Chapter 5

Luxembourg: Dual Residence and Income Qualification of a Lawyer in Hong Kong

Werner Haslehner*

5.1. Introduction

The reviewed judgment[1] concerns a dispute between Luxembourg's direct tax administration and a lawyer (the taxpayer) who resided and worked in Hong Kong for 7 months of the relevant tax year. Two questions of interest to this review were raised in the case: first, whether the taxpayer was correctly classified as a resident of Luxembourg despite his longer presence in Hong Kong during the tax year; and second, how the relevant income should be classified for tax treaty purposes: it would qualify as business income under Luxembourg's domestic law but was treated as employment income in Hong Kong.

Luxembourg's highest administrative court (*Cour administrative*, hereinafter the court) relied on the 2007 double taxation convention (DTC) between Luxembourg and Hong Kong to resolve these issues. It made ample reference to the relevant explanations of the Commentary on the OECD Model when answering the first question, holding that the taxpayer's centre of vital interests remained in Luxembourg throughout the relevant period. By contrast, the court made no such reference in responding to the second issue, where it held that Luxembourg should follow the qualification of Hong Kong, since doing so would not conflict with any legal requirement in Luxembourg law.

5.2. Legal background

Under the provisions of article 2 of the Income Tax Law (LIR),[2] individuals are considered resident taxpayers and therefore subject to worldwide

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1. LU: *Cour administrative* [Highest Administrative Court], 2 Mar. 2017, Case 38088C.

2. LU: *Loi modifiée du 4 décembre 1967 concernant l'impôt sur le revenu* [Income Tax Law, 1967 as amended, subsequently referred to as LIR], art. 2.

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taxation if they have either their residence (*domicile fiscal/Wohnsitz*) or their habitual abode (*séjour habituel/gewöhnlicher Aufenthalt*) in Luxembourg. Both these terms are defined in the Tax Adaptation Law (StAnpG).[3] Pursuant to section 13 of the StAnpG, a taxpayer is a resident if he keeps a home under circumstances that lead to the conclusion that he will retain and use that home.[4] Pursuant to section 14 of the StAnpG, a taxpayer has his habitual abode where he stays under circumstances that show a more than merely temporary presence, specifying a threshold criterion of 6 months as conclusive in this respect.[5]

Luxembourg concluded a DTC with Hong Kong on 2 November 2007, which entered into force on 20 January 2009. The DTC defines as a resident, in the case of Hong Kong, any individual who "ordinarily resides" or stays for "more than 180 days during a year of assessment".[6] In the case of Luxembourg, the definition coincides with the OECD Model and includes "any person who, under the laws of Luxembourg, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature",[7] with the exception of those who are only liable to tax in respect of income or capital from Luxembourg sources. The tie-breaker rule of article 4(2) of the Hong Kong-Luxembourg DTC follows the OECD Model, only substituting the term "Contracting Parties" for "Contracting States" and "the right to abode" for "nationality" in the case of Hong Kong.

Under Luxembourg law, the income of self-employed lawyers is classified as income from an "independent profession" (*profession libérale*) as opposed to "business income" for the majority of income earned by self-employed activity. By contrast, income from salaried activity is classified as employment income (*revenu provenant d'une occupation salariée*). The

3. LU: *Steueranpassungsgesetz vom 16 Oktober 1934 (loi d'adaptation fiscale)* [Tax Adaptation Law, 1934].
4. "*Einen Wohnsitz im Sinn der Steuergesetze hat jemand dort, wo er eine Wohnung innehat unter Umständen, die darauf schließen lassen, dass er die Wohnung beibehalten und benutzen wird*" (sec. 13 StAnpG).
5. "*Den gewöhnlichen Aufenthalt im Sinn der Steuergesetze hat jemand dort, wo er sich unter Umständen aufhält, die erkennen lassen, dass er an diesem Ort oder in diesem Land nicht nur vorübergehend verweilt. Unbeschränkte Steuerpflicht tritt jedoch stets dann ein, wenn der Aufenthalt im Inland länger als sechs Monate dauert*" (sec.14(1) StAnpG).
6. *Agreement between the Hong Kong Special Administrative Region of the People's Republic of China and the Grand Duchy of Luxembourg for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital* art. 4(1)(a) (2 Nov. 2007), Treaties IBFD [hereinafter *Hong Kong-Luxembourg DTC*].
7. Art. 4(1)(b) *Hong Kong-Luxembourg DTC*.

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latter requires the taxpayer's subordination, which is compatible with the status of "*avocat*" only if the employer is himself a member of the Luxembourg bar.[8] Most lawyers' income is thus classified under the first category, as they are not formally employed. Income under that category is not subject to any withholding obligation, but subject to an annual tax return filing and regular prepayments based on previous years' taxed income.

5.3. Facts of the case

The dispute arose between the Luxembourg direct tax administration and the taxpayer 2 years after his return from a 7-month stint at the Hong Kong office of another law firm. During that stay, from 1 May 2012 to 3 December 2012, the taxpayer kept the lease of his Luxembourg apartment and continued to receive payments from the law firm he was previously and subsequently affiliated with.

The tax administration had initially set the taxpayer's prepayments for the fiscal year 2012 to zero after it was informed of his 7-month *détachement professionnel* to Hong Kong. Yet, following his return and subsequent promotion at the Luxembourg law firm (without ever filing a tax return for 2012), the tax administration proceeded to assess the taxpayer for his annual income in 2012 as a Luxembourg resident, maintaining that the earlier decision on prepayments was not to be seen as a recognition of the taxpayer's change of residence status.

The taxpayer argued that he had left Luxembourg with no (concrete) intention to return in May 2012. As evidence, he put forward several arguments: first, the fact that he had already practiced in Luxembourg for 9 years at the time, claiming that it would be unusual for such an experienced lawyer to be sent on temporary secondment to a foreign firm, as this is only common for lawyers at an earlier stage of their career. In his case, the move to Hong Kong was intended to develop the legal business and foster the connections with the practice there. Second, he left following the appointment of another lawyer as partner, which had the significant potential to impair his chances of advancement in Luxembourg, and which consequently spurred him into pursuing an alternative (foreign) career path. His eventual return to Luxembourg in December 2012 was unforeseeable at the time and only

8. This follows the interpretation of art. 8.1. of the *Règlement Intérieur de l'Ordre des Avocats du Barreau de Luxembourg* du 9 janvier 2013 [Internal Regulation of the Luxembourg Bar, 9 Jan. 2013].

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came as a consequence of negotiations with the law firm that led to him securing promises of subsequent promotion in that firm. Third, he had kept his apartment lease merely because he was bound by the terms of the agreement, which also prevented him from subletting it after his departure in May 2012.

The court of first instance (*tribunal administratif*) dismissed the taxpayer's arguments, concluding that his dwelling in Hong Kong was always only meant to be temporary until his certain return to his home in Luxembourg.

5.4. The court decision

The court proceeded to a detailed analysis of both the facts and the law applicable to the case.

First, it rejected the taxpayer's claim that setting advance payments to zero had created legitimate expectations on his part that he would not be assessed for income tax as a resident for 2012. Although legal certainty could prevent the administration from changing the final assessment of a factual situation to the detriment of the taxpayer, the waiving of prepayments constituted no such final assessment, but a mere provisional assessment based on the likely taxable income for the year.

Second, the court weighed the facts of the case in order to decide whether the taxpayer was a resident under section 13 of the StAnpG. This turned on whether his continuous presence in Luxembourg had been sufficiently ruptured by his departure to Hong Kong so as to suggest that he would not retain and use his home here. Recalling that the law stipulates an objective test by referring to the circumstances of the keeping of a home rather than the intention of the taxpayer, the court concluded that he had remained a resident under that standard through 2012. The evidence presented in court – including a special tax declaration filed in October by his employer in Hong Kong, which indicated the imminent departure of an employee, and the precise information given by the taxpayer in a fax to the tax office in August 2012, which stipulated his move to Hong Kong for professional reasons "until 3 December 2012" – was such as not to support a conclusion that the taxpayer would not retain and use his apartment in Luxembourg.

Third – after acknowledging that the taxpayer was legitimately qualified as a resident of Hong Kong according to article 4 of the Hong Kong-Luxembourg DTC, due to his more-than-180-day presence during the year – the court

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proceeded to analyse the effects of the tie-breaker rule, beginning with the "permanent home" test. The court made reference to the Commentary on Article 4 of the OECD Model, in particular to paragraphs 12 and 13. It did so after explicitly invoking the parliamentary materials on the law implementing the 2007 DTC, which noted that "the usual criteria of the OECD" had been kept in defining residence in the tie-breaker rule.[9] On the basis of the explanations provided thereby for the term "permanent home" – i.e. a home that is arranged and retained for permanent use as opposed to conditions that make it evident that the maintenance of a place is intended for a short duration and that it is continuously available to the taxpayer at all times – the court accepted that the taxpayer maintained such a home in Hong Kong, citing a certain difference of opinion with the first instance judges. The court then proceeded to examine the taxpayer's centre of vital interests, without analysing whether the taxpayer's apartment in Luxembourg also fulfilled the conditions for a "permanent home", taking the status of that apartment as such for granted. This is not very surprising, given the circumstances: the taxpayer had lived in that apartment since moving to Luxembourg in 2003 and apparently took up his residence there again after returning from Hong Kong.

Analysing the taxpayer's centre of vital interests, the court made reference to paragraph 15 of the Commentary on Article 4 of the OECD Model, which calls for "special attention" to be given to personal circumstances.[10] The taxpayer claimed to have no personal ties to Luxembourg at all. Even though the court expressed doubts as to the veracity of that claim after almost 10 years of living and working in the country, the court agreed to restrict its analysis solely to the closeness of the taxpayer's economic relations, since the tax administration had not submitted any concrete claims (let alone evidence) in this respect. In any event, the taxpayer's economic relations, the court ruled, were clearly closer to Luxembourg: the taxpayer continued to receive monthly payments by the Luxembourg law firm into his Luxembourg bank account. The court added that Luxembourg had clearly been his centre of economic interest for the first 5 months of 2012 and then again after November 2012. The court held that

> under these conditions, the transfer of the appellant's place of professional activity to Hong Kong for a period of seven months cannot be considered as

9. LU : *Parliamentary document 5862/00*, page 4: "*pour les cas de double résidence, les critères usuels préconisés par l'OCDE ont été retenus*" (4 Apr. 2008).

10. *See* OECD *Model Tax Convention on Income and on Capital: Commentary on Article 4*, para. 15, third sentence (22 July 2010), Models IBFD: "The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention".

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> a real and durable move of his centre of economic interests but instead constituted a temporary and only partial change of that centre that does not affect the conclusion that, overall, the economic relations of the appellant remained closer with Luxembourg.
>
> It must be concluded that the centre of vital interests of the appellant for the period of 2012 was located in Luxembourg and that he must therefore be considered a Luxembourg resident for purposes of applying the [double tax] convention for [income of] that year.[11]

Having thereby established that the taxpayer was a Luxembourg resident for the entire tax year, the court turned to the question of the applicable allocation rule to determine Luxembourg's right to levy tax as the residence state following the imposition of a salary withholding tax by Hong Kong as the source state.

Both parties to the dispute argued for the application of article 7 of the Hong Kong-Luxembourg DTC ("business profits") with respect to the taxpayer's income, since he exercised his activity as a lawyer independently. (The parties were in disagreement only as to whether the taxpayer could claim the existence of a permanent establishment in Hong Kong.) Under the applicable law in Hong Kong, however, the income had been taxed as income from employment.

The court analysed the facts as follows: the taxpayer had exercised his professional activity in Luxembourg as an independent lawyer in collaboration with the Luxembourg law firm prior to and after his move to Hong Kong, but had been engaged under the legal framework of a dependent employee for the duration of his stay there. Since a qualification of the income in question as employment income does not collide with any legal or regulatory provision in Luxembourg that would require a different qualification, the court also accepted that qualification for Luxembourg as the residence state.[12]

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11. Author's translation of the French original: "*Dans ces conditions, le transfert par l'appelant du lieu de son activité professionnelle vers Hong Kong pour une période de sept mois ne peut pas être considéré comme déplacement réel et durable du centre de ses intérêts économiques mais s'analyse plutôt en une mutation temporaire et seulement partielle dudit centre qui n'affecte pas la conclusion que globalement les liens économiques de l'appelant étaient restés les plus étroits avec le Luxembourg.*
Il convient partant de conclure que le centre des intérêts vitaux de l'appelant durant l'année 2012 était localisé au Luxembourg et qu'il était dès lors à considérer comme résident luxembourgeois pour les besoins de l'application de la Convention au titre de cette année".
12. *See*. the court's original wording: "*Dans la mesure où la qualification des revenus réalisés par l'appelant durant son détachement à Hong Kong comme revenus d'une*

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Assessing the situation under article 14 of the DTC (≈ article 15 of the OECD Model), the court upheld Hong Kong's right to tax the income earned for the period of 7 months, since it exceeded the 183-day threshold in 2012; it subsequently ruled that the exercise of that taxation right triggered an obligation for Luxembourg to exempt the same income under article 22(2) of the DTC, which provides for the application of exemption with progression.[13]

5.5. Comments on the court's reasoning

The court's approach is welcome. It is a very clear, methodical approach that places DTC law squarely at the centre of its analysis. Three brief comments should be made with respect to the court's use of the OECD Commentary and the two substantive questions raised by the case.

First, on the use of the OECD Commentary: Luxembourg is a member of the OECD and generally models its tax treaties after the OECD Model. As the parliamentary materials for the law implementing the DTC with Hong Kong explain it, negotiations were based on two different models, one put forward by each contracting party, whereby the Luxembourg "model" had been "inspired largely by the provisions of the OECD model with certain changes to take into account specificities of Luxembourg tax law".[14] The resulting agreement takes account of both parties' preferred model. Luxembourg courts have long made reference to the OECD Commentary in interpreting its treaties, the only uncertainty being that surrounding the question of whether additions to the Commentary that were included after the conclusion of a treaty could be taken into account for interpretation

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occupation salariée ne se heurte à aucune disposition légale ou réglementaire de droit luxembourgeois qui imposerait une qualification divergente, il y a lieu d'admettre cette qualification également du côté du Luxembourg en tant qu'État de résidence".

13. Art. 22(2) *HK-Lux. Income and Capital Tax Agreement* reads: "Subject to the provisions of the law of Luxembourg regarding the elimination of double taxation which shall not affect the general principle hereof, double taxation shall be eliminated as follows: (a) Where a resident of Luxembourg derives income or owns capital which, in accordance with the provisions of this Agreement, may be taxed in the Hong Kong Special Administrative Region, Luxembourg shall, subject to the provisions of sub-paragraphs (b) or (c), exempt such income or capital from tax, but may, in order to calculate the amount of tax on the remaining income or capital of the resident, apply the same rates of tax as if the income or capital had not been exempted".

14. Author's translation of the French original: "*Le modèle luxembourgeois s'inspire largement des dispositions du modèle de l'OCDE tout en prévoyant un nombre d'adaptations pour tenir compte des spécificités de la législation fiscale du Grand-Duché*".

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purposes (they can if they are mere clarifications).[15] In light of this practice, the court's reference to the parliamentary materials prior to using the OECD Commentary is superfluous. It should certainly not be interpreted as meaning that without such reference, the court would not or could not have considered it. Doubts may be raised by the fact that the court did not make any reference to the Commentary's explanations when considering the questions of income qualification or double taxation relief. It is notable that the referenced parliamentary materials make only one direct reference to the OECD Commentary in order to elucidate the meaning of a DTC provision. This one reference is made to explain why residence in Hong Kong does not require worldwide taxation. By contrast, the materials refer to the OECD Model more than 20 times; often, however, in order to express differences between its provisions and those of the DTC. It seems unlikely that the court meant to give so much weight to the parliamentary materials' reference to the OECD Model; it is reasonable to assume that it would have reached the same conclusions had it not found any such reference.

Second, on the issue of the taxpayer's residence: in resolving the question of the taxpayer's residence under the DTC tie-breaker, the court seems to follow the general consensus reflected in the OECD Commentary, to which it makes extensive reference in this analysis. The fact that the court did not stop to examine the status of the taxpayer's Luxembourg apartment as a "permanent home", though unsurprising, betrays an unspoken assumption that the test of residence has to be made for the entire year. It was crucial for the court that the taxpayer had lived in the apartment both before and after his departure, and that it qualified as a "home". Yet, during the relevant 7-month period, it would appear that he did not spend any time in his Luxembourg apartment. Why would it qualify as a "home" for that time? More importantly, what would the taxpayer have had to do in order for it not to count as his "permanent home"? The court does not give any guidance; there seems to have been no argument made with respect to potentially relevant facts in order to answer that question. It is not clear whether the taxpayer kept personal possessions in the Luxembourg apartment or whether it remained in a condition that would allow him to move back at any time during his absence. It would seem relevant to know whether the apartment had been furnished and whether it had remained connected to electricity, water and other utilities (telephone, TV and Internet) during the time. The taxpayer claimed only to have kept the lease since he had been unable to rescind it.

15. *See* e.g., LU: *Cour administrative* [Highest Administrative Court, CA], 14 Mar. 2013, Case 32184C (presented and discussed in *Tax Treaty Case Law around the Globe 2014* (E.C.C.M. Kemmeren et al. eds., IBFD 2014), Online Books IBFD.

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Under these circumstances, the lack of inquiry into the state of the apartment during the taxpayer's absence can be reasonably explained in two ways: the first, that the court was looking to make a determination for the entire tax year rather than for three separate periods (first: January-April, second: May-November, and third: December). But it is not clear why that should be done. It is generally accepted that a taxpayer may change his residence during a fiscal year.[16] This is also clear under Luxembourg tax law.[17] The second explanation is that the criterion of residence is characterized by a certain degree of inertia:[18] had the taxpayer not returned to Luxembourg at the end of the year, and eventually given up his apartment in Luxembourg, it would seem clear that it had already stopped being a permanent home for him at the time of his departure. But the court was capable of taking the fact of his return into account in order to decide whether his apartment was indeed a "permanent home" for him during the period of his absence. This would appear to be what the court did, and the result is unobjectionable, although a more thorough investigation into the question would have been preferable.

As to the determination of the taxpayer's centre of vital interests, the court's use of the OECD Commentary is not very revealing: while paragraph 15 of the Commentary gives special weight to personal acts by the taxpayer, the court ignores these entirely due to a lack of submissions from the tax administration to counter the taxpayer's claim that he had no personal relations to Luxembourg at all.[19] The final determination of the closer economic relations by the court is open to some criticism, as it was content merely to point to the fact that the taxpayer's income continued to be paid from Luxembourg and to a Luxembourg bank account. Although the result is almost certainly correct, one could have wished for a more thorough analysis and assessment of the facts. It is notable, for example, that the OECD

16. *See* e.g. R. Ismer & K. Riemer, *Article 4*, in *Klaus Vogel on Double Taxation Conventions* m.no. 79 4th edition (E. Reimer & A. Rust eds., Kluwer 2015).
17. LU: LIR, art. 6 stipulates that, "if a person is a resident taxpayer during a part of the tax year and a non-resident taxpayer during another part of the tax year, the [income] tax applies to the income realised by that person during each period separately". (French original: "*Lorsqu'une personne a été contribuable résident pendant une partie et contribuable non résident pendant une autre partie de l'année d'imposition, l'impôt frappe distinctement le revenu imposable réalisé par cette personne pendant chacune de ces périodes*".)
18. Ismer & Riemer, *supra* n. 16.
19. This is acceptable for the court since it concerns a question of fact, which it need not investigate if the facts are not in dispute. Had it been a question of law, agreement by the parties to the dispute would not absolve the court from making its own determination, as it did later in the judgment on the question of the applicable distributive rule.

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Commentary explicitly mentions the "place of business" of the taxpayer.[20] The taxpayer's place of business for the 7-month period was almost certainly in Hong Kong, as he was meant to develop business opportunities for the law firm there. By contrast, the country from which a payment is made or where the relevant bank account is registered is not a very reliable criterion.[21] More substantive scrutiny would have included the effective place of his work, including possibly an inquiry as to whether his true employer was in Luxembourg or in Hong Kong. The court may have had a much clearer picture as to all the relevant circumstances when it concluded that the taxpayer's relocation could not be considered a "real and durable move of his centre of economic interests" but only a "temporary and partial change of that centre". However, the judgment does not reveal those circumstances.

Third, on the possibility and resolution of the income qualification conflict: the court adopts a solution fully in line with the OECD's "new approach",[22] but makes no mention of the OECD's view. Luxembourg has offered no reservations to the Commentary on this view; the relevant tax treaty follows the relevant change in the Commentary in the year 2000 and the phrase used for that interpretation ("in accordance with the provisions of this Convention, may be taxed") is also found in the Hong Kong-Luxembourg DTC. It would thus appear to be a simple case of following that interpretation. Yet the court seems to only accept that it *should* follow the source state's qualification of the income as employment income ("*il y a lieu d'admettre cette qualification*"), not that it was legally bound to do so. The only reason given by the court is that following the source state's qualification did not create any conflict with Luxembourg law ("*la qualification … ne se heurte à aucune disposition légale ou réglementaire de droit luxembourgeois*"). This is somewhat ambiguous: it seems clear that under Luxembourg law the income would have qualified as *bénéfice d'une profession libérale* if – and the court made no determinations to the contrary – the activity was actually exercised independently, from the perspective of Luxembourg law. It is unclear what other possible collision with Luxembourg law or regulation the court could have had in mind – other than maybe a requirement under the internal regulations of the Luxembourg bar that its lawyers must act independently (unless they are employed by another lawyer who is a member of the bar). The court may be saying that the qualification of the taxpayer's income as a salary

20. *See* para. 15 *OECD Model: Commentary on Article 4* (2010).
21. *See also* Ismer & Riemer, *supra* n. 16, at Article 4 m.no. 95. Although it has been accepted by a number of courts to be a relevant fact to be taken into account. *See* e.g. CA: Federal Court of Appeal, 26 Jan. 2006, A-89-05; DE: *Finanzgericht* München, 4 Apr. 2003, 12 K 2867/96.
22. *See* paras. 32.1-32.7 *OECD Model: Commentary on Article 23* (as of 2000).

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does not violate the bar's regulations. But it would be doubtful whether that could have an impact on Luxembourg's obligations to exempt that income.

Finally, the court did not investigate whether the taxpayer's "employer" for tax purposes was the Luxembourg law firm or the Hong Kong law firm. It emerges from the facts that the former bore the cost of his work and it may well be that he indeed worked on behalf of the Luxembourg firm to develop relations between the two during his stay abroad. The court did not establish the employer and did not enquire into the formal relations between the taxpayer and the two firms. It also did not refer to the lengthy explanations in the OECD Commentary – admittedly, many of them were added in 2010, and thus after the conclusion of the relevant DTC – on the difficulty of delineating employment and business activity.[23] Additional considerations regarding this matter would have been illuminating for other cases, although it was immaterial in this case whether the real employer was a resident of Hong Kong, since the lawyer had in any case surpassed the 183-day presence threshold for granting taxation rights to Hong Kong.

5.6. Conclusion

The court decision correctly identifies the issues covered by an applicable DTC and applies the relevant provisions generally in line with commonly accepted doctrine and the OECD Commentary. A Luxembourg lawyer who spent 7 months during a tax year working in an office in Hong Kong before returning, without giving up his apartment in Luxembourg during this period, was correctly qualified as a resident of Luxembourg for the entire tax year and taxed accordingly. The income earned during the stay in Hong Kong was exempt under the DTC, but Luxembourg retained a right to apply a higher tax rate to his domestically earned income for the year.

Although the court could have elaborated on certain points, such as the reasons for referring or not referring to the OECD Commentary in its resolution of the case, and a more thorough description (or investigation) of the facts on the ground, the outcome of the case appears to be fully in line with international standards and the objective of the DTC.

23. *See* paras. 8.1-8.28 *OECD Model: Commentary on Article 15* (2010).

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