6. The structure and system of DTCs

6.1. Applying the convention

156 The structures and systems of **all DTCs show similarities**. Tax treaties usually contain rules relating to the personal and substantive scope. The allocation of taxing rights over the persons and taxes covered is dealt with in one of the allocation rules. The avoidance of double taxation is almost always dealt with in the method article. Other provisions supplement the treaties.

157 Insofar as the treaty follows the OECD Model, the **personal scope** of a DTC is established by Art. 1 and Art. 4 (cf. m.no. 182 et seq.). Under Art. 1 OECD Model, the convention is applicable to persons who are residents of one or both contracting states. According to Art 3(1) OECD Model, a person includes an individual, a company and any other body of persons. However, a PE is not regarded as being a person. Under Art. 4(1) OECD Model, any person who, under the laws of that state, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, is considered a "resident of a Contracting State". Persons who are liable to tax in that state in respect only of income from sources in that state or capital situated therein are not considered "residents of a Contracting State". It is inferred from this article that worldwide tax liability in one of the two states is a condition for the application of the DTC.

158 The **substantive scope** is established by Art. 2 (cf. m.no. 225 et seq.). Art. 2(1) OECD Model states that the convention shall apply to taxes on income and on capital imposed on behalf of a contracting state or of its political subdivisions or local authorities, irrespective of the manner in which they are levied. Usually, Art. 2 also lists the taxes in force at the time the treaty is concluded, which fall into the substantive scope of the treaty, and establishes that the convention is applicable to any identical or substantially similar taxes that are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes.

159 If the convention is applicable to both the person and the taxes, the **allocation rules** must be applied (cf. m.no. 233 et seq.). With respect to the taxation of income, the allocation rules can be found in Art. 6 to Art. 21 OECD Model (with the exceptions of Art. 9). With respect to the taxation of capital, the allocation rules are set out in Art. 22 OECD Model. The legal consequences of the allocation rules differ: some allocation rules reduce source taxation; others entirely remove the taxing rights of the source state. The restriction of taxing rights of the residence state is not generally found in an allocation rule but rather in the method article.

160 The **method article** (Art. 23 OECD Model) contained in DTCs provides the manner in which double taxation will be eliminated (cf. m.no. 405 et seq.): either the exemption method or the credit method will be applied. The exemption method interferes with the taxable base, so that certain income or assets become tax exempt. The credit method obliges the residence state to credit the taxes levied by the source state in accordance with the allocation rules.

6.2. Persons covered

DTC provisions that reproduce Art. 1, Art. 3 and Art. 4 OECD Model cause the DTC to be applicable if **worldwide tax liability** exists in at least one of the two states. Consequently, the law of the contracting states is decisive in this respect. In the case of worldwide tax liability in one of the two states, the other contracting state is obliged to apply the DTC. 161

DTCs are applicable even if worldwide tax liability exists in both states. In this case, a choice between the two contracting states must be made in order to determine the residence state for tax treaty purposes, since the functioning of the allocation rules and the method article requires that there **is only one residence state**. Insofar as individuals are concerned, the criteria under which the residence state is established are found in Art. 4(2) OECD Model (cf. m.no. 208 et seq.). Permanent home, centre of vital interests, habitual abode and nationality arise in sequence. As far as persons other than individuals are concerned, the criterion to determine the residence state is found in Art. 4(3) OECD Model (cf. m.no. 222 et seq.). The place of effective management is decisive. In the **UN Model**, apart from the place of effective management, the place of incorporation is mentioned as an additional criterion in Art. 4(1). However, in accordance with the OECD Model, Art. 4(3) UN Model states that ultimately the place of effective management shall be decisive for determining the residence state. 162

The determination of the residence state is **for treaty purposes only**. The residence in just one of the two states does not automatically mean that in the other state taxes are levied under the limited tax liability rules. Domestic full tax liability rules of the source state may remain applicable. The amount of tax might still be determined according to the residence taxation rules and not according to non-residence taxation rules. 163

The DTC signed between two states, however, is not applicable in cases of **limited tax liability in both states**. In these cases, a taxable person can only rely on DTCs potentially existing between the states in which he/she/it is subject to limited taxation and the state where he/she/it is subject to full tax liability. If such DTCs do not exist, double taxation can only be avoided by unilateral measures. 164

Example 165

An individual is resident in Switzerland. She receives dividends from a corporation incorporated in France with its place of effective management in the Netherlands. Both France and the Netherlands tax the dividends paid to the individual. However, the France–Netherlands DTC does not apply since the individual is subject only to limited tax liability in both states. Double taxation can only be avoided by the application of the France–Switzerland DTC and the Netherlands–Switzerland DTC.

6.3. Taxes covered

166 Pursuant to DTC provisions that reproduce Art. 2(1) OECD Model, the treaty is applicable with respect to **taxes on income** imposed on behalf of a contracting state or its political subdivisions or local authorities. The manner in which they are levied is irrelevant. In general, taxes imposed on total income or on elements of income are covered. In addition, Art. 2 OECD Model sets out a list of the taxes in force at the time the treaty was concluded to which the DTC shall apply. An adjustment clause usually supplements this provision. Pursuant to this clause, the OECD Model is also applicable to any identical or substantially similar taxes that are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes.

167 Pursuant to DTC provisions patterned after Art. 2 OECD Model, the treaty is also applicable to **taxes on capital** imposed on behalf of a contracting state or its political subdivisions or local authorities. As with taxes on income, the manner in which taxes on capital are levied is irrelevant. In general, taxes imposed on total capital or on elements of capital are covered. When taxes on capital are included in the substantive scope of a DTC, the treaty can still have an impact when those taxes have been abolished in the domestic law of one of the contracting states: as long as the other contracting state keeps levying taxes on capital, the treaty benefits are available to taxable persons despite the fact that the former state has waived levying taxes of that kind.

6.4. Allocation rules

168 The allocation rules of DTCs (patterned after Art. 6 to 8 and 10 to 21 and Art. 22 OECD Model) shall apply only if the personal and substantive scope of the treaty are fulfilled. Thus, the personal and substantive scope must first be examined. In most cases, the allocation rules do **not ensure that double taxation is avoided**. The limitation of the taxing rights of the residence state is provided for in the method article.

169 ***Example***

Pursuant to Art. 7(1) of the Italy–Spain DTC, business profits of an enterprise of a contracting state are taxable in the other contracting state if the enterprise carries on business in that other state through a PE. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other state but only so much of them as is attributable to that PE. The profits that an Italian company makes through its PE in Spain can therefore be taxed in Spain. This does not mean, however, that Italy cannot tax these business profits. Art. 7(1) does not address Italy's right to tax. The method article (Art. 22 Italy–Spain DTC) does not deprive Italy of its right to tax but rather provides that Italy will credit the tax paid to Spain on the business profits.

The allocation rules impose **limitations on the taxing rights of the source state**. This is frequently the case with dividends, interest and royalties. The allocation rules often state that the source state's tax cannot exceed a certain rate. The avoidance of the remaining double taxation is dealt with in the method article. 170

Example 171

Under Art. 10(1) of the Australia–Japan DTC, dividends paid by a company that is a resident of a contracting state to a resident of the other contracting state may be taxed in that other contracting state. Australia may therefore tax dividends received by an Australian resident from a Japanese company. Japan's taxing right is not restricted by this provision. Art. 10(2) Australia–Japan DTC provides that the dividends may also be taxed in the contracting state of which the company paying the dividends is a resident but the tax cannot exceed 10% of the gross amount of the dividends. Thus, Japan's right to tax is restricted to 10%. The double taxation of this 10% is avoided through the method article (Art. 25 Australia–Japan DTC), which provides that Australia will give a credit for the tax paid to Japan.

In some cases, however, the allocation rule **excludes the taxing rights** of one of the two states entirely. This is usually the case when the allocation rules state that certain income "shall be taxable only" in the other state. In this case, the former state no longer has any taxing rights. 172

Example 173

Pursuant to Art. 9 of the Belarus–Denmark DTC (interest article), interest arising in a contracting state and paid to a resident of the other contracting state shall be taxable only in that other state. Thus, interest arising in Denmark and paid to a resident of Belarus can only be taxed in Belarus.

All items of income are to be assigned to one single allocation rule. In cases in which none of the allocation rules established in Art. 6 to Art. 8 and Art. 10 to Art. 20 OECD Model applies, the **blanket clause** in Art. 21 OECD Model (other income) is applicable: all items of income not dealt with in the foregoing articles of the DTC are covered by this clause. Art. 22(4) OECD Model regarding taxes on capital has a similar function. Nearly all DTCs include such other income provisions as foreseen by the OECD Model. However, the treaty network of Jersey shows that these provisions are not necessarily to be found in a DTC: only a few treaties (e.g. those signed with Estonia, Hong Kong, Ireland and Malta) include a blanket clause along the lines of Art. 21 OECD Model. In the absence of such a rule domestic taxation may arise because not all sources of income are covered by the allocation rules. Still, this type of con- vention remains an exception. 174

Example 175

Dividends are covered by Art. 10 OECD Model. The provision applies only to dividends arising in a contracting state and paid to an individual resident in *the other contracting state. Thus, dividends received by a resident of Belgium from a company resident in Belgium or in a third country are not covered by Art. 10 OECD Model. In such a case, Art. 21 OECD Model applies. This rule gives the exclusive right to tax to the residence state and prevents the other contracting state from levying a tax on these dividends.*

176 Each item of income or element of capital can **only be covered by one** allocation rule, not by several. The application of the method article presupposes that only one allocation rule is applicable. Should two or more allocation rules receive consideration, it is essential to clarify through interpretation which allocation rule is to be applied. In some cases the allocation rules contain express priority provisions. If this is the case, these treaty provisions state which allocation rule is to be given priority in the conflict.

177 ***Example***

A Dutch company receives dividends from Iceland. Under Art. 7 of the Iceland–Netherlands DTC, the profits of the Dutch company cannot be taxed by Iceland unless the Dutch company has a PE in Iceland. Dividends, however, are covered by Art. 10 Art. 7(7) of the applicable treaty provides that where profits include items of income which are dealt with separately in other articles, the provisions of those articles shall not be affected by the provisions of Art. 7. Thus, Art. 7 provides that Art. 10 Iceland–Netherlands DTC is to be given priority and Iceland will be entitled to levy source taxation on the dividends.

6.5. Methods for elimination of double taxation

178 Generally, in the allocation rules, the taxing rights of one of the two contracting states are partially restricted. Therefore, the manner in which double taxation is avoided is set out in the method article. In continental Europe, the **exemption method** is often adopted: the residence state excludes from the taxable base the income derived or the capital owned in the other state. In this case, the taxing rights lie only with the source state. The residence state may nevertheless take the exempt income or capital into account in calculating the amount of tax on the remaining income or capital of the taxable person. This proviso safeguarding progression ensures the mitigation of the advantages that are created through the allocation of income to different states and the corresponding classification of income into low-tax brackets in both states.

179 ***Example***

A Beligian entrepreneur has a place of business in Brussels and another in Amsterdam. In each place of business, he earns business profits of EUR 30,000. Pursuant to Art. 7(1) of the Belgium-Netherlands DTC, the business profits earned in Amsterdam may be taxed by the Netherlands. Art. 23(1) of

that DTC precludes Belgium's right to tax these profits, but the DTC also allows these profits to be taken into account in determining the tax due on the remaining income. Consequently, only the income of EUR 30,000 in Belgium is subject to tax in this state but the applicable rate of tax is the one that would be applied to income of EUR 60,000.

The second method is the **credit method**. It is especially common for countries 180
belonging to the Anglo-American legal system. It is also adopted in almost all DTCs to avoid double taxation on dividends and interest and, in some DTCs, to avoid double taxation on royalties. Under the credit method, the taxable base in the residence state remains unchanged. In other words, the foreign income is still included in the domestic taxable base. However, the taxes levied in the source state are credited on the taxes levied in the residence state.

Example 181

A Maltese corporation receives dividends of EUR 10,000 from a 5% holding in an Irish corporation. Pursuant to Art. 10(1) Ireland–Malta DTC, Malta may tax these dividends. Under Art. 10(2), Ireland may also tax the dividends to a maximum of 15%. Under Art. 22(2), Malta will give a credit for Irish tax at source. In Malta, the EUR 10,000 are subject to corporate tax of 35%, and tax of EUR 3,500 is payable. The Irish tax at source amounts to EUR 1,500, which is credited on the Maltese tax due such that it amounts to EUR 2,000.