ARTICLES

The OECD Partnership Report – A Swiss View on Conflicts of Qualification[1]

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1. The issue

In line with the OECD Model Tax Convention on Income and Capital (OECD Model Convention), Swiss double taxation conventions (DTCs) provide that international double taxation is to be eliminated through a two-step mechanism. First, they allocate taxing jurisdiction between the Contracting States by a set of distributive rules,[4] which restrict their fiscal sovereignty.[5] Secondly, where the application of these distributive rules does not fully eliminate international double taxation, DTCs stipulate that the state of residence is to avoid this residual double taxation[6] provided, however, that the state of source has exercised its taxing right 'in accordance with the provisions of the convention'.[7] This second step thus comes into place whenever one of the Contracting States is not granted an exclusive right to tax.[8] Where it is placed into the position of the state of residence, Switzerland eliminates this double taxation through the use of the exemption method[9] laid down in Art. 23A of the OECD Model Convention.

At first sight, this mechanism does not seem to be problematic. Yet, a closer look at the distributive rules reveals that the application of DTCs may not necessarily be self-evident. Indeed, these rules contain several undefined terms which, pursuant to Art. 3, para. 2 of the OECD Model Convention, Contracting States may define *lege fori* unless the context otherwise requires. Where, as a result of their diverging domestic law, Contracting States define these terms differently, the system described above may be distorted. Furthermore, such divergences may well lead to double taxation or double non-taxation situations.[10]

Among these difficulties are those created by conflicts of qualification. In essence, a conflict of qualification may be described as a disagreement as to the applicable distributive further to a diverging characterisation of an item of income or capital.[11] For example, in a famous case involving the US–Germany DTC, the US (state of source) and Germany (state of residence) had a different view with respect to the remuneration received by the conductor Pierre Boulez in relation to concerts carried out in the US. For Germany this remuneration was a royalty solely taxable in the state of residence (Art. 12 of the OECD Convention). By contrast, the US was relying on former Art. 14 of the Convention and thus contended that it could tax the income derived by Pierre Boulez.[12] In other words, the conflict led to double taxation. On the contrary, a conflict of qualification may also lead to double non-taxation. Suppose that both Contracting

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1 The present contribution is a slightly revised English version of an article that was released in the November 2002 Issue of the *Archiv für Schweizerisches Abgaberecht*.

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4 Art. 6à22 of the OECD Model Tax Convention on Income and Capital, OECD, Paris, 2000. Vogel, *On Double Taxation Conventions*, 3rd ed. (Kluwer, London, 1997), p. 357, no. 1.

5 RDAF 2000 495, 499.

6 Para. 7 of the OECD Commentary, Art. 23A and 23B of the OECD Model Convention.

7 Art. 23A and 23B of the Model Convention.

8 Xavier Oberson, *Précis de droit fiscal international* (Bern, 2001), p. 30, no. 97; see Vogel, n. 4 above, p. 30, no. 51 and p. 1130, no. 36a.

9 However, the credit method is applicable to dividends, interest and royalties.

10 See in this regard Robert Danon and Hugues Salomé, 'Avoidance of Double Non-Taxation', Swiss report presented at the conference organized by the *Institut für österreischisches und Internationales Steuerrecht* of the Universita of Vienna from 20 to 23 June 2002, to be published in 2003 in Eucotax Series on European Taxation, Kluwer.

11 Conflicts of qualification should be distinguished from *conflicts of attribution*. In the latter case, both Contracting States apply indeed the same distributive rule but attribute the item of income or wealth to a *different taxpayer*. For an analysis of this issue, see Danon and Salomé, n. 10 above (chapter II) as well as Salomé, *International Taxation of Partnerships: Divergences in the Personal Attribution of Income* (Zurich, Brussels, 2002).

12 See *Pierre Boulez v Commissioner*, 83 TC 508 (1984).

States apply a distributive rule that prevents them from taxing the element of income or capital at issue. This is the case, for example, if the state of source characterizes an item of income as a capital gain taxable in the state of residence (Art. 13, para. 4 of the OECD Convention), whereas the state of residence considers this element as employment income taxable in the source state (Art. 15, para. 1).

Conflicts of qualification may furthermore arise in the context of transactions involving partnerships. For instance, this may occur with regard to the characterization of the interest remunerating a loan granted by a partner to a partnership. Indeed, some states treat such a loan as an asset belonging to the private wealth of the partner and tax the interest accordingly at the level of the latter. On the contrary, other states characterize this interest as income from a gainful self-employed activity. Thus, when the partner is not resident in the state under the laws of which the partnership is organized (state P), the interest may be taxed in two states, i.e. in the state of residence of the partner (state R) as income from private wealth and in state P – where the partnership constitutes a permanent establishment of the partner – as income from a gainful self-employed activity. Yet, despite the fact that state R and state P have concluded a double tax treaty, double taxation may not be fully eliminated. Indeed, state P may take the view that it is not barred from exercising its taxing power pursuant to Art.7, para. 1 of the OECD Model Convention. Conversly, state R, based on Art. 11, para. 1 may subject the entire interest to tax. In these circumstances, as state R will consider that the interest may be subject in state P only to a limited tax liability,[13] it may not agree to grant a direct foreign tax credit[14] for the full taxes levied in state P. As a result, the interest would suffer a partial double taxation.

In the reverse case, state P will accept the deduction of the income attributable to the permanent establishment that the partnership constitutes in its territory. Based on its domestic law, state P may levy a tax at source on the interest, but only within the limits of Art. 11, para. 2 of the OECD Model Convention. Conversely, if it characterizes the income by reference to its domestic law, state R will take the view that this item of income is fully taxable in state P, based on Art. 7, para. 1. Where state R, like Switzerland, applies the exemption method, such conflict of qualification will end up in the non-taxation of the interest, to the extent that the amount of exemption exceeds the residual tax at source levied in state P.

Finally, a conflict of qualification may also result from a diverging view among the Contracting States with regard to either the automous interpretation that should be given to a treaty term[15] or to the factual situation. Indeed, based on our example, one could imagine a case where state R takes the view that the partnership carries on its activity in state P through a fixed place of business whereas state P considers that the partnership does not avail of such installations in its territory. In these circumstances, based on Art. 23A, para. 1 and Art. 7, para. 1, 2nd phrase of the OECD Model Convention, state R would exempt the income attributable to this permanent establishment. This would also result in the non-taxation of the interest.[16]

In its report entitled 'The Application of the OECD Model Tax Convention to Partnerships' of 20 January 1999, the Committee of Fiscal Affairs of the OECD (CFA) issued various recommendations aiming at solving the above double taxation and double non-taxation issues in the context of transactions involving partnerships. These recommendations were then inserted in the April 2000 update of the OECD Commentary.[17] More recently, the application of these principles has been suggested in order to solve certain conflicts of qualification that may arise in the field of stock option taxation.[18]

We thus find it appropriate to explore whether the solution advocated by the OECD may be applied to Swiss DTCs.[19] To that end, we shall first briefly review its content (II). We then turn to its legal status (III) and to its compatibility with the principles governing the interpretation of DTCs, i.e. those of the Vienna Convention on the Law of Treaties of 23 May 1969 (IV).[20]

2. The solution of the OECD Commentary

When an item of income or wealth is taxed in the state of source 'in accordance with the provision of this

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13 Art. 11, para. 2 of the OECD Model Convention.

14 Art. 23A, para. 2 or 23B, para. 1 of the OECD Model Convention.

15 When the 'context otherwise requires' (Art. 3, para. 2 of the OECD Model Convention).

16 See also para. 32.5 of the OECD Commentary on Art. 23A and 23B of the OECD Model Convention.

17 In the context of the present contribution, we generally refer to this version of the OECD Commentary.

18 See OECD, 'Cross-Border Income Tax Issues Arising from Employee Stock-Option Plans', draft document available on Internet for public discussion at: *http://www.oecd.org/pdf/M00026000/M00026818.pdf* as well as Peter Baumgartner, 'Vorschläge der OECD zur Vermeidung der internationalen Doppelbesteuerung auf Mitarbeiteroptionen', in *IFF Forum für Steuerrecht* 2002, p. 223.

19 We will not examine in the context of the present contribution the specific provisions that are inserted in certain Swiss DTCs, in particular Art. 7, para. 7 of the Treaty concluded with Germany (RS 0.672.913.62) as well as Art. 7, para. 8 of the Treaty concluded with Austria (RS 0.672.916.31). In this respect, see Danon and Salome, n. 10 above, chapter 3.3.

20 RS 0.111 (VC). With regard to the appicability of the VC to Swiss DCTs, see in particular StR 2002 30, 35; RDAF 1998 73; ASA 41, 470; Jean-Marc Rivier, 'L'interprétation des Conventions de double imposition', RDAF 2000, p. 113; Xavier Oberson and Howard R. Hull, *Switzerland in International Tax Law* (IBFD, Amsterdam, 2001), p. 91; Peter Locher, *Einführung in das internationale Steurrecht der Schweiz*, 2nd ed. (Bern, 2000), p. 102.

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Convention', the state of residence shall eliminate the residual double taxation by way of the imputation[21] or the exemption method.[22] And this is precisely with regard to the interpretation of this expression[23] that the CFA elaborated a solution which enables to avoid the difficulties triggered by conflicts of qualification.[24] Indeed, the latter considers that when, due to a reference to its domestic law, the state of source applies a different distributive rule to an item of income or capital than the one that the state of residence would have applied to the same item of income or capital, the latter is still – from the perspective of the state of source 'taxed in accordance with the provision of this Convention'. In these circumstances and notwithstanding the conclict of qualification, the state of residence would thus be compelled to eliminate the double taxation.[25] This approach would enable to avoid not only double taxation but also double non-taxation situations. With regard to the latter case, if the state of source takes the view that it is barred by a distributive rule from taxing an item of income or capital, the state of residence should indeed consider that this item of income or capital may not be taxed in accordance with the provisions of the Convention, even if the latter state would have applied another distributive rule, which would possibly have allowed it to levy taxes.[26] In this case, the state of residence would not be obliged to exempt this item of income or capital.

The application of these recommendations to the above example regarding the loan granted by a partnership to a partner would be as follows. To the extent that, based on its domestic law, state P would treat the interest as business income attributable to the permanent establishment constituted by the partnership in its territory, state R would be compelled to accept that this item of income is taxable in state P in accordance with the provisions of Art. 7, para. 1 of the OECD Model Convention. Thus, even if placed in the position of state P, state R would consider, by virtue of its domestic legislation, that the interest should be assimilated to income 'from debt-claims of every kind'[27] and that it shall refrain from taxing it based on Art. 11, para. 2 of the Convention, the latter state would be obliged to fully eliminate double taxation.[28] Conversely, in the reverse situation, state R would not be bound to consider that this income may be taxed in state P in accordance with the provisions of Art. 7, para. 1, even if, according to state R's domestic law, the interest should be assimilated, for treaty purposes, as business profits attributable to a permanent establishment of the partner in state P. Hence, if it applies the exemption method, state R would eliminate double taxation only to the extent provided by Art. 23A, para. 2 of the Convention. This approach would thus ensure that the application of the DTC does not turn into a double non-taxation of this interest.

This being said, the recommendations of the CFA do only aim at eliminating conflicts of qualifications resulting from differences in the domestic legislations of the Contracting States. Therefore, these principles are not applicable to conflicts of qualification stemming from diverging views in the contextual interpretation of a treaty term or when states disagree on the facts. In these circumstances, nothing prevents the state of residence from considering that taxes were not levied by the state of source in accordance with the provisions of the DTC. Thus, even if these divergences result in double taxation, the latter could be eliminated only by way of mutual agreement procedure (Art. 25 of the OECD Model Convention).[29] Even if the OECD recommendations do not expressly so provide, we take the view that this is also true with regard to the interpretation of a given treaty term, when the state of residence does not agree that the state of source refers to its domestic law. In the context of the above example, this issue would arise in particular in respect of the construction of the term 'debt-claim' contained in Art. 11, para. 3.[30]

We should also stress that Switzerland made an observation to the recommendations of the CFA which reads as follows: 'Switzerland reserves its right not to apply the rules laid down in paragraph 32 in cases where a conflict of qualification results from a modification of the internal law of the State of source subsequent to the conclusion of a Convention'.[31] Switzerland takes indeed the view that the solution put forward by the OECD could enable the state of

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[21] Art. 23B of the OECD Model Convention.

[22] Art. 23A of the OECD Model Convention.

[23] As well as of the similar terms used in Art. 23A, para. 1 of the OECD Model Convention.

[24] Para. 32.2 of the OECD Commentary and Art. 23A and 23B of the OECD Model Convention.

[25] Commentary, OECD, para. 32.3 and Art 23A and 23B of the OECD Model Convention.

[26] Para. 32.6 of the OECD Commentary and Art. 23A and 23B of the OECD Model Convention.

[27] See also Art. 11 of the OECD Model Convention.

[28] In other words, the state of residence would be bound to exempt this income (Art. 23A, para. 1 of the OECD Model Convention) or to credit on its own tax the entire amount of tax – and not only an amount corresponding to 10 per cent of the gross interest – levied in the state of source (Art. 23B, para. 1 of the OECD Model Convention).

[29] Para. 32.5 of the OECD Commentary and Art. 23A and 23B of the OECD Model Convention.

[30] Implicitly, Lang suggests that this expression be construed autonomously (Michael Lang, *The Application of the OECD Model Tax Convention to Partnerships – A Critical Analysis of the Report Prepared by the OECD Committee on Fiscal Affairs* (Vienna, 2000), p. 80.

[31] Para. 81 of the OECD Commentary and Art. 23A and 23B of the OECD Model Convention.

source to expand its taxing rights at the expense of the state of residence, after a DTC has been concluded, by subsequently amending its domestic tax law. In such a case, applying of the principles conveyed by the CFA would lead to the conclusion that the state of residence is bound to accept this situation, as the taxation by the state of source would be made in accordance with the provisions of the DTC.[32]

Having realized that double non-taxation situation could not be prevented when they result from a conflict pertaining to the contextual interpretation of a treaty term or of the facts, the CFA finally decided in 2000 to add a fourth paragraph which reads as follow: 'The provision of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income'. In the example mentioned above, this provision could thus be applied if both Contracting States would agree that the interest shall be treated as business profits but where state R would take the view that the partner has a fixed place of business in state P while the latter state would consider that the partner does not avail of such installations.

3. The scope of the OECD recommendations

Most Swiss DTCs are to a large extent drafted along the lines of the OECD Model Convention. Therefore, it is quite logical to determine whether the above recommendations are applicable to them. This raises the issue of the legal status of the OECD Commentary. Exploring this problem which is still very much debated among international scholars[33] would widely exceed the object of the present contribution. We shall thus restrict ourselves to the following remarks.

According to the CFA, there is no doubt that a DTC is to be construed in light of the OECD Commentary if is its content is identical to the OECD Convention. Further, one should further refer to the latest version of the OECD Commentary: 'other changes or additions to the Commentaries are normally applicable to the interpretation and application of conventions concluded before their adoption, because they reflect the consensus of the OECD Member countries as to the proper interpretation of existing provisions and their application to specific conventions'.[34] In other words, for the OECD, the construction of a treaty term may well vary, depending on amendments made to the OECD Commentary. Following this interpretation, one could conclude without further analysis that conflicts of qualification triggered by the application of Swiss DTCs that are similar to the OECD Model Convention should now be solved in light of the principles conveyed by the OECD Commentary.

Yet, we agree with leading scholars[35] that this approach should be rejected. Indeed, such a dynamic interpretation of the OECD Commentary would enable to change indirectly the meaning of a term at the time a DTC was concluded. From this perspective, the approach supported by the OECD seems incompatible with the principles of international public law.[36]

Considering the above, we take the view that the solutions advocated by the OECD in the field of conflicts of qualification are not automatically applicable to Swiss tax treaties existing prior to their adoption. Thus, we may examine whether these solutions may be inferred from the principles governing the interpretation of DTCs. Since Switzerland eliminates double taxation by way of the exemption method, our analysis will essentially focus on the provisions of Art. 23A, para. 1 of the OECD Model Convention.

4. The recommendations of the OECD and the interpretation of DTC

A. The Interpretation of Art. 23A, para. 1 of the OECD Model Convention

As far as double non-taxation is concerned, the OECD justifies its recommendation pertaining to cases where recourse to the *lex fori* is admitted by both Contracting States by referring to the object and purpose of DTCs. In these circumstances, 'the State of residence is not required by paragraph 1 to exempt the item of income, *a result which is consistent with the basic function of Article 23 which is to eliminate double taxation*'.[37] Solutions leading to double non-taxation are indeed viewed by the OECD as in contradiction to the object and purpose of DTCs.[38] The CFA indeed takes the

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32 OECD Report 'The Application of the OECD Model Tax Convention to Partnerships' in *Issues in International Taxation*, no. 6 (Paris, 1999), Annex II, para. 27.

33 In this respect, see Avery Jones, 'The effect of Changes in the OECD Commentaries after a Treaty is Concluded' in *IBFD Bulletin for International Fiscal Documentation* 2002, p. 102.

34 OECD Commentary, para. 35 and introduction.

35 Oberson, see n. 8 above, p. 23, no. 71; Robert Waldburger, 'Die Auslegung von Doppelbesteuerungsabkommen in der Rechtsprechung des Schweizerischen Bundesgerichts', in Lang *et al.*, *Die Auslegung von Doppelbesteuerungsabkommen* (Vienna, 1998), p. 61. In the same vein, Lang, 'Die Bedeutung des Musterabkommens und des Kommentars des OECD-Steuerausschusses für die Auslegung von Doppelbesteuerungsabkommen', in Gassner *et al.* (eds.), *Aktuelle Entwicklungen im internationalen Steuerrecht*, p. 11.; Vogel, 'The influence of the OECD Commentaries on Treaty Interpretation' in *IBFD Bulletin for International Fiscal Documentation* 2000 p. 612; Vogel 1997, see n. 4 above, no. 82a; Hugh J. Ault, 'The Role of the OECD Commentaries in the Interpretation of Tax Treaties', *Intertax* 1994/4, p. 144.

36 In the same vein, Avery Jones, n. 33 above, p. 104.

37 Last phrase of para. 32.6 of the OECD Commentary on Art. 23A and Art. 23B of the OECD Model Convention (emphasis added).

38 Lang, see n. 30 above, p. 29, quoting para. 109 of the Partnership Report.

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view that the basic purpose of DTCs is to 'eliminate double taxation and to prevent double non-taxation'.[39]

Another argument is to be found in paras. 102 and 103 of the OECD Partnership Report. For instance, para. 103 reads:

> 'When taxing an item of income, the source State therefore applies its domestic law, subject to the restrictions and limitations imposed on it by the provisions of its tax conventions. The way that the State of residence qualifies an item of income for treaty purposes has no relevance on how and in the hands of whom the State of source taxes that item of income. The reverse, however, is not true. *The way the State of residence eliminates double taxation will depend, to some extent, on how the Convention has been applied by the State of source*.'

Implicitly, the OECD refers to the suggestions made by Avery Jones and his co-authors in various contributions. According to these scholars, 'the question of categorization of the income applies only to the source State and that State's determination of the question of how the income is to be taxed is conclusive against the residence State, which must merely satisfy itself that the taxation by the source State is in accordance with the treaty'.[40] The state of residence should indeed 'take the answer to this question for granted and "apply the Convention as it affects itself, by exempting or giving credit for the source State's tax on the income which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State" '.[41] In our view, this latter approach is by far the most persuasive.

First of all, Avery Jones *et al*. point out that the expression 'in accordance with the provisions of this Convention, may be taxed' does not contain any undefined treaty term requiring a definition.[42] In such case, Art. 3(2) of the OECD Model Convention cannot be of any help. Indeed, this provision 'governs no more than the interpretation of words ("terms") used in the treaty'[43] and is thus inappropriate to construe such a composite expression. According to this view, its interpretation should be governed by the provisions of Art. 31 *et seq*. of the VCLT.

In our opinion this conclusion should be supported by another argument. Indeed, the meaning of a term such as 'provisions' that is not defined by the Convention could be subject to controversy. In particular, does it refer to the distributive rules that are applied by the state of residence or to those that are applicable by the state of source?[44] As we will see below, this question is of paramount importance in the context of conflicts of qualification. In this respect, a reference to the *lex fori* would, however, not provide much guidance. For instance, we cannot figure out which provision of the Swiss domestic law would enable to answer this question. As a consequence, the context of Art. 3, para. 2 of the Convention – to which the provisions of the Contracting States' domestic law belong[45] – requires that the term 'provisions' be given an autonomous meaning.[46] This is why, whether the recommendations of the OECD stem from a correct interpretation of Art. 23A, para. 1 of the OECD Convention should be examined from the perspective of Art. 31f of the VCLT.

In this context, one should distinguish the application of the distributive rules from that of Art. 23A(1) of the OECD Model Convention. Indeed, the former are, if needed at all, complemented by the subsequent application of the latter.[47] Further, while Art. 23A(1) of the OECD Convention is applied solely by the state of residence, distributive rules are applied by both Contracting States.[48] However, even if one construes the term 'application' contained in Art. 3(2) of the OECD Convention as interpreted by Engelen and Poetgens,[49] it is a matter of fact that the state of source does not apply the same distributive rules as the state of residence does. Otherwise, there would be no reference to one or to the other Contracting State in the provisions of chapter III and IV of the OECD Convention. And obviously, the distributive rules referred to in Art. 23A(1) of the OECD Convention are those that are applied only by the state of source. This stems from the text of this provision which refers to items of income or capital which 'may be taxed in the *other Contracting State*'.[50]

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39 Partnership Report, see n. 32 above, II.4.52.

40 Avery Jones *et al*. 'The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model', *British Tax Review* 1984, pp. 14 to 25, 48 to 54 and 90 to 108.

41 Avery Jones *et al*., see n. 40 above, p. 50. In the same vein, see also Avery Jones, *et al*. 'Credit and Exemption under Tax Treaties in Cases of Differing Income Characterisation', *European Taxation* 1996, p. 133 as well as Van Raad, Kees, 'International Coordination of Tax Treaty Interpretation and Application', *Intertax* 2001, p. 212), p. 4.

42 Avery Jones *et al*., see n. 41 above, p. 134.

43 Vogel 1997, see n. 4 above, p. 209, no. 62.

44 Another term requiring a definition is the expression 'taxed'. For instance, is it here required that taxes be effectively paid?

45 Vogel 1997, see n. 4 above, p. 215, no. 72.

46 See thereupon Salomé and Danon, n. 10 above, pp. 257 to 274.

47 Vogel 1997, see n. 4 above, p. 30, no. 51 as well as p. 1130, no. 36a.

48 *Ibid*., p. 358., no. 3 to 5 as well as p. 1130, no. 36.

49 According to the latter, 'a state applies a tax treaty not only if it refrains from levying tax on the basis of the treaty provisions, but also if it does levy tax on the basis of the treaty provisions' (Engelen and Poetgens, 'Report on The Application of the OECD Model Tax Convention to Partnership and the Interpretation of Tax Treaties', in *ET* July 2000, p. 257).

50 This holds true with regard to Art. 23A(2) as well as 23B(1) of the OECD Model Convention.

Thus, both the text and the context (systematic interpretation) of Art. 23A(1) of the OECD Convention support the view that the issue as to whether the income may be taxed 'in accordance with the provision of this Convention' shall be examined, by the state of residence, from the perspective of the source state.

Yet, this does not mean that the state of residence is precluded from challenging the categorization of the income made by the state of source. Indeed, there is no reason why the state of residence would not be entitled – but also limited – to verifying that the interpretation given by the source state to the distributive rule called upon by that latter state is sustainable in light of the principles governing the interpretation of DTCs.[51] Consequently, if the state of residence takes the view that the context referred to in Art. 3(2) of the OECD Convention requires that such distributive rule be construed autonomously, it should not be bound by the interpretation of the source state if the latter gave to an undefined treaty term the meaning it has under its domestic tax law. On the other hand, to the extent the state of residence agrees that reference is to be made to the *lex fori*, it must accept that the income be characterized based on the domestic tax law of the state of source. This holds true even if, should it be in the position of the source state, the state of residence would have applied a different distributive rule.

Further, following this approach leads to the conclusion that the state of residence shall also characterize an item of income from the perspective of the state of source in the event the latter does not make use of its taxing right.[52] This is because tax treaties do not only aim at eliminating effective but also virtual double taxation.[53] The fact that the characterization of the income shall be made – or verified – from the perspective of the state of source is also the reason why it may influence the way a possible remaining double taxation is to be eliminated by the state of residence.[54]

We thus support the view that the recommendations of the OECD pertaining to the interpretation of Art. 23A(1) OECD Model Convention are fully compatible with the principles governing the interpretation of tax treaties. Yet, they have been subject to many objections in scholarly writings.

Some commentators stress that Contracting States should rather try to solve conflicts of qualification by searching for an autonomous definition of undefined treaty terms. In other words, these authors take the view that the OECD attempts to solve a problem that it has created itself by implicitly putting on an equal level in the context of Art. 3(2) of the OECD Model Convention, the *lex fori* and the autonomous interpretation.[55] The issue as to whether an autonomous interpretation should generally be preferred is subject to controversy.[56] Yet, even considering that it should, states are often inclined to construe treaty terms by reference to their domestic law, with which they are obviously more familiar.[57] The OECD is thus right when it takes due consideration of this factual situation. Furthermore, as already mentioned, Contracting States may also have different views with regard to a contextual meaning.

The recommendations of the OECD may also encourage the state of source to expand its tax base at the expense of the state of residence.[58] One could for instance imagine that a state in which significant construction projects are carried out by foreign enterprises be tempted to amend its domestic tax law with a view to characterize as business profits the interest remunerating loans granted by members of the consortium conducting this activity. In this respect, the Swiss observation to para. 32ff. of the OECD Commentary and Art. 23A and 23B of the OECD Convention is quite sensible. However, even in the absence of this observation, the state of residence may not be bound to consider that the item of income or wealth has been taxed in accordance with the provisions of the Convention if it cleary appears that

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51 This was also made clear later on by Avery Jones et al. The latter ones indeed argued that 'since Art. y has to be considered by both states – first by the source state as it has to decide whether it is prevented from taxing or required to reduce its tax, secondly by the residence state as it has to decide whether or not to give credit – it would be odd if the correct interpretation of this phrase caused a conflict between the two states' (Avery Jones et al., n. 41 above, p. 134). Concurring: Van Raad, 'Interpretation and Application of Tax Treaties by Tax Courts', ET January 1996, p. 4.

52 For instance, because, based on the domestic tax law, such income is not subject to tax or attributed to a tax exempt entity.

53 Vogel 1997, see n. 4 above, p. 28, no. 46a.

54 As noted above, the qualification made by the state of source may bind the state of residence to apply the credit method rather than the exemption method.

55 See Lang, n. 30 above, p. 28; Claus Staringer, 'Leistungsbeziehungen zwischen der Personengesellschaft und den Gesellschaftern aus abkommensrechtlicher Sicht', Gassner *et al.* (edd.), *Personengesellschaften im Recht der Doppelbesteuerungsabkommen – Die Auswirkungen des OECd-Reports auf die Abkommenspraxis*, pp. 116 to 118.

56 According to Vogel, 'a departure from interpretation by reference to domestic law will be permissible to the extent that theˆcontext¤, in this wide sense, reveals weighty arguments in favor of such departure' (see n. 4 above, p. 215, no. 72). Yet, with regard to conflicts of qualification, this author takes the view that an 'autonomous qualification seems to be the only supportable solution' (Vogel, n. 4 above, p. 57, no. 98). On the contrary, Edwardes-Ker considers that an autonomous interpretation should always prevail (Edwardes-Ker, *Tax Treaty Interpretation* (In-Depth Publishing, London), loose-leaf, 7.10). The latter viewpoint is also shared by the leading Swiss doctrine (Waldburger, see n. 35 above, p. 62; Locher, see n. 20 above, p. 123; Oberson, see n. 8 above, p. 24).

57 This trend seems to be confirmed by a recent decision of the Swiss Supreme Court. In its decision of 31 May 2002 (2A.50/2002/dxc) pertaining to the interpretation of Art. 2, no. 2 of the double tax treaty concluded between France and Switzerland (RS 0.672.934.91), the Swiss Supreme Court succinctly concluded that 'pour l'application de la convention de double imposition par un Etat contractant, tout terme ou expression qui n'y est pas défini a le sens que lui attribue le droit de cet Etat concernant les impôts auxquels s'applique la convention, à moins que le contexte n'exige une interprétation différente (art. 3 ch. 2 CDI-F), ce qui n'est pas le cas ici' (cons. 2.1). In this regard, see also Waldburger, n. 35 above, p. 63 and the case law quoted. Fortunately, this approach has not systematically been endorsed by all Swiss courts (see in particular the decision of the Federal Appelate Commission for Taxation of 28 February 2001 (CRC 2000 – 055), in *Revue Fiscale* 2002, p. 305).

58 See Lang, n. 30 above, p. 41.

this legislative amendment was adopted on purpose.[59] Indeed, Art. 31, para. 1 of the VCLT provides that a treaty shall be interpreted in good faith.

It also seems that the implementation of the recommendations of the OECD may sometimes trigger practical difficulties. Schuch and Bauer mention in particular the hypothetical case where an item of income would not be addressed by the domestic tax law of the source state.[60] One can indeed not exclude that this problem might arise when, in the state of source, personal income tax is governed by a schedular system.[61] In these circumstances, it seems at first view delicate to determine how this income would be characterized under the domestic tax law of this state. This difficulty does not, however, appear to be impossible to overcome. When trying to determine – from the perspective of the state of source – the distributive rule applicable to an item of income or wealth, the state of residence is not bound to construe treaty terms by reference to the domestic law of the state of source in all circumstances. Indeed, when the 'context otherwise requires', the state of residence should search for an autonomous interpretation. Furthermore, even if a *lex fori* meaning seems appropriate, a reference to another area of the domestic law should be admitted when treaty terms are not defined by the domestic tax law of the state of source.[62] To the extent that this procedure does not enable to connect an item of income to one of the provisions of Arts. 6 to 20 of the OECD Model Convention, such item may then fall into the scope of application of Art. 21, para. 1 of the Convention ('other income'). Yet, there is no doubt that the implementation of the OECD recommendations will increase the need for exchange of information among Contacting States.

B. The new Article 23A(4) of the OECD Model Convention

Finally, let us now consider the the new Art. 23A(4) of the Convention. The OECD Commentary makes it clear that this provision aims at preventing double non-taxation resulting from conflicts of qualification, in circumstances in which the Contracting States disagree on the contextual interpretation of distributive rules or where they disagree on the factual situation of the case.[63] Art. 23A(4) is, however, not intended to apply when double non-taxation results from the fact that the Contracting States characterize an item of income differently because they take the view that a treaty term shall be construed by reference to the *lex fori*.[64] This limitation stems from a systematic interpretation of Art. 23A(4) of the Convention. In such case, the state of residence is to consider that the income may not be taxed 'in accordance with the provisions of this convention', so that there is no longer a need to restrict the application of Art. 23A(1).[65] Switzerland has not yet officially expressed an intention to include Art. 23A(4) in its new treaties or into amendments of existing conventions.

5. Conclusion

We have concluded that the solutions proposed by the OECD are not automatically applicable to Swiss DTCs concluded prior to their adoption by the CFA. We have thus examined the relevance of these recommendations with regard to the principles governing the interpretation of tax treaties. Based on the above, we have concluded the following.

- The recommendations of the OECD stem from a textual and contextual interpretation of Art. 23A and 23B of the OECD Model Convention. Therefore, they should be applied to all DTCs drafted along the lines of the OECD Convention, irrespective of the fact that the latter were concluded before or after the April 2000 update of the OECD Commentary.
- The scope of the principles developed by the OECD widely exceeds the restricted context of transactions involving partnerships.
- In this respect, the aim to avoid double taxation or double non-taxation is a consequence of a correct interpretation of Art. 23A and 23B of the OECD Model Convention rather than the theoretical support of the recommendations of the OECD.[66]

Notes

[59] Joseph Schuch and Josef Bauer, 'Die Ueberlegungen des OECD-Steuerausschusses zur Lösung von Qualifikationskonflikten', Gassner *et al.* (eds.), *Personengesellschaften im Recht der Doppelbesteuerungsabkommen – Die Auswirkungen des OECD-Reports auf die Abkommenspraxix* (Vienna, 2000), pp. 27 to 45.

[60] *Ibid.*, p. 37.

[61] For an overview of the various implementations of the global or schedular system around the world, see Victor Thuronyi (ed.), *Tax Law Design and Drafting*, vol. 2 (Washington D.C., 1998), pp. xxiii to xxxv.

[62] Indeed, para. 13.1of the OECD Commentary and Art. 3, para. 2 of the OECD Model Convention provides that 'for purposes of paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of the relevant provision of the domestic law of a Contracting State, whether or not tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws'.

[63] Para. 56.1 of the OECD Commentary on Art. 23A(4) of the OECD Model Convention.

[64] Para. 56.3 of the OECD Commentary on Art. 23A and 23B of the OECD Model Convention.

[65] Para. 56.3 of the OECD Commentary on Art. 23A and 23B of the OECD Model Convention.

[66] See Danon and Salomé, n. 10 above.