ARTICLE

Worrying Interpretation of 'Liable to Tax': OECD Clarification Would Be Welcome

Arnaud de Graaf* & Frank Pötgens**

This article examines the rather strict interpretation of 'liable to tax' by the Dutch and Canadian Supreme Court requiring persons to be effectively liable in order to be treated as a treaty resident. As outlined, such an interpretation has the consequence of preventing tax-exempt bodies from being able to claim treaty benefits while also resulting, under certain allocation rules, in source states being unable to exercise their taxing rights. In the view of the authors, a person should be regarded as a treaty resident if he has such a nexus with a state that he would normally be taxed on his worldwide income there. Whether he actually pays tax is irrelevant, which is the view of many. For resolving the issue, the authors outline a proposal.

1. Introduction

1.1. General

This article focuses on the term 'resident' as used in tax treaties. The first sentence of Article 4(1) of the Organisation for Economic Co-operation and Development (OECD) model convention refers to a resident of a contracting state as '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'.[1] The second sentence of Article 4(1) goes on to state that a person is not 'a resident of a contracting state' if such person is 'liable to tax' in that state in respect only of income from sources in that state.[2] In the commentary on Article 4 of the OECD model convention,[3] the OECD states that the term 'liable to tax' should be taken to mean a 'full liability to tax' or 'comprehensive liability to tax'. The general understanding of this is that such a liability can only be said to apply if the state in which the person is resident (and which applies the principle of universality in tax matters rather than the principle of territoriality) taxes the person's worldwide income under any of the above criteria and not just the person's income from sources in that state. If a state applies the principle of territoriality, the requirement for 'full liability to tax' and the second sentence of Article 4(1) of the model convention do not mean, however, that persons who are residents in that state cannot be regarded as 'residents' of that 'contracting state' for treaty purposes.[4] This is because, according to the OECD commentary, the second sentence should be interpreted in the light of the object and purpose of the 'Resident' article. OECD Member States seek to exclude from treaty benefits any persons who are not liable to the 'most comprehensive taxation (full liability to tax)' in a state. However, they expressly do not seek to exclude from the scope of a treaty all residents of countries basing their taxation on the principle of territoriality.

In this respect, there is clarity on how 'liable to tax' should be interpreted. It is, however, still very much unclear as to whether the term 'liable to (comprehensive) tax' requires a person to be taxed in a state, whether in fact, actually or effectively, on income from his activities. The way in which the highest tax courts in Canada,[5] according to Ward et al.,[6]

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* Arnaud de Graaf, Associate Professor of International and European Tax Law. The author is on the staff of the Erasmus School of Law (Erasmus University Rotterdam), in which capacity this article has been written, and the Netherlands Ministry of Finance.

** Frank Pötgens, Professor of International and European Tax Law. The author is on the staff of VU University Amsterdam and a tax lawyer practising at De Brauw Blackstone Westbroek NV in Amsterdam.

1 This first sentence also clarifies that the term 'resident of a contracting state' includes 'the state' as such and 'any political subdivision or local authority thereof'.

2 See paras 8.1 and 8.2 in the commentary on Art. 4(1) OECD model convention.

3 Paragraphs 3, 4, and 8 in the commentary on Art. 4 OECD model convention.

4 See para. 8.3 in the commentary on Art. 4(1) OECD model convention.

5 Supreme Court of Canada, 22 Jun. 1995, no. 23940 (*Crown Forest Industries Ltd. v. Canada*) [1995] 2 SCR 802 (see <http://scc.lexum.umontreal.ca/en/1995/1995scr2-802/1995scr2-802.html>). For a discussion of this case, see D.A. Ward et al., 'A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries', *Canadian Tax Journal* 2 (1996): 408–424, and K. Brooks, 'Canada', in *Residence of Companies under Tax Treaties and EC Law*, ed., 6. Maisto, EC and International Tax Law Series no. 5 (Amsterdam: IBFD, 2009), 425–428.

6 In their article 'A Resident of a Contracting State for Tax Treaty Purposes: A Case Comment on Crown Forest Industries', Ward et al., state on 419 that 'if the broad sweep of the statements of the Supreme Court in Crown Forest Industries were to be applied, such entities [authors: tax-exempt charitable organizations and pension trusts] would be considered not to be entitled to the treaty-reduced rates of tax'.

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and the Netherlands[7,8] interpret this term at least requires a person actually to be liable to tax on his income (in other words, a more, albeit limited, material rather than formal approach to 'liable to tax'). One result of a limited, or material, approach of this nature is in any event that tax-exempt pension trusts and non-profit organizations (operated for religious, charitable, cultural, scientific, and public purposes) are considered not 'liable to tax' and therefore cannot be a 'resident of a contracting state'. The same applies to legal entities under public law and (non-transparent) investment funds, which are commonly exempt from tax. If contracting states do not specify that such tax-exempt entities should be regarded as a 'resident of a contracting state', such entities cannot claim entitlement to treaty benefits if this approach is applied. And that in turn means they will pay considerably more tax in other countries on investment income sourced from those countries than if they had not been exempt from tax in their residence state.

Another possible consequence of this material approach to the term 'liable to tax' is that a state may be unable, under its tax treaties, to tax dividends that a tax-exempt investment fund resident in that state pays to beneficial owners who are residents in other contracting states. This is because, for tax treaty purposes, the fund is not considered a resident of its residence state and so, under the second paragraph of the 'Dividend' article (Article 10 of the OECD Model), cannot impose tax on dividends paid. The second paragraph of the article allows only a limited right of taxation to the contracting state of the company paying the dividends, and this is conditional on the company being a resident of this state for treaty application purposes. Similar problems arise in respect of fees paid by tax-exempt entities to directors resident in other contracting states as the source state is also unable to tax such fees if this material approach is applied.

1.2. Research Structure

This article examines the meaning of the term 'liable to tax'. Firstly, in section 2, we discuss the requirement arising from the term 'liable to tax' for a person's worldwide income to be taxed if that person is to be regarded as a 'resident of a contracting state'. We follow this with a discussion, in section 3, of the position taken by the Dutch Supreme Court, whereby 'liable to tax' also requires a person to be actually liable to tax on his income. This includes an examination of the way in which courts in other OECD Member States, tax authorities, and various leading academics interpret 'liable to tax'.[9] The approach adopted by these courts, tax authorities, and tax experts is also the approach that we favour because, as we outline in section 4, the alternative interpretation, which is shared *inter alia* by the Dutch Supreme Court, has in our view the undesired consequence of preventing tax-exempt bodies from being able to claim entitlement to treaty benefits while also resulting, under certain allocation rules, in source states being unable to exercise their rights to impose tax (in Articles 7, 10, 11, 12, and 16 of the OECD model convention, for example, the term 'resident of a contracting state' plays a prominent role). Another repercussion of a situation in which a source state and a residence state interpret 'liable to tax' in different ways is the possibility of double taxation or double exemption from tax. In order to avoid such repercussions, we outline a proposal in section 5 for resolving the problem of contracting states having diverging interpretations of 'liable to tax'. The article ends in section 6 with a conclusion.

2. 'Liable to Tax' and the Second Sentence

As indicated in the introduction, the second sentence of Article 4(1) of the OECD model convention states that a person is not a 'resident of a contracting state' for treaty purposes if he is liable to tax in that state in respect only of income from sources in that state. According to the second sentence of paragraph 8.2 of the commentary on Article 4(1) of the model convention, this second sentence of Article 4(1) also means that a person is 'not subject to comprehensive liability to tax in a Contracting State' if the person is a resident of that state under that state's national tax legislation but is regarded as a resident of another state (the 'winner state') under a treaty between the two states.[10] In such situations, the tax treaty allows the 'loser state' only a limited right to tax – in other words, the right to tax the person's income from sources in that 'loser state'. As this dual resident is consequently only 'liable to tax' in the loser state on income from sources in that state and, in OECD terminology, is also 'not subjected to comprehensive taxation (full liability to tax)', the person also cannot be regarded as a resident of the 'loser state' for the application of tax treaties between the 'loser state' and other states.

In paragraph 8.3 of the commentary on Article 4(1)(2nd sentence) of the model convention, the OECD states, however, that this second sentence is specifically not intended to exclude all residents of countries adopting a territorial principle in their taxation from the scope of the convention. According to this paragraph, the second sentence should be interpreted in the light of its 'object and purpose'. As the OECD states in paragraph 8.3 of its commentary, the object and purpose of this second sentence are 'to exclude persons

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7 Dutch Supreme Court, 28 Feb. 2001, no. 35557, BNB 2001/295; Dutch Supreme Court, 4 Dec. 2009, nos 07/10382–07/10384, V-N 2009/63.17; and Dutch Supreme Court, 4 Dec. 2009, no. 08/05071, V-N 2009/62.5. For a discussion of these cases, see A.C.G.A.C. de Graaf & F.P.G. Pötgens, 'Verontrustende *HR-uitleg verdragsbegrip* "resident"', WFR 2010/6848, 267–282.

8 Paragraph 47 of the OECD Report, *The Application of the OECD Model Tax Convention to Partnerships* (Paris: OECD, 1999).

9 For the history of the term 'liable to tax', see R. Vann, '"Liable to Tax" and Company Residence', in *Residence of Companies under Tax Treaties and EC Law*, ed., 6. Maisto, EC and International Tax Law Series no. 5 (Amsterdam: IBFD, 2009), 197–227.

10 See also para. 6 of the OECD Report, *Draft Contents of the 2008 Update to the Model Tax Convention* (Paris: OECD, 2008).

who are not subjected to comprehensive taxation (full liability to tax) in a State'. In essence therefore, the OECD attributes no significance to the second sentence of Article 4(1) of the model convention or paragraphs 8.1 and 8.2 of its commentary on this second sentence in respect of countries that base their taxation on the principle of territoriality.

It follows from the first paragraph in the introduction to this article and the two above paragraphs that, according to the commentary on Article 4(1) of the model convention, the decisive factor for the OECD as to whether a person should be regarded as a 'resident of a contracting state' is whether the specific person is fully or comprehensively liable to tax in his residence state or whether he is not subject to a comprehensive liability to tax. By contrast, the decisive factor according to the text of Article 4(1) of the model convention is whether the residence state taxes a person on his worldwide income or only on his income from sources in this residence state. Although, in practice, the two criteria may often produce the same result, this will not always be the case. If a state basing its taxation on the principle of territoriality taxes a person on the grounds of the person's domicile, residence, place of management, or some other circumstances, the first criterion will in principle result in the person being regarded as a resident of this state for tax treaty purposes. Under the second criterion, however, the person cannot be regarded as a resident for treaty purposes. If a state also taxes a person on income from sources in other states under the above criteria, the person will be regarded as a resident of this state for treaty purposes under the second criterion, whereas this will not necessarily be the case in respect of the first criterion.[11] Contracting states can avoid a diverging interpretation of 'resident of a contracting state' by omitting the second sentence and replacing the words 'is liable to tax' in the first sentence by 'is comprehensively (fully) liable to tax'.[12] It is our hope that the OECD will consider including this suggestion in any future amendment of the model convention.

3. 'Liable to (Comprehensive) Tax': Requirement to Be 'Subject to Tax'?

3.1. General

As explained above, a person resident in a state and wanting to be considered a 'resident of [that] contracting state' for treaty purposes needs to be liable to comprehensive taxation in that state. The question that arises in respect of the term 'liable to comprehensive taxation' is whether this requires a person to be actually liable to tax in his residence state. In its judgment of 9 December 2009, the Dutch Supreme Court ruled that taxable entities that are exempt from tax under certain conditions and also subjectively tax-exempt entities are not liable to tax within the meaning of the 'Resident' article in the 1992 tax treaty between the Netherlands and the United States, unless they are specifically designated a 'resident of a contracting state'. Ward et al., conclude from the 'broad sweep of the statements of the Supreme Court' of Canada in its ruling of 22 June 1995 in *Crown Forest Industries Ltd* that, in the Supreme Court's view, tax-exempt charitable organizations and pension trusts 'would not be considered to be residents of a contracting state'.

In section 3.2, we briefly outline the facts and the dispute that led to the above judgment of the Dutch Supreme Court. We follow this, in section 3.3, by discussing the view that 'liable to comprehensive taxation' does not require a person to be actually liable to tax in the residence state. We summarize these discussions in section 3.4.

3.2. Dutch Court Ruling

The case before the Dutch Supreme Court[13] involved an association incorporated and with its place of management in the Netherlands. This association was not regarded as a taxpayer for Dutch corporation tax purposes in the 2000 tax year as it did not perform any business activities. Under Article 2(1)(e) of the Dutch Corporation Tax Act [*Wet op de vennootschapsbelasting*] 1969, associations are only taxable if and insofar as they perform business activities. During the same year, one of the association's directors was regarded as a resident of the United States for the purposes of the 1992 Netherlands/United States tax treaty. He received a fee in consideration of his duties performed as director.

The issue at stake in this case concerned the interpretation of the term 'resident' in the article on directors' fees in the tax treaty between the Netherlands and the United States, which is based on the OECD model convention.[14] This is because the way in which this term is interpreted is relevant in respect of whether the Netherlands, as the source state, is entitled to tax the director's fee (and, therefore, whether the United States should grant relief) or whether the United States, as the director's residence state, should have the exclusive right to tax these fees. According to the first sentence of Article 4(1)

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11 An example of this could be a non-domiciled resident of, for instance, the United Kingdom, as a non-domiciled resident is taxed in the UK on UK-source income and on any non-UK-source income if and insofar as remitted to the UK.

12 In interpreting the term 'resident of a contracting state' in the 'Resident' article in the 1980 tax treaty between Canada and the United States and the 1970 tax treaty between Belgium and the Netherlands, the Supreme Court of Canada and the Dutch Supreme Court respectively concluded – without the provision containing a second sentence in line with Art. 4(1) of the OECD model convention – that the term 'liable to tax' required there to be tax on a person's worldwide income (SCC, 22 Jun. 1995, no. 23940, *Crown Forest Industries Ltd v. Canada* [1995] 2 SCR 802, and Dutch Supreme Court, 28 Feb. 2001, no. 35557, BNB 2001/295).

13 Dutch Supreme Court, 4 Dec. 2009, nos 07/10382–07/10384, V-N 2009/63.17.

14 In contrast to the article on directors' fees in the OECD model convention, Art. 17 of the 1992 Netherlands/United States tax treaty contains a second sentence to the effect that such fees shall be taxable in the residence state only to the extent to which such fees are derived from services rendered in that state.

of the Netherlands/United States tax treaty, the words 'resident of one of the states' mean:

> any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature, or that is an exempt pension trust, as dealt with in Article 35 (Exempt Pension Trust) and that is a resident of that State according to the laws of that State, or an exempt organization, as dealt with in Article 36 (Exempt Organizations) and that is a resident of that State according to the laws of that State.

Essentially, this definition of 'resident of one of the states' is the same as that in the first sentence of Article 4(1) of the OECD model convention.

In its judgment of 26 June 2007, the Court of Appeal in The Hague stated that the association should be regarded as a resident of the Netherlands within the meaning of the tax treaty. As the Court of Appeal stated in paragraph 6.4.4:

> The decisive factor [is]. . .whether, given its domicile, the relationship that [the association] has with the Netherlands can give rise to an unlimited liability to tax. Viewed from the perspective of the object and purpose of Article 4 of the tax treaty (concerning the allocation of taxation powers between the two states), there is no additional requirement; in other words, no requirement to be effectively liable to a tax on profits.[15]

This interpretation means that the Netherlands is in principle allowed to tax the director's fees.

The Supreme Court went on to rule that, under the Dutch Corporation Tax Act, an association is not generally taxable. As the Supreme Court pointed out, an association is only taxable if and insofar as it performs business activities. The Supreme Court also raised the question of whether an association that is established in the Netherlands, does not perform business activities, and so is not taxable under the Corporation Tax Act can nevertheless be regarded as being 'liable to tax' in the Netherlands within the meaning of the 'Resident' article. In answering this question, the Supreme Court referred to the fact that, not just persons who are liable to tax as residents, should be regarded as residents, but the 'Resident' article also regards exempt pension trusts and exempt organizations, as dealt with in Articles 35 and 36, as residents. According to the Supreme Court, the addition of the words 'or that is an exempt pension trust, as dealt with in Article 35 (Exempt Pension Trust) and that is a resident of that State according to the laws of that State, or an exempt organization, as dealt with in Article 36 (Exempt Organizations) and that is a resident of that State according to the laws of that State' to the definition of the term 'resident of one of the states' means that, for tax treaty purposes, such trusts and organizations cannot, at least not in all cases, be regarded as residents under the 'liable to tax' criterion unless they are specifically mentioned in the 'Resident' article. This prompted the Supreme Court to conclude that, by not being a taxpayer, the association could not be regarded as a resident for the purposes of the treaty.

3.3. Alternative View on Interpreting 'Liable to Tax'

3.3.1. *Introduction*

In this section, we set out to explain why we are not in favour of the material approach adopted by the Supreme Court of Canada, as discussed by Ward et al., and the Dutch Supreme Court. We then explain why we do not support this approach and give examples from various sources to back up our views (sections 3.3.2–3.3.7).

3.3.2. *Textual Interpretation of 'Liable to Tax': No Requirement to Be 'Subject to Tax'*

In English, a clear distinction is made between 'subject to tax' and 'liable to tax'.[16] Linguistically, the words 'liable to tax' have a broader meaning than 'subject to tax', with the former not requiring a person actually to be taxed on all or some of his income. The requirement to be 'liable to tax' is consequently also met if the person in question is entitled to an objective or subjective exemption from tax on income or profit and, as a result, effectively pays no or a reduced amount of tax. This view was also confirmed during the panel discussion on subject I (double non-taxation) at the International Fiscal Association (IFA) Congress in 2004.[17] In contrast to 'liable to tax', the words 'subject to tax' may require an effective liability to tax on a person's income.[18] In other words, 'liable to tax' refers simply to an abstract liability to tax on a person's worldwide income. In this respect, it is consequently irrelevant whether certain items of income are exempt from tax or whether no tax is actually payable as a result, for example, of personal allowances or losses.[19] The material interpretation of 'liable to tax' favoured

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15 Unofficial translation.

16 For an explanation of this distinction, see also A. Scapa & L.A. Henie, 'Avoidance of Double Non-Taxation under the OECD Model Tax Convention', *Intertax* 6, no. 7 (2005): 271–272, and Ward et al., *supra*, 421.

17 See also I.J.J. Burgers, 'Recente ontwikkelingen in het Nederlands belastingverdragenrecht', Tydschrift Fiscaal Ondernemingsrecht (TFO) 78 (2005): 48. The panel concluded that the meaning of 'liable to tax' is wider than that of 'subject to tax'. Of the two, the latter term is the least wide and requires that tax is actually paid. Cf. J. Svobodová, 'Treaty Entitlement of Dual Residents', in *Dual Residence in Tax Treaty Law and EC Law*, ed. M. Hofstätter & P. Plansky (Vienna: Linde Verlag, 2009), 110.

18 Scapa & Henie, *supra*, 272.

19 *Ibid., supra*, 271.

by the Dutch Supreme Court, for example, suggests that it adheres to the meaning of 'subject to tax' rather than 'liable to tax', such as applied in Article 4(1) of the 1992 Netherlands/ United States tax treaty and in the OECD model convention,[20] while the approach that we favour makes this distinction (see also section 3.3.3).[21]

3.3.3. *Teleological Interpretation 'Liable to Tax': A Certain Nexus to a Jurisdiction Is Sufficient*

In our view, the primary idea behind the term 'resident of a contracting state' is that the person should have a nexus to a treaty party to such an extent that he fully falls under its tax jurisdiction. In other words, the person has a link to a contracting state, such as domicile, residence, or place of management, such that he would normally have a 'full liability to tax'. Whether the person is also actually fully liable to tax is in our view irrelevant. There may be various reasons why the person is not actually fully liable to tax. A country may have chosen for various reasons to make certain tax facilities available in respect of certain persons, activities, or income. Such facilities may result in a subjective exemption, a zero rate, an objective exemption, or a reduction in the taxable base, with the result that a person's income is not actually taxed. In our view, a distinction should be made between such a situation and a situation in which an entity is regarded as fiscally transparent[22] or in which a country does not have a tax on profits. This view is supported by the various sources we refer to below and also by the linguistic distinction discussed above in section 3.3.2.

3.3.4. *OECD Commentary on 'Liable to Tax': Various Exempt Entities Are Liable to Tax*

Although the OECD is not always completely unambiguous on the interpretation of the term 'liable to tax' in its commentary on Article 4(1) of its model convention, support for the above textual and teleological interpretations of 'liable to tax' can be found in paragraph 8.5 of the commentary on this article:

> Paragraph 1 refers to persons who are 'liable to tax' in a Contracting State under its laws by reason of various criteria. In many countries, a person is considered liable to comprehensive taxation even if the Contracting State does not impose tax.

The OECD, too, had to respond to the question of what the condition of being 'liable to comprehensive taxation' means for persons who are not in fact fully liable to taxation. Does this condition mean that a state, public sector entities, public universities, pension trusts, or non-profit organizations can qualify as residents for treaty purposes? In order to remove some of the uncertainty in this respect, Article 4(1) of the OECD model convention has since 1995 explicitly stated that a resident of a contracting state for treaty purposes includes a state and any political subdivision or local authority thereof. And, as paragraph 8.4 of the commentary on Article 4(1) of the model convention shows, most OECD Member States do not regard this as a substantive change in the OECD model convention but merely as a clarification.

Many Member States adopt the same approach in respect of pension trusts. As paragraph 8.5 of the commentary on Article 4(1) of the model convention shows, many Member States regard an entity that is exempt from tax in certain circumstances, such as pension trusts and charities, as residents for tax treaty purposes. Since 2000, paragraph 8.5 of the commentary on Article 4(1) of the model convention has stated that even if a taxable entity is exempt from tax, most OECD Member States will nevertheless view it as a resident for tax treaty purposes, provided it meets certain requirements for exemption. An entity not meeting those requirements would be required to pay tax. As paragraph 8.6 of the commentary on Article 4(1) notes, some states do not share[23]this view and so do not regard such exempt entities as residents for treaty purposes as, in their view, these entities are not 'liable to tax'. The French tax authorities are an

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20 With regard to the ruling of the Dutch Supreme Court of 28 Feb. 2001, BNB 2001/295, see also F. Pötgens, ***Income from International Private Employment***, Doctoral Series no. 12 (Amsterdam: IBFD, 2006), 743.

21 For more information on this distinction, see the decision by the Indian Authority for Advance Rulings (AAR) in Mumbai, 2005, no. 659, *General Electric Pension Trust v. Director of Income Tax (International Taxation)*, International Tax Law Reports 2005, 1053 et seq., discussed by A. Jayaseelan & S. Goradia, *Ruling Authority Denies Tax Benefit to US Pension Trust*, Tax Notes International, 23 Jan. 2006, 267; and S. Gupra, 'Residence in Tax Treaty Law – A Recent Decision', SWI 4 (2006): 169–172. In this decision, an exempt US pension trust was not regarded as a resident within the meaning of the 1981 India/US tax treaty. Here, however, it should be noted that Art. 4(1) of the India/US tax treaty uses the term 'liable to tax' for ordinary residents but in the case of pension trusts, for example, requires the income derived to be 'subject to tax' in order for the trust to qualify as a resident. According to the AAR's decision, the term 'subject to tax' means, in contrast to the term 'liable to tax', that tax is actually paid. See also the ruling by the Indian High Court of Gujarat of 24 Nov. 2004, *Emmerich Jaegar v. Commissioner of Income Tax*, 274 ITR 125, discussed by S. Sanghvi, TNS Online, 11 May 2005. See also Supreme Court of India, 7 Oct. 2003, International Tax Law Reports, 2004, 233 (also discussed by K. Vogel, 'Tax Treaty News', *Bulletin for International Taxation* 3 (2004): 3) on the place of residence for treaty purposes of an FII (foreign institutional investors establishing in Mauritius via a subsidiary). An FII is subject to special tax arrangements. It is not permitted to perform business activities in Mauritius or to generate income from sources in Mauritius. In other words, it is established for the purposes of making investments outside Mauritius. The added value that an FII generates on its foreign interests is also exempt from tax in Mauritius. The Indian tax authorities did not regard the FII as a resident within the meaning of Art. 4(1) of the tax treaty between India and Mauritius. The Supreme Court of India, however, rejected this view and ruled that the term 'liable to tax' did not have to mean that the relevant person actually paid tax. 'Liable to tax' is a legal situation, while paying tax is a factual situation. Compare also the decisions by the AAR in the cases of *M.A. Rafik* and *Dr Rajnikant Bhatt* (the AAR took the opposite stance in the case of *Cyril Pereira*), discussed by S. Shah & G. Ramrakhani, 'How the Concept of Residence Is Dealt With', *International Tax Law Review* 5 (2009): 47–48.

22 See also para. 6.11 of the commentary on Art. 1 of the OECD model convention, where it states that 'Such a fiscally transparent CIV would not be treated as a resident of the Contracting State in which it is established because it is not liable to tax therein'.

23 See N. de Boynes, 'France', in *Residence of Companies under Tax Treaties and EC Law*, ed., 6. Maisto, EC and International Tax Law Series no. 5 (Amsterdam: IBFD, 2009), 453.

example of this.[24] In such situations, exempt entities can only be regarded as residents for treaty purposes if they are explicitly referred to in the treaty. According to the OECD in its commentary, contracting states taking this view are free to address the issue in their bilateral negotiations. Interestingly, some OECD Member States agreeing with paragraph 8.5 of the commentary on Article 4(1) of the model convention also sometimes include an explicit provision to this effect in their bilateral treaties. An example of this can be seen in the first sentence of Article 4(1) of the 1992 Netherlands/United States tax treaty, as referred to in section 3.2, in which both countries explicitly agree to recognize exempt pension trusts as residents for treaty purposes. The tax authorities in both these countries regard explicitly including pension trusts in the definition of residents as a clarification (see section 3.3.5 below).

Paragraph 6.12 of the 2010 commentary on Article 1 of the model convention is illustrative in respect of whether a collective investment vehicle (CIV) qualifies as a resident for treaty purposes.[25] This is because a CIV may be exempt from tax, taxed at a zero rate, or taxed at a special low rate (on, for example, profits distributed to a subsidiary) and may therefore not actually pay any tax. In its commentary, the OECD states that:

> For those countries that adopt the view, reflected in paragraph 8.5 of the Commentary on Article 4, that a person may be liable to tax even if the State in which it is established does not impose tax, the CIV would be treated as a resident of the State in which it is established in all of these cases because the CIV is subject to comprehensive taxation in that State.

3.3.5. *Views of Various Tax Authorities on 'Liable to Tax'*

In the past, the tax authorities of Canada, the Netherlands, and the United States have all expressed views on the residency of entities such as pension trusts and other not-for-profit organizations for the application of their tax treaties. The Canadian Revenue Agency expressed its stance in respect of tax-exempt US pension trusts in a document of 17 May 1993.[26] Although the Dutch State Secretary of Finance has not yet responded to the Dutch Supreme Court's ruling of 9 December 2009, he made known his views on subjects such as the interpretation of 'liable to tax' in his Decree of 18 July 2008. In this Decree, he stated that the Dutch tax treaties require a person qualifying as a resident to be 'liable to tax'. According to the State Secretary of Finance, however, this condition is not designed to exclude from the scope of the treaty pension trusts and non-profit organizations (such as organizations operated for religious, charitable, cultural, scientific, and public purposes) that are subjectively exempt from tax. The US government in turn made its position known in, for instance, Revenue Ruling 2000-59 and the Technical Explanation to the 1996 US model. The US models of 1996 and 2006 contain a specific provision that explicitly includes such exempt entities in the definition of a resident for treaty purposes. The US model of 1981, on the other hand, did not include any such provision. The US Internal Revenue Service stated the following in this respect in Revenue Ruling 2000-59:

> While the 1981 U.S. Model does not specially provide that persons organized under the laws of a state that are generally exempt from tax and established and maintained exclusively to provide pensions or other similar benefits are residents of that state (and the 1996 U.S. Model does so provide), the Treasury Department's Technical Explanation to the 1996 U.S. Model confirms that the specific provision in the 1996 U.S. Model merely clarifies the generally accepted practice that these entities are residents even though they may be entitled to a complete or partial exemption from tax.

The tax authorities in many other countries also hold this view.[27]

3.3.6. *Other Case Law on 'Liable to Tax'*

There is a number of other case law on the term 'liable to tax' within the meaning of Article 4(1) of tax treaties based on the OECD model convention is relatively scarce. In addition to the Indian case law referred to earlier, support for the above view can be found in the following court rulings

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[24] *Ibid.*

[25] This section was included in the commentary in 2010 following the OECD report on *The Granting of Treaty Benefits with respect to the Income of Collective Investment Vehicles* (Paris: OECD, 2010).

[26] Ward et al., *supra*, 417 and 419. This is also confirmed by the relevant parliamentary discussions of the tax treaty between Canada and the United States, in which tax-exempt pension trusts were not explicitly stated to be residents for treaty purposes. Cf. Ward et al., *supra*, 417–418.

[27] As demonstrated in certain other countries' contribution to *Residence of Companies under Tax Treaties and EC Law*, ed., 6. Maisto, EC and International Tax Law Series no. 5 (Amsterdam: IBFD, 2009), the views of the US and Canadian tax authorities are also supported by Austria (K. Simader), 359; Belgium (N. Bammens), *supra*, 393–394 (it should be noted that this view is based on Belgian tax literature as the Belgian tax authorities have not published any official stance; see also W. Heyvaert, 'Artikel 4 – Inwoner', in *Het Belgisch-Nederlands dubbelbelastingverdrag* ed., B. Peeters(Ghent: Larcier 2008), 44; in the case of the previous Belgian-Dutch tax treaty, the Belgian tax authorities believed that, despite their subjective exemption from tax, foundations/pension trusts established under Dutch law should be regarded as residents for the purposes of that treaty, Com Ov. 4/132 (Commentary by the Belgian tax authorities on tax treaties entered into by Belgium); South Africa (J. Hattingh), in the work cited, pp. 715–716 (also based on literature, given that the South African tax authorities, too, have not published an official position); Spain (L.A. Martinez Giner), in the work cited, pp. 778–780 (also based on tax literature) and Switzerland (J-F Maraia), in the work cited, p. 810 (based on Swiss tax literature). The United Kingdom (C. Hji Panayi), in the work cited, p. 839, refers only to the concept of residency under UK national legislation, which is also decisive for that country's tax treaties. In supplement of the above, reference can also be made to a resolution by the Italian tax authorities on 21 Apr. 2008 (Ruling no. 167), discussed by G. Chiesa in TNS Online of 28 Apr. 2008, in which the authorities confirmed that a tax-exempt, Dutch-registered foundation/pension trust qualifies as a resident within the meaning of the Dutch-Italian tax treaty because of being 'liable to tax'.

(non-exhaustive): the ruling by Sweden's Supreme Administrative Court (*Regeringsrätten*) of 2 October 1996,[28] the ruling by Finland's Supreme Administrative Court (*Korkein hallinto-oikeus*),[29] the decision by the Munich Lower Finance Court (*Finanzgericht*),[30] and the rulings by the Paris Administrative Court of Appeal (*Cour Administrative d'Appel*)[31] and the Administrative Court (*Tribunal Administratif*).[32] UK Special Commissioner J.F. Avery Jones also followed this view in *Smallwood*,[33] albeit that the Supreme Court, as far as we could establish, has not explicitly commented on this on appeal.[34]

3.3.7. *Literature on Liable to Tax*

The view that we have outlined is also supported in authoritative literature. Without seeking to be comprehensive, we refer to a quotation from Ward et al., as we believe that this correctly and succinctly conveys the definition of residence at a treaty level:

> The definition of residence is intended to refer to the connecting factors of a person with a contracting state that are used by that state to impose unlimited taxation, but it is not a requirement that the person who has such connection factors actually be subject to unlimited taxation if the domestic laws release him of some or all tax on his income under special provisions.[35]

Lehner and Wassermeyer arrive at a similar conclusion to that of Ward et al.,[36] while Van Weeghel supports the interpretation of the Dutch Supreme Court.[37]

3.4. Interim Conclusion

As demonstrated above, as well as in the current version of and the envisaged changes to the commentary on Articles 1 and 4(1) of the OECD model convention, the majority of OECD Member States do not wish to deny access to treaty benefits by demanding that persons must actually be liable to tax on their worldwide income in their residence state. In essence, most OECD Member States allow their 'residents' unobstructed access to treaty benefits, and a strict, that is, material, interpretation of the terms 'liable to tax' and 'resident' would not be in line with the approach adopted by these Member States.

4. Consequences of Divergent Interpretations

In the introduction to this article, we briefly examined the implications of a material approach to the term 'liable to tax'. We indicated that adopting such an approach can mean that entities not fully and effectively liable to tax are denied access to treaty benefits. As a result, they will most likely have to pay considerably more tax than otherwise on their income, often portfolio dividends and interest income, from sources outside their states. If such an entity is established in another state through, for example, a permanent establishment and profit is attributable to this permanent establishment, the entity will neither be entitled to claim tax relief under the treaty in the source state nor in the

Notes

28 *Regeringsrätten*, 2 Oct. 1996, RÄ 1996 ref. 84 (6301-1994). Summarized by M. Hilling and included in IBFD's Tax Treaty Case Law Database (ed. W. Wijnen). An investment company, established under Luxembourg law, with its place of management in that country (probably a SICAV) and exempt from Luxembourg corporation tax, is 'liable to tax' and is therefore a resident within the meaning of Art. 4(1) of the Luxembourg/Sweden tax treaty. This ruling is discussed by D. Kleist, 'Treaty Entitlement of Tax Exempt Entities', *Intertax* 6, no. 7 (2008): 266. Kleist, *supra*, 266 refers to a similar ruling by the Swedish *Regeringsrätten* concerning a Norwegian foundation that was partially exempt from tax under the Nordic multilateral double tax treaty, which contains a requirement in Art. 4(1) for residency that includes a requirement to be liable to tax (RÄ 2004 ref. 29).

29 *Korkein hallinto-oikeus*, 22 Dec. 2004, KHO 2004:111, summarized by K. Pettersson and included in IBFD's Tax Treaty Case Law Database (ed. W. Wijnen). A SICAV exempt from Luxembourg corporation tax is regarded as a resident within the meaning of Art. 4(1) of the Finnish-Luxembourg tax treaty ('liable to tax'). For a comparable ruling by a lower Finnish court, see the Central Board of Taxation [*Keskusverolautakunta*], 25 Sep. 2002, KVL 2005:31, summarized by K. Pettersson and included in IBFD's Tax Treaty Case Law Database (ed. W. Wijnen) concerning a German tax-exempt real estate fund.

30 Munich Lower Court, 13 Jun. 2003, 7 K 3871/00, EFG 2004, 478, concerning a religious order with the status of a statutory body under public law [*Körperschaft des öffentlichen Rechts*] and consequently exempt from German corporation tax (the entity was established under German law and had its actual place of management in Germany). This entity was a resident of Germany within the meaning of Germany's tax treaties with Spain and Italy. The Lower Court referred to the German tax literature mentioned below (Lehner & Wassermeyer) in clarification of its stance. Another view was taken by the Lower Court of Lower Saxony on 29 Mar. 2007, 6 K 514/03, EFG 2007, 1223 (in a case concerning a SICAV in the form of an SA, established under French law and with its actual place of management in France, which was exempt from corporation tax and did not qualify, according to the Lower Court, as a resident within the meaning of the German-French tax treaty).

31 In three judgments on 6 Dec. 2007, the *Cour Administrative d'Appel* in Paris found that various foundations/pension trusts established in the Netherlands (being Fondation Stichting Pensioenfonds Hoogovens, no. 07-01717; Fondation Stichting Unilever Pensioenfonds Progress, no. 06-03370; and Fondation Stichting Providentia, no. 06-03371), which were subjectively exempt from Dutch corporation tax, were 'liable to tax' and so were residents within the meaning of Art. 4(1) of the Dutch/French tax treaty. These judgments are discussed by C. Védrine, TNS Online 26 Jun. 2008, while judgment no. 06-03370 on Fondation Stichting Unilever Pensioenfonds Progress is also discussed by D. Gutmann, S. Austry & P. Le Roux, 'Tax Treatment of Foreign Pension Funds', *European Taxation* 1 (2009): 21–22 (residency). A similar conclusion was reached by the Nîmes Administrative Court of Appeal, as discussed by B. Peeters, 'Wie is inwoner van welke verdragsstaat?', *Fiscoloog Internationaal* 189 (1999): 6–8.

32 Decision of 14 Jan. 2010, no. 08-11669, TNS Online, 23 Jul. 2010 (discussed by E. Roberts) re *Sti Apothekerversorgung Niedersachsen*. According to the Tribunal, a German exempt pension trust should be regarded as a resident within the meaning of Art. 2(4)(a) of the tax treaty between France and Germany (similar to Art. 4(1) of the OECD Model).

33 [2008] UKSPC00669, para. 101, *International Tax Law Reports* (2008), 574–627.

34 [2009] EWHC 777 (Ch), *International Tax Law Reports* (2009), 943–976.

35 D.A. Ward et al., *supra*, 422.

36 M. Lehner, Art. 4, in K. Vogel & M. Lehner, *DBA (Doppelbesteuerungsabkommen), Kommentar* (Munich: Verlag C.H. Beck, 2008), 412–413: 'Die Frage der Ansässigkeit kann zwar zweifelhaft sein, wenn eine Person nach innerstaatlichem Recht vollständig von der direkten Besteuerung freigestellt ist. Die Berücksichtigung der Funktion der Ansässigkeit als Anwendungsvoraussetzung der Verteilungsnormen muss jedoch auch in diesem Fall dazu führen, die Ansässigkeit zu bejahen. . .Der MA-Komm. Ziff. 8.2/8.3 lässt jedoch auch eine andere Sichtweise zu'. See, in a similar context, F. Wassermeyer, 'Art. 4 MA', in *Doppelbesteuerung – Kommentar*, ed. H. Debatin & F. Wassermeyer (Munich: Verlag C.H. Beck), loose leaf, Art. 4, no. 23.

37 BNB 2010/177.

entity's own residence state. This is because Article 3(1)(d) of the OECD model convention defines an 'enterprise of a contracting state' and an 'enterprise of the other contracting state' differently, namely as an enterprise carried on by a resident of a contracting state and an enterprise carried on by a resident of the other contracting state, respectively. This implies that, for the application of Article 7 of the OECD model convention, an enterprise has to be carried on by a resident of one of the contracting states and that a permanent establishment must therefore be maintained by such a resident. If, say, an entity is not regarded as a resident for tax treaty purposes, based on the approach adopted by the Supreme Court of Canada, as discussed by Ward et al., and the Dutch Supreme Court, its treatment in national law will not be restricted by the applicable tax treaty. This means that the entity will be unable to claim entitlement to the elimination of double taxation in its residence state while also being able to be taxed in full under the national laws in the state of the permanent establishment.

As outlined in the introduction, a material approach to the term 'liable to tax' also restricts contracting states' ability to impose tax. Under its tax treaties, a state may not, for example, tax dividends paid by tax-exempt investment funds established in that state to beneficial owners resident in other contracting states. This is because, for tax treaty purposes, the fund is not a resident of its residence state and so, under the second paragraph of the 'Dividends' article (Article 10 of the OECD model), the state is not allowed to tax dividends distributed. Similar problems arise in respect of fees paid by exempt entities to directors resident in other contracting states.

5. Proposal to Amend OECD Model and Commentary

In section 3.3.2, we set out what we see as the thinking behind the term 'resident of a contracting state'. In order properly to reflect this thinking, we propose that paragraphs 2 and 3 should be renumbered 3 and 4 and a new second paragraph added, or a proposal made to this effect, in the commentary on Article 4(1) of the OECD model convention. This would read as follows:

> 2. A person, other than an individual, that is governed by the laws of a Contracting State or has its place of management in a Contracting State, shall be deemed to be liable to tax in that State provided that income derived by that person is treated under the tax laws of that State as income of that person and not as the income of the person's beneficiaries, members or participants.[38]

Under this new second paragraph, an entity would be deemed to be 'liable to tax' if it exists as such for tax purposes in its state of establishment and is a taxable entity and so not fiscally transparent. Under the proposed definition of 'liable to tax', an entity with its place of establishment or place of management in a contracting state will be deemed to be 'liable to tax' in that state, providing income derived by the entity is regarded by the tax laws of that state as that entity's income and not as income of the entity's beneficiaries, members, or participants. The Netherlands and Panama recently agreed to introduce such a provision.[39]

An alternative provision, which would achieve the same effect, is the provision that Australia includes in its tax treaties on a standard basis. The provision agreed with the United Kingdom in 2003, for example, states that:

> 1. For the purposes of this Convention, a person is a resident of a Contracting State:
>
> (a) in the case of the United Kingdom, if the person is a resident of the United Kingdom for the purposes of United Kingdom tax; and(b) in the case of Australia, if the person is a resident of Australia for the purposes of Australian tax.
>
> A Contracting State or a political subdivision or local authority of that State is also a resident of that State for the purposes of this Convention.
>
> 2. A person is not a resident of a Contracting State for the purposes of this Convention if that person is liable to tax in that State in respect only of income or gains from sources in that State.

The definition of the term 'liable to tax' that we propose will mean that it will no longer be necessary to include a provision in a tax treaty to the effect that entities not effectively liable to tax, such as pension trusts or non-profit organizations, are explicitly deemed to constitute 'residents of a contracting state'. This is because, under our proposed approach, entities that have their place of establishment or management in a contracting state and are not in fact liable to corporation tax in that state but are regarded under the tax legislation of that state as taxable entities can be seen as residents of that state for the application of the tax treaty, provided they comply with the other requirements of the 'Resident' article. This provision will in principle allow entities not effectively liable to tax nevertheless to gain access to the benefits of a tax treaty. Furthermore, it will also result in the residence state of a CIV that is not effectively liable to tax being able to exercise its right, as the source state, to tax dividends and interest paid by the CIV to investors, to the extent that the tax treaty assigns the right to tax this income to the source state. The source state will also be able to exercise unrestrictedly its right to tax fees paid, for example, by a non-profit organization resident in this source state to its directors who are residents in another contracting state.

Notes

38 This proposal is based on the current OECD text of Art. 4(1) and so takes no account of the suggestion we make in s. 2 of this article.

39 The two countries signed this treaty on 6 Oct. 2010.

Contracting states concerned about allowing too unlimited access to treaty benefits could include a special provision in, for example, the protocol to Article 1 of the treaty, so that certain entities would be excluded in accordance with paragraphs 21, 21.1, 21.2, and 21.5 of the commentary on Article 1 of the OECD model convention. This could be worded as follows:

> Notwithstanding Article 1, a resident of one of the Contracting States shall not be entitled to some or all the benefits of this Convention if such resident is wholly or partly exempted from tax by a special regime under the laws of either one of the States. The competent authorities of the Contracting States shall by mutual agreement decide which special regime is meant in the previous sentence. The provisions of the first sentence are also applicable to any identical or substantially similar special regimes in addition to or in place of the existing special regimes unless the competent authorities of the States decide otherwise by mutual agreement.

6. Appeal to the OECD

In this article, we examine the rulings of the Supreme Court of Canada, as discussed by Ward et al., and the Dutch Supreme Court and the fact that these are based on a relatively material approach to the concept of 'liable to tax' as used in the first sentence of Article 4(1) of the OECD model convention. This approach results, among other things, in tax-exempt pension trusts and charities not being able to be treated as residents for tax treaty purposes. We regard this approach as incorrect. In our view, a person should be regarded as a resident within the meaning of the first sentence of Article 4(1) of the model convention if that person has such a nexus with that state that he would normally be taxed on his worldwide income or worldwide profits in that state. Whether the person in question actually pays tax is irrelevant in this respect. In other words, the person may be exempt from tax or pay a zero rate. As we have established, this view is also supported by authoritative authors, by the majority of the OECD Member States, by case law in countries other than Canada and the Netherlands, and by tax authorities in various countries.

Dutch and Canadian rulings, however, can result in double taxation or double exemption from tax, given that residency is important not only in respect of the right, as a treaty benefit, to the elimination of double taxation but also in respect of a significant number of other allocation provisions that refer to the concept of residency (such as Articles 10, 11, 12, and 16 of the OECD model convention). It is in order to resolve problems of this nature that we have proposed the alternative treaty provision set out in this article.