3. The effects of DTCs

3.1. The allocation of taxing rights

39 In DTCs the two contracting states commit themselves to relinquishing or restricting their taxing rights. This should result in the elimination of double taxation. According to some DTC rules, certain income or capital can be taxed only in one of the two contracting states. Other income or capital can be taxed by both states proportionately: the right to tax for the source state, however, is usually limited to a certain percentage. Via the application of the so-called method articles, the state of residence has to avoid double taxation (**exemption method**, cf. m.no. 420 et seq and **credit method**, cf. m.no. 439 et seq.).

Example

40 *Under Art. 12(1) OECD Model, royalties can only be taxed in the state of residence. The source state is precluded from taxing. Dividends can, however, be taxed by the source state (Art. 10(2) OECD Model). Depending on the percentage of participation and the beneficial owner, the source state may tax dividends at 5 or 15% of the gross amount. The state of residence will also tax but will credit the taxes paid in the source state.*

41 In tax literature, it is frequently said that DTCs **allocate jurisdiction to tax**. This terminology has been criticized (cf. Vogel, DTC Introd., m.no. 45b). States have original jurisdiction to tax and this is in accordance with international law. If this premise is accepted, it does not make any difference, in my view, whether the effects of a DTC are described as division, allocation or distribution of taxing rights, or whether one prefers, instead of the term “taxing rights”, one of the following terms: tax sources, tax claims or taxable objects.

42 In DTCs the contracting states bind themselves not to raise any taxes with respect to taxing rights that are given to the other contracting state under the tax convention. The DTC rule applies even if one of the contracting states to which the right has been given does not impose taxes. In this respect, the application of the DTC can lead to **double non-taxation**.

Example

43 *An individual resident in Munich has immovable property in Italy. The individual sells those assets long after their acquisition and realizes a gain. Under German tax law, the individual would be liable to tax in Germany. Under the DTC, however, Germany is bound to exempt this gain from tax. Italy may tax such profits under the DTC but is limited by its domestic law to taxing within the speculation period. Under Italian domestic law, therefore, the gain on the sale is exempt from tax. As a result, the gain from the sale is taxed neither in Germany nor in Italy.*

3.2. The limiting effects of DTCs

44 In DTCs the contracting states mutually agree to limit their taxing rights. Thus, DTCs affect the legal systems of both contracting states. In both states, domestic tax law is **restricted**.

45 Vogel compares the way how a DTC applies to a “**stencil**“ (cf. Vogel, DTC Introd., m.no. 56): the treaty acts like a stencil that is placed over the pattern of domestic law and covers over certain parts. In some areas, the pattern covers the domestic tax liabilities. In these cases, the imposition of taxes is restricted or eliminated. In the areas in which the pattern has holes, the domestic tax liability remains.

46 In tax literature, it has been said that DTCs **cannot generate tax liability**; however, there is no legal basis for this statement. There is no international law rule preventing tax liabilities from being increased because of a DTC. In practice,

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however, DTCs serve as a limitation on tax liabilities. This does not mean though that the application of a DTC could not worsen the position of the taxable person.

47 From the limiting effects of DTCs it can be understood that the exemptions granted by DTCs only affect positive income. DTCs would not, therefore, prevent foreign-source **losses** from offsetting the taxpayer's taxable base in the residence state. This conclusion has been drawn by the courts of several countries (e.g. Austria, Belgium, Finland, the Netherlands and Switzerland). According to the courts of other countries (e.g. Germany), however, DTCs have effects on positive and negative income. Thus, the DTC would prevent foreign-source losses from being taken into account in determining the taxpayer's taxable base in the residence state (for a comparative summary, cf. Vogel, DBA Art. 23, m.no. 45 et seq.).

3.3. The relationship to domestic law

3.3.1. Implementation of DTCs into domestic law

48 DTCs are treaties under international public law. It is up to the contracting states to decide how they are implemented into domestic law. Usually, this is a **constitutional issue**. According to constitutional provisions, DTCs might either have the same status as domestic provisions or they are superior to domestic provisions or their status might be below domestic provisions.

49 The contracting states oblige themselves to **implement the substance** of the provisions of a DTC. It is up to them whether they prefer to have the DTCs as such applicable or whether they introduce domestic provisions for that purpose.

3.3.2. Priority of DTC law

50 Irrespective of their status in domestic law, the content of the rules of a DTC often contradicts with domestic rules. According to most scholars, DTC rules are **special rules** in relation to domestic tax rules. The priority of DTC law is based on its lex specialis character.

Example

51 *A construction company resident in Bangladesh is hired to build an office in India and requires 4 months for the construction. Under the Bangladesh–India DTC, the income from this project cannot be taxed by India; Art. 7 of the DTC provides that income of a company resident in Bangladesh can only be taxed in Bangladesh. An exception exists if the Bangladesh company carries on business in India through a PE (Art. 7 (1) of the Bangladesh–India DTC). Under Art. 5(2), however, a construction site constitutes a PE only if it lasts for more than 183 days. Therefore, there is no PE in India under the DTC. According to Indian domestic law, income received in India or arising in India is taxable under Sec. 4 of the Indian ITA. Since the DTC is the more specific law, India will apply the DTC and not the domestic rules. The imposition of tax by India would constitute an infringement of international law.*

52 The characterization of DTC rules as special rules makes it necessary that DTC rules refer not only to the same requirements to which domestic tax rules refer but also to at least one supplementary requirement. Accordingly, DTC rules are as a rule only important if all the requirements for the application of a certain domestic tax provision are met and the DTC rules lead to different legal consequences. In other words, there are **two groups of requirements** in connection with DTC rules: One group consists of the requirements which lead to taxation under domestic law and the other group consists of the supplementary requirements that are found in DTC rules.

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Example

53 *A scientist is resident in Switzerland and is subject to worldwide taxation therein. He performs independent personal services in Italy. Under Italian law, the scientist would be subject to tax on the income earned from these activities. Under Art. 14 of the Italy–Switzerland DTC (Art. 14 of the former OECD Model), however, as long as the scientist does not have a fixed base regularly available to him in Italy, Italy may not tax the income. The law in Italy (imposition of tax) is in conflict with the DTC (no imposition of tax). The conflict is to be resolved in favour of the DTC rule.*

54 In addition to the lex specialis rule, the ***lex posterior*** **rule** can play a role in the interpretation of DTCs. It is doubtful whether a domestic tax rule can prevail over an existing DTC. In these cases it is questionable whether the treaty prevails as lex specialis or whether a later domestic law prevails as lex posterior. This question cannot be decided by examining the provisions alone. In the scope of the interpretation, all the interpretation materials must be taken into account. If the interpretation leads to the result that the domestic law prevails, this constitutes an infringement of international law.

3.3.3. Priority of domestic law

55 If an interpretative provision specifies that the later domestic law derogates from the special rule provided by the DTC, the result must be regarded as a "treaty override". To the extent that a national legal system does not provide any constitutional law protection against international law violations by the legislator, however, a "**treaty override**" can only be countered at the international law level.

Example

56 *Individuals resident in Germany were partners in a limited partnership in Belgium. Under the Belgium–Germany DTC, the income earned by the individuals was exempt from tax in Germany because the exemption method applies to exempt income derived from the capital invested in a Belgian limited partnership. Instead, however, the individuals were subject to tax in Germany and were given a credit for tax paid to Belgium. German domestic law (the Außensteuergesetz) provided that when income derived from the capital invested in a foreign partnership is subject to a tax on profits of less than 30% in the source state, the credit method applies rather than the exemption method. The domestic law provision was introduced after the entry into force of the Belgium–Germany DTC and constitutes a treaty override (cf. ECJ, 6 Dec. 2007, Case C-298/05, Columbus Container Services BVBA & Co v. Finanzamt Bielefeld-Innenstadt).*

3.3.4. What to consider first in practice: DTC or domestic law?

57 In practice, the question of the relationship between domestic law and treaty law arises when cross-border situations have to be analysed. In determining whether the contracting state has any taxing rights, what should be **examined first**: domestic law or DTC? Should domestic law establish tax claims first or should the DTC be tested first to determine whether there is any right to tax under the DTC? This issue was extensively discussed in Germany (cf. Debatin, DB 1985 Beilage 23, 5 et seq.; Vogel, DB 1986, 508 et seq.; Debatin, DB 1986, 512 et seq.). The discussion has since ceased.

58 Vogel concisely summarizes the results of the discussion (Vogel, DTC Introd., m.no. 56; emphasis added): "Only very little legal background is required to recognize that logically, **both methods of procedure are equivalent**. Indeed, the treaty is lex specialis in relation to domestic law. The requirements for application of the allocation rules are, as discussed above, additional requirements for establishing tax liability, aside from those of domestic law. Illustratively expressed: the treaty acts like a stencil that is placed over the pattern of domestic law and covers certain parts. Whether the stencil or the pattern is examined first, the same conclusion results, so the order of application can be decided pragmatically from case to case." (cf. m.no. 45). The order is therefore not a matter of interpretation and does not have any impact on the content of individual treaty articles. Anyone applying the treaty must consider this issue in every particular case exclusively under practical criteria.

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Example

59 *In IN, ITAT 30 Jun. 2008, Epcos AG v. Assistant Commissioner of Income Tax, a German company earned income from the provision of technical services to an Indian subsidiary. The German company paid taxes in India at a rate of 10%, relying on the applicability of Art. 12 of the Germany–India DTC ("Royalties and fees for technical services"). The Indian Tax Officers assessed the German company arguing that Art. 7 rather than Art. 12 of this treaty was applicable. The Indian Tax Officers argued that the German company had a PE in India and therefore the income in question should be taxed in India in accordance with Art. 7 of the Germany–India DTC. They therefore assessed tax at 20% instead of 10%. The Indian Tax Officers gave an interpretation of Indian domestic law by which the onus of proving the non-existence of a PE in India was upon the German company, supporting their argument by stating that domestic law is to be applied first and tax treaty law is to be applied thereafter. The ITAT stated that there is no "conceptual support or other material whatsoever for ' domestic law first' approach, though, in all fairness, there is literature to support the proposition that the debate regarding whether one should see the treaty first or domestic law first is a non-starter. Whichever path we follow, we reach the same destination anyway; whether or not cross- border income is taxable in the source state in the light of the domestic tax laws read with the applicable tax treaty, it would not make any difference, in the ultimate analysis, whether one examines the case on the touchstone of the scheme of the treaty first and domestic law later, or vice versa."*

60 What has proven to be **useful** is the practice of first consulting domestic law to determine whether any liability for tax exists and then consulting the DTC to determine whether it provides any relief from this liability. If there is no liability for tax under domestic law, there is no need to consult the DTC since the DTC in practice does not create a liability to tax (cf. m.no. 46). The mere allocation of taxing rights to a contracting state does not create an independent basis for taxation. On the other hand, it can occasionally be useful to consult the DTC first to determine whether a contracting state has the right to tax at all, and, as a second step, to determine the manner in which the contracting state exercises this right. If, under the treaty, there is no right to tax, there is no need to consult domestic law.

Example

61 *A resident of Canada wins a lottery in Austria. One begins with the domestic right to tax. Since Canadian domestic law does not tax lottery winnings, the winnings are not taxable in Canada. From the point of view of Canadian tax law, an examination of the DTC between Austria and Canada is therefore unnecessary. This is not altered by the fact that under Art. 21(1) of the DTC between Canada and Austria, Canada has the right to tax this income. Furthermore, the lottery winnings are not taxable in Austria either because they are not regarded as taxable income. This is not altered by the fact that under Art. 21(2) Austria–Canada DTC, Austria also has a right to tax this income. The DTC does not provide an independent legal basis for taxing this income.*

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