. Bundesfinanzhof Decision of Nov., 20, 1974, reprinted in 28 DER BETRIEB 1107 (1975) (regarding the German treaty with Luxembourg).

355. Concerning the interpretation of the word "owns" in the treaty between the United States and France, see Rev. Rul. 84-21, 1984-86 I.R.B. 11. See also 118 BFH 553, which relied on [1973] II BStBl 57 and - incorrectly - on [1967] III BStBl 397.

356. See *supra* Part III.B.2.b.

357. See the example, *supra* Part VI.B.

358. Concerning the origin of the concept *Beteiligung an einem gesellschaftlichen Unternehmen* (participation in a common enterprise) from the Austrian *Personalsteuergesetz* (individual income tax law), see [1966] III BStBl 483, 485 (regarding the German treaty with Sweden); [1971] II BStBl 379, 380 (regarding the German treaty with Switzerland).

359. Fothergill v. Monarch Airlines, [1980] 3 W.L.R. 209.

360. Vogel, *Interprétation de l'article 3*, *supra* note 306, at 964.

361. See *supra* notes 346 & 347.

Final Protocol,³⁶² if income is qualified differently, or if it is attributed to different persons (the latter being a “conflict of attribution”) and if, moreover, a mutual agreement of the contracting partners cannot be achieved, double taxation resulting from this conflict will be avoided by the allowance of a credit in Germany for tax paid in Canada with regard to that income. In contrast, to avoid double non-taxation in similar cases, Germany will switch from allowing an exemption for the affected income to allowing a credit for the tax paid in Canada. This approach will usually mean that Germany simply will tax the income in question, because the conflict of qualification or attribution ordinarily will mean that no tax will be levied in Canada.³⁶³

If it is assumed that the cases of “positive” and “negative” conflicts are of equal frequency, this solution may prove to be equitable to taxpayers as well as to the contracting states. It is true that as currently formulated, Paragraph 13 is appropriate only for treaties between credit and exemption states, but it could be adapted to other situations if it were rephrased to provide that a credit would always be granted by the state of residence of the taxpayer in question (rather than as currently formulated, always by the same treaty partner, Germany). It should be observed, moreover, that the provision applies only with regard to conflicts of qualification or attribution of income, and not with regard to other qualification conflicts. For instance, issues concerning the “connecting point”, such as where a ship has its place of management, or where personal services are performed, are not covered by the rule of Paragraph 13. The provision raises other questions as well,³⁶⁴ which, however, will not be developed here.

C. Article 3(2) of the Treaty Models

1. Characteristics

Part of the problem of “qualification” is governed by Article 3(2) of the OECD Model, which has been adopted by the UN and U.S. Models. For treaty terms that correspond to terms in the tax law of the contracting states, this Article provides that each contracting state is to interpret such terms according to the domestic law of the state applying the treaty. In other words, the treaty models to a certain extent adopt the *lex fori* approach.

362. Menck, *Der Qualifikationskonflikt im neuen deutschkanadischen Doppelbesteuerungsabkommen*, INTERTAX 417 (1982).

363. In some cases, however, due to the conflict, Canada will levy a reduced tax rate.

364. Under the language of Paragraph 13, it may be asked whether the credit mechanism provided for in cases of double non-taxation applies only when Germany is the state of residence or when it is the state of source as well. Furthermore, a situation can be imagined in which Canada, according to German qualification, would be entitled to tax (not according to its own qualification), where, however, Canadian substantive law does not provide for taxation. In this case it would not be justified for Germany to be entitled to switch to the credit method, i.e., to tax the income in question.

Such an express reference to domestic law has, no doubt, certain practical advantages. To the extent Article 3(2) applies, the problem of "qualification" no longer arises. Taxpayers, administrative authorities, and courts can rely on the meanings of terms with which they are familiar through their domestic law. At the same time, the variety of interpretation possibilities is limited; the reference to domestic law therefore promotes legal certainty. An "autonomous" qualification, as discussed above, will often not be possible, due to the absence of sufficient criteria to develop such a qualification.

On the other hand, of course, one negative consequence of the reference to domestic law is that the contracting states attach different meanings to terms in applying the treaty. The consequence of such a conflict is that double taxation is not eliminated, in contrast to the established goal of the treaty, or in the opposite case, that double non-taxation can arise. The attempt of Avery Jones and his coauthors to avoid such an awkward result by a specific interpretation of the word "application"³⁶⁵ seems not to be convincing, as will be shown below. Moreover, Article 3(2) is understood to refer to domestic law as it is amended from time to time. It thus provides the contracting states the opportunity to evade their international obligations by changing their domestic law.

In view of these negative effects, it is astonishing that the provision in its current broad and somewhat rigid wording has found acceptance in the OECD Model. It is derived, as indicated above, from Anglo-American treaty practice and may have its origin in the "security interests" of the contracting states,³⁶⁶ and in their attempt to protect their own sovereignty to the greatest extent possible, even within the scope of a treaty obligation.³⁶⁷ Of course, some of the negative consequences have been eliminated: those treaties that rely on the credit method of avoiding double taxation preclude the most disadvantageous consequence of the provision for the contracting states, namely that of double taxation.³⁶⁸ As outlined above, however, all recent tax treaties, especially those following the OECD, UN and U.S. Models, combine the exemption and credit methods. Therefore, even if the credit method is chosen in principle to avoid double taxation, there are distributive rules in all existing treaties that oblige the other contracting state to exempt a certain item of income.³⁶⁹ The problem, therefore, arises today for all treaties and for all states. Commentators have attempted to ameliorate these negative effects of

365. Avery Jones, *supra* note 205, at 48.

366. See Debatin, *supra* note 105, at 480.

367. See Sibille, *L'interprétation des traités de double imposition* (country report of Belgium), 42 C.D.F.I. 206, 209 (1960).

368. Vogel, *Interprétation de l'article 3*, *supra* note 306, at 957; Avery Jones *supra* note 205, at 50.

369. See *supra* Part III.B.2.

Article 3(2) by interpreting it to provide that the provision is only to be applied as a subsidiary means.³⁷⁰

Article 3(2) is a "general rule of interpretation" as compared to the special rules of interpretation of the OECD Model³⁷¹ and the individual treaties. It is on the other hand itself a special rule of interpretation as opposed to the general rules of interpretation of international treaties, and as a special rule of interpretation it has priority over such general rules. The scope of Article 3(2), however, is limited. Article 3(2) governs only the interpretation of terms that are used in the treaty; it provides no justification for reliance on general legal principles of domestic law in interpreting treaty law, or for closing loopholes within the treaties by reference to domestic law.³⁷² Furthermore, Article 3(2) refers only to the meaning of the term in question³⁷³ according to the domestic law of the contracting state "concerning the taxes to which the convention applies." Thus, it requires that the term be applied by the law concerning these taxes, and not merely by any domestic law. If a term has no specific legal meaning, such as "oil and gas deposits", or if a term is only defined in civil law, such as "branch establishment", or in tax law other than the law of income or property tax, such as, in German law, "enterprise" (*Unternehmen*), then Article 3(2) is not controlling. Instead, the general principles regarding qualification apply.³⁷⁴ On the other hand, the special rules of interpretation of the treaty have priority over Article 3(2). Included here are not only special treaty definitions expressly mentioned within the treaty provision,³⁷⁵ but also references in particular provisions to domestic law.³⁷⁶

2. Requirements of Article 3(2)

Article 3(2) applies "as regards application of the Convention." It refers to "the law of that state concerning the taxes to which the Convention applies," with the reservation "unless the context otherwise requires."

"Application" means each decision of a fiscal authority or of a court concerning a tax question in which the treaty is referred to (or should be referred to). The exemption of income pursuant to the treaty also constitutes

370. Flick, *supra* note 137, at 163; Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 122, 125; Höhn, *supra* note 23, at 76; H. FLICK, K. WASSERMAYER, & D. WINGERT, *DOPPELBESTEUERUNGSABKOMMEN DEUTSCHLAND/SCHWEIZ*, art. 3, Rz. 181.

371. See, e.g., OECD Model, *supra* note 1, art. 6(2).

372. *Contra* Kluge, *supra* note 137, at 96; Diehl, *supra* note 257, at 517.

373. The United States Tax Court has extended this rule to terms of domestic law achieving a similar purpose. See *Estate of Burghardt v. Comm'r*, 80 T.C. 705 (1983). This interpretation, however, goes beyond the language of Article 3(2).

374. See *supra* Part VI.B. A different view is advocated in Klebau, *Einzelprobleme bei der Auslegung von Doppelbesteuerungsabkommen*, 1985 RECHT DER INTERNATIONALEN WIRTSCHAFT/AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS 125, 128.

375. See e.g. "interest" in OECD Model, *supra* note 1, art. 11(3) and "royalties" in OECD Model, *supra* note 1, art. 12(3).

376. OECD Model, *supra* note 1, arts. 4(1), 6(2), & 10(3).

its "application", as well as the decision that the treaty does not apply in a particular case. Avery Jones and his coauthors disagree to some extent. They claim that "the residence state . . . by asking itself whether in the opposite situation it would have taxed the income in the same way as the source state . . . does not apply the convention." They infer that qualifications by the state of source according to its domestic law are binding for the state of residence ("it should take the answer for granted") and, therefore, that double taxation or double non-taxation cannot arise.³⁷⁷

However, such reasoning fails to consider the different structures of double taxation rules. As mentioned above, there are distributive rules in Chapters III and IV of the model treaties that, by using the words "shall only . . .", oblige the other contracting state to exempt the item of income without reference to Article 23. In such cases, it can hardly be denied that the state of residence, in granting exemption, "applies" the distributive rule. Even where an exemption or credit is granted according to Article 23, the state of residence will always examine whether the state of source was entitled under the treaty to levy tax, and it will refuse to exempt or give credit if it denies that right to the other state. Thus, the treaty and its distributive rule are always "applied" by the state of residence, too.

The phrase "the law of the state concerning the taxes . . ." has been briefly discussed above.³⁷⁸ If a term used in the treaty also has a meaning outside of the tax law, its meaning for purposes of tax law is controlling. If it has a meaning only outside of the tax law, or a meaning for tax purposes only with respect to taxes not covered by the treaty, Article 3(2) does not apply. The connection to tax law, it is true, is less clear in the English version of the 1977 OECD Model than in the 1963 version ("concerning" rather than "relating to"), and it may be just slightly weaker in the new French version than in the 1963 version ("concernant" rather than "régissant"). Such variations, however, do not lead to a different interpretation; it seems that the OECD Fiscal Committee only intended to improve the language of the English version, and the French version followed. In contrast, the official German translation has not been changed (*Recht dieses Staats über die Steuern*).

The reference to domestic law ordinarily has been understood to be a reference to that law as amended from time to time which may be called an

377. Avery Jones, *supra* note 205, at 50.

378. The German treaty with the United States refers only to the "applicable laws". United States-Germany, *supra* note 305, art. 2(2), 5 U.S.T. at 2778. However, because both the United States and Germany include the OECD Model version of the clause in their treaties, and because the United States in particular included the clause both in its older treaties and in the U.S. Model, the provision can be interpreted according to the meaning of the OECD Model. The treaty between Germany and Finland refers, in contrast to the OECD Model, to all the domestic law of the contracting states and not just to the tax law. Convention for the Avoidance of Double Taxation, July 5, 1979, Germany-Finland, art. 2(2), 1981 BGBl II 1165. Except for the "old" treaty with Italy, Convention for the Avoidance of Double Taxation, Oct. 31, 1925, Germany-Italy, RGBl II 1146, all German treaties contain the clause recommended by the OECD Model.

“ambulatory” interpretation as opposed to a “static” one.³⁷⁹ This widespread conviction has been challenged recently, however, by the Canadian Court of Appeals and Supreme Court; both courts applied the provision exclusively to the law in force at the time the treaty was concluded.³⁸⁰ The question is discussed extensively and most convincingly by Avery Jones and his coauthors.³⁸¹ It may of course be said in favor of the Canadian courts that a reference to domestic law as amended would allow the contracting states to alter the scope of their obligations under international law through domestic legislation. On the other hand, it could be extremely difficult to ascertain what the domestic law of a contracting state was if the question arises with regard to an older treaty, such as the treaty between Germany and Italy from 1925, which is still in force. There are provisions, moreover, in the model treaties which are meaningful only in reference to the law as amended, such as Article 10(3) of the OECD Model.³⁸² Avery Jones and his coauthors correctly point out that there may be major changes in the domestic law which can make it impossible to continue applying the treaty without modification. But apart from such extreme alterations, the “ambulatory” interpretation of Article 3(2) should be preferred.

The context requires “otherwise” than an interpretation according to domestic law if such a reference would fail to provide a clear solution to the particular tax issue. Such was the case in a decision of the German Bundesfinanzhof:³⁸³ the question of whether an employee’s dependent services’ income constituted “domestic income” under the treaty between Germany and the United States (U.S. source income) led to the criteria of *Ausübung* (exercise) and *Verwertung* (utilization) of the activity according to the German Individual Income Tax Law (*Einkommensteuergesetz*).³⁸⁴ In this particular case, the activity was utilized in the United States but was not exercised there. The Bundesfinanzhof held, through the application of U.S. law, and with reference to Article 15 of the OECD Model, that the “exercise” requirement was controlling.

Reference to the domestic law of one of the contracting states, in contrast, is unnecessary if both legal systems lead to the same result. This situation occurred in a Dutch case³⁸⁵ involving the question of whether the profit realized through new valuation of a mortgage claim that had been partially

379. See Lenz, *supra* note 301, at 310. See also Rev. Rul. 80-243, 1980-2 C.B. 413.

380. The Queen v. Melford Developments, Inc., 35 D. Tax 5020 (1981); 36 D. Tax 6281 (1982).

381. Avery Jones, *supra* note 205, at 25. See Brockway, *supra* note 63, at 632; Widmann, *Zurechnungsänderungen und Umqualifikationen*, in GRUNDFRAGEN DES INTERNATIONALEN STEUERRECHTS 235 (K. Vogel ed. 1985); Langbein, *supra* note 81, at 145.

382. See OECD Model, *supra* note 1, art. 10(3) (“... income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.”).

383. [1969] II BStBl 579.

384. EStG § 49(2)(1).

385. 1965 BNB 206 (Hoge Raad).

depreciated constituted "income" from the claim under Article 4(3) of the treaty between Germany and the Netherlands.³⁸⁶ The Dutch Hoge Raad mentioned Article 3(2), but it based its decision on the context of the treaty.

3. Preference for Interpretation from the Context

The undesirable legal consequences to which treaty interpretation according to domestic law may give rise have resulted in efforts by legal commentators to emphasize treaty interpretation according to its context, to the greatest extent possible, in order to limit the references to domestic law. Unfortunately, this approach can be only partly supported.

First, it is impossible to infer a systematic preference for interpretation from the context over interpretation by reference to national law.³⁸⁷ Whether the context "otherwise requires" an approach other than recourse to domestic law can only be determined logically if the meaning of a term has *already* been established. In other words, it would seem that an interpretation according to domestic law should take precedence.³⁸⁸ Since, however, this interpretation may also require further correction, both interpretation procedures should, in fact, be viewed as having a relationship of mutual reciprocity.

Second, it is inconsistent with the wording of Article 3(2) to limit reference to domestic law to those cases where "the criterion of interpretation according to the context is fully explored but the sense of the treaty . . . still remains unclear."³⁸⁹ The OECD Model says "unless the context otherwise requires," and not, "unless the context yields no other, or absolutely no other, interpretation."³⁹⁰ It is thus expressly stated that not every apparently convincing interpretation from the context should give rise to a divergence from the rule of Article 3(2), but only those based on relatively strong arguments. The history and development of the provision both confirm that an interpretation contrary to the domestic law meaning must constitute the exception.³⁹¹ Even if reference to domestic law would lead to double taxation or double non-taxation, that alone cannot support an interpretation which deviates from domestic law, even considering that the treaty seeks to avoid double taxation and that interpretations which avoid double taxation should be preferred.³⁹² For apart from the consideration that often several different interpretations can avoid double taxation, the special quality of Article 3(2) lies

386. Convention for the Avoidance of Double Taxation, June 16, 1959, Germany-Netherlands, art. 2, 1960 BGBI II 1782.

387. See Debatin, *supra* note 105, at 479; Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 122.

388. Van Raad, *supra* note 80, at 52.

389. Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 126; Debatin, *supra* note 105, at 480.

390. OECD Model, *supra* note 1, art. 3(2).

391. See *supra* Part III.B.

392. Ia A. PHILIPP & R. POLLAK, INTERNATIONALES STEUERRECHT 70, Rdn. 37 (2d ed. 1981).

precisely in the fact that it accepts double taxation as a result, subject to mutual agreement procedures.

If, on this basis, the idea of priority for the “context” is not upheld, then, however, the concept of “context” should nevertheless be interpreted as broadly as possible.³⁹³ The definition of “context” in Article 31(2) of the Vienna Convention is not decisive for the interpretation of the OECD Model. Nor can a narrow interpretation of the term “context” be justified by referring to the interest of the contracting states to yield as little of their sovereignty as possible, whether or not Article 3(2) originally may have been a direct result of this interest. Further, the derivation of the provision from English law favors a broad interpretation, including in the concept of “context” even the treaty’s history and development.³⁹⁴ Finally, the fact that the undesirable consequences of recourse to domestic law are most readily held in check by such a broad interpretation also speak in its favor.³⁹⁵ Accordingly, in addition to the treaty documents, any supplementary protocols, and the OECD Model, the relevant provisions of both national law systems, too, should be considered within the “context” of the treaty.³⁹⁶ As long as there is a strong argument derived from the “context” in this broader sense, a deviation from an interpretation according to domestic law will be admissible.³⁹⁷

If this result is applied to the various elements of the paradigm distributive rule,³⁹⁸ it becomes apparent that the resulting difference with respect to the general rules for resolving the problem of qualification is only a matter of degree. Application of domestic law will continue to prevail in interpreting the applicability requirements, certain general concepts, such as “income”, “profit” and “property” (*Objekttatbestände*), and the legal consequences of the distributive rules of the treaty. For the interpretation of the special requirements of these distributive rules (*Metatattbestand*), however, application of domestic law within the scope of Article 3(2) will be a bit more likely than with respect to general rules. That reference to domestic law can on this level lead to double taxation or double non-taxation will reinforce the importance of the context, at least with respect to the requirements of a distributive rule.

In summary, the following order of reference is recommended for interpreting the terms of tax treaties:

- (1) First, any special definitions and rules of interpretation of the treaty apply.
- (2) If no special rules apply, one should next ask whether the law of the state applying the treaty (the *lex fori*), within the context of the taxes covered by the treaty, attaches a special meaning to the term.

393. See *supra* Part IV.B.

394. *Beswick v. Beswick*, [1967] 3 W.L.R. 932.

395. Vogel, *Interprétation de l'article 3*, *supra* note 306, at 962.

396. For a case deviating from the OECD Model, see [1973] II BStBl 531 (regarding the German treaty with the Netherlands).

397. See also Avery Jones, *supra* note 205, at 106; Klebau, *supra* note 374, at 131.

398. See *supra* Part III.B.2.

(3) If this is the case, the meaning of the term, however, is not yet determined. One should inquire whether the context suggests a different interpretation and, in light of the weight to be given to alternative interpretations, whether the context requires the deviating interpretation. Reasons for adopting a deviating interpretation have additional weight on the level of the *Metatatabestand* in particular where determination of the type of income, profit or property, to which the norm applies is involved, because in such cases an interpretation according to the law of the state applying the treaty is especially apt to lead to inappropriate results.

(4) If question (2) is answered in the negative, but the term is applied in domestic law outside of the scope of the taxes covered by the treaty, then the general rules of interpretation should apply. The practical result of this is that on the level of the *Metatatabestand* in cases not covered by Article 3(2) an interpretation by reference to domestic law is admissible only if the context does not provide any basis for interpretation at all.

D. Special Problems of Partnerships and Non-corporate Entities

Special problems arise with respect to partnerships and other non-corporate entities if they make payments to partners or beneficiaries in another state and these payments or benefits are treated differently by the tax law of the respective states. Some authors use the term "qualification" here, too. However, this situation is once again a problem of a quite different logical structure. Two situations can arise in this context, depending on whether the entity is treated as a legal person in the other contracting state.

1. Inference From Treaty Entitlement to the Type of Income³⁹⁹

If an entity is treated as a legal person for tax purposes by one of the contracting states but not by the other, the qualification of the type of income may be inferred in certain special situations from the right of the legal person to claim treaty protection.⁴⁰⁰ As has been shown above, the company ordinarily is entitled to treaty protection if it is independently taxable in the state in

399. See Korn & Debatin, *Systematik IV*, *supra* 3, at Rdn. 137; Debatin, *supra* note 269; Debatin, *Inländische Beteiligungen an Mitunternehmensschaften im Ausland*, 1978 DER BETRIEBSBERATER 669; Haas, *Qualifikationskonflikte ausländischer Mitunternehmensschaften*, 1978 DER BETRIEBSBERATER 1253 [hereinafter Haas, *Qualifikationskonflikte*]; Debatin, *Inländische Beteiligungen an ausländischen Mitunternehmensschaften*, 1978 DER BETRIEBSBERATER 1608; Debatin, *Die Bilanzbündeltheorie im Spiegel des internationalen Steuerrechts*, 31 DER BETRIEB 2437 (1978); Diehl, *supra* note 257; Manke, *Personengesellschaften im internationalen Steuerrecht*, JAHRBUCH DER FACHANWÄLTE FÜR STEUERRECHT 333 (1978/79); Haas, *Nochmals: Inländische Beteiligungen an ausländischen Mitunternehmensschaften*, 1979 DER BETRIEBSBERATER 84; Debatin, *Qualifikationsprobleme im Doppelbesteuerungsrecht*, 1979 FINANZRUNDschau 493; Debatin, *Entwicklungsaspekte des internationalen Steuerrechts*, 1980 RECHT DER INTERNATIONALEN WIRTSCHAFT/AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS 3 [hereinafter Debatin, *Entwicklungsaspekte*]; Schlütter, *Die Sondervergütungen eines Mitunternehmers im Ausensteuerrecht*, JAHRBUCH DER FACHANWÄLTE FÜR STEUERRECHT 152 (1979/80); Storck & Selent, *Die Besteuerung inländischer Beteiligungen an ausländischen Mitunternehmensschaften im Ertragsteuerrecht*, 1980 RECHT DER INTERNATIONALEN WIRTSCHAFT/AUSSENWIRTSCHAFTSDIENST DES BETRIEBSBERATERS 332; D. PILTZ, *supra* note 219.

400. OECD Model, *supra* note 1, arts. 1 & 3.

which its seat is located; if it is not, it may be nevertheless entitled to treaty protection in the other state if it is independently taxable there.⁴⁰¹

In such cases, if the company transmits payments or other benefits to its shareholders whether the payments are made by a company resident and taxable as such in the source country to its shareholders in the state of residence, or whether they are made by a source country permanent establishment of a company located in the country in which the shareholders also are residents, these payments qualify for treaty purposes as separate proceeds (dividends, interest, etc.) of the shareholders, even if under the law of the state in which the shareholders reside they would be considered as part of the share of the company's general profits. It follows that the respective distributive rules apply, such as Article 10 of the treaty models for the distribution of profits,⁴⁰² or Article 11 for interest.⁴⁰³

For example, interest that a foreign partnership subject to corporate tax in the state in which its seat is located pays to its German partners is to be taxed according to Article 11, even though German domestic law would not recognize interest payments to partners but would treat such payments as profit distributions. Due to application of the treaty, however, such interest can be taxed in Germany with a credit for the source country tax, although under German domestic tax law they are and remain business profits (*Gewinne aus Gewerbebetrieb*) of a partnership.⁴⁰⁴ Under Article 11(3) of the 1963 OECD Model, this treatment would apply automatically because the term "interest" according to that model is defined according to the practice of the country of source.⁴⁰⁵ However, even the "autonomous" definition in the 1977 OECD Model can only be understood as specifying that a state that taxes the company, and thereby allows the deduction of interest as operating costs, must be able to tax these distributions as income of the partners under Article 11.⁴⁰⁶ The obligation of the other state arises in this case from an appropriate interpretation of Article 11.

The same analysis applies to partnership draws, so that the other state can tax such payments as dividends within the scope of Article 10 of the OECD Model.⁴⁰⁷ Consequently, Germany would be entitled under treaty law to tax the draws itself (it must, of course, allow a credit for the tax of the

401. See *supra* Parts V.B. & V.C.

402. OECD Model, *supra* note 1, art. 10.

403. *Id.* at art. 11.

404. EStG § 15(1)(2).

405. OECD Model (1963), *supra* note 1, art. 11(3). Korn & Debatin, *Systematik III*, *supra* note 3, at Rdn. 123; Krabbe, *supra* note 247, at 138; Debatin, *supra* note 137, at 6; Manke, *supra* note 399, at 346; Schlütter, *supra* note 399, at 168; Diehl, *supra* note 257, at 522. The same also applies when the provision corresponding to Article 23 does not expressly refer to Articles 10 & 11. However, this requires the support of further argumentation.

406. See D. PILTZ, *supra* note 219, at 173, 182.

407. As is expressly provided in the Germany-Spain Tax Treaty, *supra* note 295, art. 10(4), 1968 BGBl II, at 16.

source country).⁴⁰⁸ The German income tax, however, does not provide for taxation of draws from a partnership. The qualification of the draws as dividends under the tax treaty cannot alter the German domestic tax law; that is, it cannot give rise to taxation of the draws as if they were dividends.⁴⁰⁹ Similarly, other provisions of the German tax law that require independent taxability of the taxpayer do not apply.⁴¹⁰ On the other hand, the profits of the company as well cannot be taxed in Germany if the company, as stipulated here, is entitled to treaty protection.⁴¹¹ For this, it is irrelevant whether the profits are distributed in the year in which they are derived, as, for instance, as disguised distribution of profits, or in some later year.⁴¹² The result, therefore, is that the profits of the company are taxed only once, as would also be the case under German law. With respect to the exemption with progression,⁴¹³ the foreign profit could be included if a permanent establishment of a German company were involved, which is exempted in Germany under Article 7(1)(2) in connection with Article 23A of the OECD Model. If the foreign entity is a company that is entitled to treaty protection, however, the same rule does not apply; instead its profits are treated for all purposes, even with respect to the exemption with progression, as are the profits of a foreign corporation.⁴¹⁴

2. No Inference from Calculation of Profits to the Type of Income

In contrast, the situation is completely different if the company itself is not subject to tax in the other state, but is allowed to deduct payments of special distributions from company profits, which are not allowed under German tax law.⁴¹⁵ The company then is not a treaty subject, and its business

408. Korn & Debatin, *Systematik IV*, *supra* note 3, at Rdn. 138; Debatin *supra* note 269, at 6; Manke, *supra* note 399, at 345; Schlütter, *supra* note 399, at 166; Diehl, *supra* note 257, at 521.

409. See Korn & Debatin, *Systematik IV*, *supra* note 3, at Rdn. 137; Manke, *supra* note 399. Compare Debatin, *supra* note 269, at 6. See also Debatin, *Inländische Beteiligungen an Mitunternehmensschaften im Ausland*, 1978 DER BETRIEBSBERATER 669, 671; D. PILTZ *supra* note 219, at 174.

410. Krabbe, *supra* note 153, at 138; Debatin, *supra* note 269, at 3. See, e.g., Aussensteuergesetz [AStG] § 7 (Foreign Tax Law), Auslandsinvestitionsgesetz [AIG] § 3 (Foreign Investment Law) and Körperschaftsteuergesetz [KStG] § 26 (Corporate Income Tax Law).

411. The second clause of the first sentence of Article 7(1) provides that the profits of an enterprise of a contracting state are taxable "only" in that state. OECD Model, *supra* note 1, at art. 7(1). This point is overlooked in Peusquens, *Beteiligung an Mitunternehmensschaften im Ausland*, 1980 DER BETRIEBSBERATER 255, 256; see Storck & Selent, *supra* note 399, at 340.

412. The analysis in Schlütter, *supra* note 399, at 167, cannot be supported. The justification supplied in Debatin, *supra* note 409, at 671, is susceptible to misunderstanding.

413. See OECD Model, *supra* note 1, art. 23.

414. See OECD Model, *supra* note 1, art. 7(1) (the first clause of the first sentence, which states "only"); cf. Debatin, *Aussensteuerrechtliche Behandlung*, *supra* note 269, at 5; Haas, *Qualifikationskonflikte*, *supra* note 399. Schlütter, *supra* note 399, at 165. In contrast to the view expressed in Krabbe, *supra* note 247, at 135, this provision also applies with certain limitations to the German treaty with Spain in accordance with the framework of that treaty.

415. See, e.g., EStG § 15(1)(2) (special compensation paid to partners). For an overview of the treatment of special compensation paid outside of Germany, see Storck & Selent, *supra* note 399, at 337.

enterprise is treated as a permanent establishment of the partners. Article 7(3) and following of the OECD Model and paragraph 15 of the Commentary to Article 7 apply to determine profits. According to these provisions, interest and royalties in particular are not deductible by the permanent establishment.⁴¹⁶

If the state in which the permanent establishment is located nevertheless allows a deduction — which it is free to do — the state of residence does not thereby become entitled to allocate those amounts to the profits of the entity controlling the permanent establishment (the “home enterprise”).⁴¹⁷ Contrary to what has been maintained in the literature, it cannot be assumed that the other state, by allowing the deduction in calculating the profits of the permanent establishment, does qualify these as deductions of “interest” or “royalties” for treaty purposes. As used in the treaty,⁴¹⁸ royalties and, according to the 1977 OECD Model, interest are defined autonomously (Articles 11(3) and 12(2)), and the country of source cannot establish their meaning unilaterally.

Even to the extent that, according to treaties concluded before 1977, the term “interest” is still determined with reference to the legal treatment in the source country by reason of Article 11(3) of the 1963 OECD Model, this requirement cannot be read without reference to the Commentary under Article 7(3) regarding this point. Otherwise it could be advantageous for the state in which the permanent establishment is located to tax the “interest” of a permanent establishment to its controlling entity under Article 11 because the tax rate is measured from the gross amount in the case of a deduction while the costs can be deducted in calculating the profits of the permanent establishment.⁴¹⁹ Such taxation, however, would be prohibited by the model treaties.

VII

INTERNATIONAL TAX AVOIDANCE⁴²⁰

Finally, an analysis of treaty interpretation would not be complete without at least a brief discussion of tax avoidance. This Part discusses the limits

416. See OECD Commentary, *supra* note 217, art. 7, comment 17 (expressly stating that banks are to receive different treatment).

417. See *supra* Part III.B. (concerning prohibition of “potential double taxation”).

418. See Manke, *supra* note 399, at 341; Debatin, *Entwicklungsaspekte*, *supra* note 399, at 6. For a contrasting view on this point, Schlütter, *supra* note 399, at 162. See also D. PILTZ, *supra* note 219, at 161.

419. See OECD Commentary *supra* note 217, art. 7, comment 17.

420. See generally Flick, *Vereinbarkeit des Steuerfluchtgesetzes mit Doppelbesteuerungsabkommen*, 1971 *DER BETRIEBSBERATER* 250; B. GROSSFELD, *BASISGESELLSCHAFTEN IM INTERNATIONALEN STEUERRECHT* (1974); Van Hoorn, Jr., *The Use and Abuse of Tax, TAX HAVENS AND MEASURES AGAINST TAX EVASION AND AVOIDANCE IN THE EEC* (Avery Jones, ed. 1974); J. HUISKAMP, B. BRACEWELL-MILNES & M. WISSELINK, *INTERNATIONAL TAX AVOIDANCE*, VOL. B (1978), VOL. A (1979); B. BRACEWELL-MILNES, *THE ECONOMICS OF INTERNATIONAL TAX AVOIDANCE* (1980); D. ALBREGTSE, *FISCAAL-ECONOMISCHE ASPECTEN VAN INTERNATIONALE BELASTINGVERMIJDING* (1983); Rosenbloom,

to tax avoidance by taxpayers as well as to treaty avoidance by states in the context of double tax treaties, and it explains the relationship of this problem to treaty interpretation.

A. *Avoidance by the Taxpayer*

It is a maxim of tax law that taxpayers may arrange their economic affairs in the manner they deem most beneficial for them. That a particular action has been taken for tax purposes cannot deprive the actors of tax benefits to which they are otherwise entitled under the law. This rule applies, if not universally, at least within all Western constitutional democracies,⁴²¹ and it is no less applicable with regard to treaty law than with regard to domestic tax law.⁴²² Tax planning on the domestic or the international level is by no means objectionable;⁴²³ extensive tax planning, it is true, is an indication that the existing tax legislation is defective.⁴²⁴ Nevertheless, tax planning inevitably reaches a point beyond which it cannot be tolerated within a legal system if it is intended that the system be just. Such limits may be reached, for example, where transactions are entered, or base companies are established in other states, solely for the purpose of enjoying the benefit of particular treaty rules existing between the state involved and a third state.⁴²⁵

Where such tax configurations exist, it must first be determined whether the legal transaction in question has validity under the law of contracts.⁴²⁶ According to the statutory or case law in most states, legal transactions are

Tax Treaty Abuse: Policies and Issues, 15 LAW AND POL'Y IN INT'L BUS. 763 (1983); Becker, *Erschleichung der Abkommensberechtigung durch Zwischenpersonen*, in GRUNDFRAGEN DES INTERNATIONALEN STEUERRECHTS (K. Vogel ed. 1985). See also the articles by Vogel, Ellis, Langer, Gnazzo, Moore, Baconnier, Bracewell-Milnes, Ward, Flick, Goldsmith, Avery Jones, Ishiyama and Ryser in J. HUISKAMP, ED., RECOURSE TO TAX HAVENS, USE AND ABUSE, (IFA Congress Seminar Series No. 5, 1981). The articles by Ellis, Moore, and Langer are reprinted in German, together with articles by Flick, Görl, Baconnier, Diehl, Ritter and Koch in STEUEROASEN UND AUSSENSTEUERGESETZE (Münchener Schriften zum Internationalen Steuerrecht, K. Vogel ed. 1981). See also OECD COMMITTEE ON FISCAL AFFAIRS, TAX EVASION AND AVOIDANCE (1980).

421. See *Duke of Westminster v. Comm'r of Inland Revenue*, [1936] 1 A.C. 20, 20-21 (Great Britain); 9 BVerfG 237, 249 (1959) (Germany); Judgment of June 6, 1961, Cour de Cassation, Belg., [1961] I Pasicrisie Belge [Pas. B.] 1082, 1087; *Perry Bass v. Comm'r*, 50 T.C. 595 (1968) (U.S.); 1981 Droit Fiscal nos. 48-49, comm. 2187 (Conseil d'Etat req. no. 19,079, decision of June 10, 1981); *Brambles Holdings Ltd. v. Fed. Comm. of Tax'n*, 17 A.L.R. 481 (1977) (Australia).

422. See *Aiken Industries, Inc. v. Comm'r*, 56 T.C. 925 (1971) (regarding the United States treaty with Honduras); [1973] II BStBl 57, 59; [1975] II BStBl 584, 586 (both regarding the German treaty with the Netherlands).

423. Van Hoorn, Jr., *supra* note 420, at 1.

424. Vogel, *Perfektionismus in Steuerrecht*, 57 STEUER UND WIRTSCHAFT 206, 208 (1980); Messmer, "Steuerungerechtigkeit" durch Normenflut, offene und verdeckte Subventionen und Entlastung der Finanzgerichtsbarkeit, 1981 DER BETRIEBSBERATER Supp. 1, at 1.

425. Langer speaks loosely of "treaty shopping" in J. HUISKAMP, ED., *supra* note 420, at 21.

426. See J. HUISKAMP, B. BRACEWELL-MILNES & M. WISSELINK, *supra* note 420, at 200; Judgments of Feb. 25, 1984, Conseil d'Etat, Fr., 1981 DROIT FISCAL comm. 1413 (req. nos. 20.577 and 20.578).

void if the legal consequences are not really intended by both parties.⁴²⁷ In the situations that are of importance here, however, the legal consequences as a rule are seriously intended, precisely because of their tax consequences.

If the transaction thus proves to be valid under the law of contracts, it must next be determined whether it is effective for tax purposes. The tax laws of most countries include provisions or principles that disregard transactions undertaken for tax purposes if, contrary to the legislative intent, the contracting parties employ unusual or artificial measures solely intended to circumvent the words of the statute, measures that would not have been employed aside from the tax considerations. It is solely the dogmatic starting point of these principles which varies to some extent among legal systems.⁴²⁸

In Anglo-American case law, principles have been developed under the heading of "substance vs. form", implying criteria such as absence of a reasonable business purpose or the existence of a sham.⁴²⁹ In continental Europe, corresponding legislation and case law are based primarily on the notion of abuse, including *abus de droit* and *fraus legis*.⁴³⁰ German legislation has adopted the concept of *Steuerumgehung* ("tax circumvention"),

427. See, e.g., for Germany, BGB § 117 (*Scheingeschäfte*, dummy transactions).

428. J. HUISKAMP, B. BRACEWELL-MILNES & M. WISSELINK, *supra* note 420, at 199; Uckmar, *Evasion Fiscale* (General Report), 68a C.D.F.I. 15, 26 (1983).

429. Gregory v. Helvering, 293 U.S. 465 (1935); Higgins v. Smith, 308 U.S. 473, 477 (1940); Knetsch v. United States, 364 U.S. 361 (1960). For application in the international area see Johansson v. United States, 336 F.2d 809 (5th Cir. 1964); Compagnie Financière de Suez v. United States, 492 F.2d 798 (Ct. Cl. 1974); Aiken Industries, Inc. v. Comm'r, 56 T.C. 925 (1971). The Aiken decision was recently discussed by James, Aiken Industries Revisited, 64 TAXES 131 (1986). In the United Kingdom, case law has been much more cautious if not reluctant to disregard form in favor of substance. See Dickenson v. Gross, 11 Tax Cases 614 (1927); Kirby v. Steele, 27 Tax Cases 370 (1946); Newstead v. Frost, [1980] 1 W.L.R. 135; I.R.C. v. Garvin [1981] 1 W.L.R. 793. Nevertheless, the House of Lords finally adopted the "step transaction" doctrine embodied in American jurisprudence, which had long been controversial in Great Britain. According to this doctrine, the tax consequences of "multiple transactions" that are intended to result in reduced tax liability are determined as a single transaction rather than as a series of isolated, individual transactions. See Ramsay v. Comm'r, [1981] 2 W.L.R. 449, 457. In subsequent decisions this jurisprudential doctrine has been developed further. See I.R.C. v. Burmah Oil Company, Ltd., 54 Tax Cases 200 (1982); Furniss v. Dawson, 53 Tax Cases 324, *aff'd*, [1983] 3 W.L.R. 635, *rev'd*, [1984] 2 W.L.R. 226. See also Ashton, *The Ramsay and Burmah Decisions, a Reappraisal*, 42 BRIT. TAX REV. 221 (1983); Frommel, *Tax Avoidance and the House of Lords: Uncertainty as Deterrent*, 1984 INTERTAX 378, 435; Wigg, *The New Approach to Judicial Interpretation of Taxing Statutes in the U.K. After Furniss v. Dawson*, 11 TAX PLANNING INT'L REV. 3 (1984); Avery Jones, *A New Approach of the Courts After Furniss*, 39 BULL. INT'L FISCAL DOC. 371 (1985). The Canadian Supreme Court has rejected the business-purpose test on the ground that there is an express anti-avoidance clause in Canadian tax law. See *Stuart Investments v. Her Majesty the Queen*, 38 D. Tax 6305 (1984).

430. For Belgium, see Judgment of June 6, 1961, Cour de Cassation, Belg., [1961] I Pas. B. 1082; Judgment of Oct. 19, 1965, Cour de Cassation, Belg., [1966] I Pas. B. 231; for France, see Livre des procédures fiscales art. L. 64. French case law was cautious in the beginning. See Judgment of Feb. 9, 1973, Conseil d'Etat, Fr., 1973 Recueil des décisions du Conseil d'Etat [Lebon] 125, 1972 DROIT FISCAL comm. 643 (req. no. 83.695); Judgment of June 10, 1981, Conseil d'Etat, 1981 Lebon 248, 1981 DROIT FISCAL comm. 2187 (req. no. 19.079); Judgment of June 22, 1983, Conseil d'Etat, Fr., 1983 DROIT FISCAL comm. 2379 (req. no. 25.167). In contrast, see Judgment of Feb. 25, 1981, Conseil d'Etat, Fr., 1981 DROIT FISCAL comm. 1490 (req. no. 19.169); Judgment of June 30, 1982, Conseil d'Etat, Fr., 1983 DROIT FISCAL comm. 355

which has to be distinguished from legitimate tax avoidance (i.e., tax planning) as well as from tax evasion, which is a criminal offense.⁴³¹ Nevertheless, if we compare the judicial application of these differing doctrines, we see that their results turn out to be interchangeable to a very great extent.⁴³² Viewed more closely, they prove to be compatible on the theoretical level as well. Both Anglo-American and European doctrines used in application and interpretation of tax statutes unanimously begin by emphasizing the characterization of the transaction according to contract law, but at a certain point switch to an emphasis on the economic reality of the transaction. The Anglo-American doctrine of "substance vs. form" in this context focuses on the fact *that* standards change, whereas the European doctrine of abuse seeks to determine the *criteria* for this change.

To cope with international tax avoidance in certain specified cases, legislation has been introduced with increasing frequency in different countries. The United States began in 1962 by introducing the provisions regarding Controlled Foreign Corporations.⁴³³ Germany adopted virtually the same rules in its *Aussensteuergesetz* of 1972,⁴³⁴ and Canada, Japan, France, and the United Kingdom have followed this trend. A decision of the Swiss Federal Council (*Schweizerischer Bundesrat*) of 1962 denies the benefits of tax treaties concluded by Switzerland to corporations residing in Switzerland if they distribute more than fifty percent of their profits to persons not entitled to treaty protection or if they are controlled by persons not entitled to treaty protection and distribute less than twenty-five percent of their profits.⁴³⁵ These provisions, established unilaterally at first, have been subsequently inserted into the tax treaties concluded between Switzerland and France and between Switzerland and Germany.⁴³⁶ The United States has included a comparable provision denying treaty protection to foreign controlled companies under

(req. no. 16.391); Judgment of Jan. 19, 1983, Conseil d'Etat, Fr., 1983 DROIT FISCAL comm. 1621 (req. no. 33.831) ("rent a star system"); Judgment of July 29, 1984, Conseil d'Etat, Fr., 1984 DROIT FISCAL comm. 1278 (req. no. 38.230); Judgment of Nov. 19, 1984, Conseil d'Etat, Fr., 1985 DROIT FISCAL comm. 1493 (req. no. 35.491); for the Netherlands, see 1968 BNB 80 (Hoge Raad), with regard to some recent decisions: 1983 EUR. TAX'N 27; for Sweden, see 1985 EUR. TAX'N 58; for Switzerland, see 51 Archiv für Schweizerisches Abgaberecht 497 (Bundesgericht 1983). See also *Evasion Fiscale*, 68a C.D.F.I. 1983.

431. AO § 42; See K. TIPKE & H. KRUSE, *supra* note 19, § 42 (1983); Kirchhof, *Steuerumgehung und Auslegungsmethoden*, 62 STEUER UND WIRTSCHAFT 173 (1983). For Austria, see § 22 Bundesabgabenordnung [BAO], 1961 BGBl Nr. 194, 1031, reprinted in II ÖSTERREICHISCHES RECHT 5979 (W. Schuppich ed. 1976); and the commentary in Gassner, *Der Gestaltungsmissbrauch im Steuerrecht*, 1981 ÖSTERREICHISCHE STEUER-ZEITUNG 262.

432. Ward, *The Business Purpose Test and Abuse of Rights*, 1985 BRIT. TAX REV. 68.

433. I.R.C. §§ 951-964 (Subpart F).

434. See Vogel, *Federal Republic of Germany: Taxation of Foreign Income - Principles and Practice*, 39 BULL. INT'L FISCAL DOC. 4 (1985).

435. Judgment of Dec. 14, 1962, Sammlung der eidgenössischen Gesetze [A.S.] 1622, modified by Judgment of Nov. 25, 1974, A.S. 1960. See Lüthi, *Die Vorschriften gegen den Missbrauch der Doppelbesteuerungsabkommen des Bundes*, in HANDBUCH DES INTERNATIONALEN STEUERRECHT DER SCHWEIZ, *supra* note 3, at 340.

436. See K. VOGEL, *supra* note 82, at 290.

certain conditions in Article 16 of the U.S. Model⁴³⁷ and has succeeded meanwhile in including this or a similar provision in its treaties with a considerable number of contracting partners.⁴³⁸ It should be noted here, too, that the OECD Model of 1977 (in contrast to the 1963 Model) and the UN Model include provisions granting treaty benefits for dividends, interest, and royalties only if the recipient is the "beneficial owner" of the underlying subjective right.⁴³⁹

More generally, courts have applied anti-avoidance principles taken from their domestic law to double taxation agreements. Thus, the U.S. Tax Court in the *Aiken* case,⁴⁴⁰ while recognizing the foreign corporation as an entity entitled to treaty protection, denied an interest exemption on the ground that the interest was not "received by" the corporation. In the case of the boxing champion Ingemar Johansson, the Court of Appeals of the 5th Circuit refused to apply the treaty between the United States and Switzerland for similar reasons.⁴⁴¹ The German Bundesfinanzhof in a series of decisions has disregarded foreign base companies of German companies if no business reason or similar justification for their participation in a particular transaction could be detected.⁴⁴² The Bundesfinanzhof, it is true, does not apply these principles to base companies controlled by corporations which are not taxable in Germany.⁴⁴³ Notwithstanding this reservation, it seems justifiable to conclude that a common principle underlies the various legal doctrines, even if the formulations of these doctrines differ in detail. Irrespective of whether the treaties contain an express abuse provision, this common principle is to be taken as a basis for the application of treaty law, too.⁴⁴⁴

437. U.S. Model, *supra* note 1, art. 16. See Rechelman & Iamura, *Treaty Shopping: Proposed Article 16 of the U.S. Model Income Tax Treaty*, 9 TAX PLANNING INT'L 3 (1982); Kramer, *Oneigenlijk gebruik van belastingverdragen*, 1981 WEEKBLAD VOOR FISCAAL RECHT 1357; Wis-selink, *Enkele notities rondom het zg. oneigenlijke gebruik van belastingverdragen*, 51 MAAND-BLAD BELASTING - BESCHOUWINGEN 45 (1982); Freud, *Treaty Shopping and the 1981 Treasury Draft Model Income Tax Treaty*, (1982/84) TAX MGMT. INT'L. J. 3; Cooper & Rasmussen, *Tax Treaty Shopping, Art. 16 of the Draft U.S. Model Income Tax Treaty*, 35 BULL. INT'L FISCAL DOC. 291 (1982); Kooiman, *Article 16: The U.S. Attitude to Treaty Shopping*, 36 BULL. INT'L FISCAL DOC. 195 (1983); Guttentag, *Tax Treaty Shopping*, 37 BULL. INT'L FISCAL DOC. 3 (1984).

438. Oliva, *Recent Protocols to Tax Treaties Indicate Changes in International Tax Policy*, 10 INT'L TAX J. 427 (1984).

439. OECD Model & UN Model, *supra* note 1, art. 10. See K. VOGEL, *supra* note 82, at 487.

440. *Aiken Industries, Inc. v. Comm'r*, 56 T.C. 925 (1971).

441. *Johansson v. United States*, 336 F.2d 809 (5th Cir. 1964).

442. Concerning the German treaty with Switzerland, see [1977] II BStBl 265, 266; [1981] II BStBl 339. Regarding the term "Organschaft," see [1970] II BStBl 554. See also [1975] II BStBl 553, 555.

443. See [1982] II BStBl 150, 153. A broader interpretation of anti-avoidance principles was applied recently in [1984] II BStBl 605 (regarding the German treaties with Switzerland and the Netherlands).

444. This principle is consistent with OECD Commentary, *supra* note 217, art. 1, comment 7.

To be sure, such an "unwritten avoidance clause" can only be assumed to the extent to which the two contracting states, according to their domestic law, consistently would view the legal form as "abusive", "without a reasonable business purpose", as a "sham", etc. It cannot function as a pretext through which the legislative or executive branch of the government, contrary to treaty law, subjects cases to taxation other than those involving genuine avoidance.

In contrast, the special legal provisions promulgated to prevent international tax avoidance and the treaty provisions to which the contracting states have agreed include, to simplify application, situations other than those involving genuine tax avoidance. Such provisions cannot be extended by analogy to other factual situations. They may at best be referred to by way of negative limitation to clarify cases where tax avoidance does not exist such as where a foreign subsidiary carries on an "active" trade or business in the state in which its place of management is located.

If the form of a transaction is not recognized for tax purposes under domestic law or under treaty law, then the tax consequences the taxpayer sought to obtain through structuring the transaction will not result and the tax authorities will apply those tax rules that would have applied according to the appropriate form of the transaction.⁴⁴⁵ Thus, if a controlled corporation is not recognized as legally independent, it must be determined whether the facilities of the corporation constitute a permanent establishment of the parent corporation. Article 5(7) of the OECD or UN Models does not prohibit characterization as a permanent establishment in such a case; it is only intended to prevent corporations which are "nonabusive" from being characterized as permanent establishments. Should a permanent establishment be deemed to exist, it is to be allocated a share of the profits according to Article 7(2) of the model treaties. This share, then, is to be exempted from tax in the state of residence of the parent corporation or the foreign tax paid by the subsidiary is to be credited against the tax of the parent. Dividend withholding tax in the source state, however, cannot be credited, because to that extent no income is deemed to be received as a consequence of the anti-avoidance provision.⁴⁴⁶

B. Avoidance by the Contracting States

It should be noted that states, too, can circumvent tax treaties. They can do so by drafting laws that according to their language try to avoid certain treaty situations, though in substance the treaty situation is present, because they want to avoid certain consequences which they may consider undesirable. Or, conversely, they may draft laws that artificially create treaty situations which the law-making state considers desirable. By such legislation the

445. As in Germany, AO § 42.

446. Finanz-Ministerium Nordrhein-Westfalen, Decree of Sept. 7, 1970.

material content of a treaty, though not its language, may be infringed.⁴⁴⁷ The legal consequences of such “treaty circumvention” by states cannot be basically different from those of tax avoidance by taxpayers. Under Article 38(1)(c) of the Statute of the International Court of Justice, “general legal principles recognized by civilized nations” constitute one of the sources of international law.⁴⁴⁸ This provision confirms that commonly acceptable principles of domestic law are binding in a parallel manner on states as principles of international law. Now, the principles on tax avoidance set forth above certainly are recognized by an overwhelming majority of states. They must therefore be binding on states, too, if they try to avoid treaty consequences by an artificial legal construction (a “sham”). In such cases, the legal consequences apply which would follow from the material content of the treaty if the state in question had chosen an adequate legal construction.⁴⁴⁹

For example, if income of a foreign subsidiary, which ordinarily would fall under Article 10 of the model treaties upon distribution to the parent corporation, is deemed by domestic law to constitute income of the parent corporation prior to such distribution and is taxed as such, the obligation to handle this forestalled dividend taxation according to the principles of the applicable treaty as concluded between the two states in question cannot be altered. If the domestic tax law treats interest paid to a shareholder as dividends, such a rule will apply for treaty purposes only if the rule for interest is limited to those loans that under the circumstances may be viewed as “real” rather than as disguised capital contributions. The legislator, it is true, can overrule treaty provisions; such legislation will then be binding on the domestic courts.⁴⁵⁰ A legislature can do so, however, only by violating international law, thus risking reprisals which the other contracting state could undertake in conformity with international law to defend its contractual rights.

According to Article 31(3)(b) of the Vienna Convention, of course, reference must also be made, in interpreting a treaty, to the subsequent practice of the parties. Therefore, if the other contracting state has accepted the application of the new law for some period of time, the avoidance objection no longer can be raised. It is, therefore, unnecessary today to examine whether the Subpart F provisions of the U.S. Internal Revenue Code or the German *Aussensteuergesetz* are reconcilable with the double tax treaties the United States

447. See Kingson, *The Coherence of International Taxation*, 81 COLUM. L. REV. 1151 (1981).

448. Statute of the International Court of Justice, June 26, 1945, art. 38(1)(c), 59 Stat. 1031, T.S. No. 993.

449. A similar result is reached by Avery Jones and his coauthors, *supra* note 226, at 47, by advocating an “implied limitation” to the “ambulatory interpretation” of treaty terms; accord Brockway, *supra* note 63, at 635. The “static interpretation”, as advocated by the Canadian Supreme Court in *The Queen v. Melford Dev'ts, Inc.*, would even bind the contracting state to a much higher degree. 36 D. Tax 6281 (1982).

450. Different rules apply, as mentioned above, with regard to the Netherlands as a consequence of the monistic view adopted by the Dutch constitution.

and the Federal Republic of Germany had previously concluded.⁴⁵¹ Moreover, with regard to Germany, Agreed Minutes between Germany and Switzerland of September 29, 1971 expressly stresses that the tax treaty between Germany and Switzerland does not prohibit the attribution of profits among controlled corporations.

VIII CONCLUSION

Tax treaty interpretation has significant consequences for the taxation of transactions which cross international borders. Only a uniform interpretation among states will ensure an efficient and equitable application of tax treaties, which aim to eliminate double taxation and distribute tax revenues among contracting states.

This Article has presented some of the problems inherent in the interpretation of tax treaties by different states, such as inconsistent interpretations of identical terms or varying domestic treatment of partnerships and similar entities. It has suggested an approach to a common interpretation, based on a paradigm distributive rule, and has emphasized the important role played by the OECD Model Treaty as a basis for understanding all other tax treaties. More generally, the Article has explained the structure and functioning of the growing network of international tax treaties and its relation to domestic taxation and traditional international law principles. As tax treaty law becomes more widely understood, and as tax treaties demonstrate growing uniformity of text and of interpretation, the international movement of goods, capital, and persons will be facilitated by a uniform and fair system of international taxation.

451. I.R.C. §§ 951-964. For a discussion of this issue from the time Subpart F was enacted, see Mutén, *The Delimitation Between the Country of Residence and Other Countries of the Power to Tax Corporations and Their Shareholders* (General Report), 49b C.D.F.I. 69 (1964).