Jacques Sasseville[*]

Klaus Vogel Lecture – Tax Treaties and Schrödinger's Cat

The Klaus Vogel Lecture, given in the memory of Prof. Dr Klaus Vogel who passed away in December 2007, is being continued by the Institute for Austrian and International Tax Law (WU) in Vienna. This year's lecture was given by Jacques Sasseville of the OECD at the WU on 24 October 2008. Frank Engelen (University of Leiden and PricewaterhouseCoopers Netherlands) commented on the lecture. This article is the 2008 Klaus Vogel Lecture given by Jacques Sasseville, as revised for publication.

1. Introduction

When I agreed to give the Klaus Vogel Lecture, I expected that I would do so in Klaus' presence. This was not to be; like all of you, it was with deep sadness that I learned in December 2007 that he had left us.

It is a great honour for me to have been asked to give the lecture that has been instituted to celebrate his remarkable contribution to tax treaties. I was fortunate to be able to meet Klaus regularly and discuss many tax treaty issues over the years. Some of you will remember that Klaus was the first chairman of the annual IFA/OECD seminar that takes place during each IFA Congress. I had the chance to work with him on many of these seminars. It was during the preparatory meetings for them that Klaus very kindly asked me, three years in a row, to call him Klaus rather than Prof. Vogel, something that I found difficult at first, but found easier to do as I got to know him better.

2. Conflicts of Qualification

I think that Klaus would have liked the topic I chose to address this year. It deals with a difficult issue that arises as a consequence of what he referred to as the "new approach of the OECD" to conflicts of qualification.

In his 2003 article entitled "Conflicts of Qualification: The Discussion is not Finished",[1] Klaus wrote:

> This article analyses why the new approach of the OECD – of which this author approves in principle – does not cover all cases of differing qualifications and when and why, as a consequence of such conflicts, double taxation or double non-taxation may still arise.

His article went on to discuss two examples where, arguably, the conflicts of qualification were not solved by the "new approach".

In an article published a few months later,[2] John Avery Jones commented on the examples used by Klaus and convincingly explained that, while it was true that not all conflicts of qualification were solved by the "new approach" (e.g. where the residence state applies a treaty provision that does not allow it to tax), this was not the case in the examples used in Klaus' article.

The second example used by Klaus was the following:

> An independent singer who is a citizen of Austria alternates between performing in Austria and in Germany. He has a permanent contract with an opera company in Germany, committing him to a certain number of appearances each year. During the taxable year in question, he had, in addition, some separate engagements in Austria. In both states, he lived in hotels. On several occasions, he stayed part of the day in Austria and part in Germany. Therefore, the aggregate of his stays in each of the two states was more than six months. He received dividends and interest from portfolios in a third country.

According to Klaus, under Austria's domestic law meaning of the term "habitual abode", which appears in the tie-breaker rule of the Austria–Germany treaty, the singer did not have an habitual abode in Austria and would therefore be considered to be a resident of Germany. Austria would thus apply the treaty in a way that prevented it from taxing the income derived from the third country. Under Germany's view, however, the singer had an habitual abode in both states and the singer, being a citizen of Austria, would be a resident of Austria under the treaty tie-breaker rule, with the result that Germany would also apply the treaty in a way that prevented it from taxing the income derived from the third country. The positions of both countries would therefore result in double non-taxation.

John dealt with that example by taking the view that since the treaty tie-breaker rule is intended to resolve cases of dual residence, this was a case where the context required that an autonomous meaning, rather than a domestic law meaning, be given to the term "habitual abode". He added that "[i]f there is a conflict between the two states' interpretations, it has to be resolved by the mutual agreement article".[3]

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1. *Bulletin for International Fiscal Documentation* 2 (2003), at 41.
2. Avery Jones, John F., "Conflicts of Qualification: Comment on Prof. Vogel's and Alexander Rust's Articles", *Bulletin for International Fiscal Documentation* 5 (2003), at 184.
3. Id. at 186.

As that response shows, there is a crucial difference between a conflict of qualification and a conflict of interpretation. Para. 32.5 of the Commentary on Art. 23 (Elimination of double taxation] of the OECD Model Tax Convention, which is referred to in a footnote to the preceding quotation, makes it clear that, under the "new approach", Art. 23 will not require the residence state to eliminate double taxation where there is a conflict regarding the interpretation of the facts or the interpretation of the tax treaty provisions.

Similarly, while Art. 23 A(4) may apply to prevent double non-taxation in some cases of conflicts of interpretation, it will not address all such cases and is not primarily intended to do so. Art. 23 A(4) is primarily intended to address conflicts of qualification, i.e. cases where the two states consider that the same item of income falls within different articles of the treaty because of differences in the domestic laws of the two states, but where the residence state agrees that the other state has applied the treaty correctly. The above example of the opera singer deals with a case where the two states disagree with the interpretation of the term "habitual abode" for the purpose of determining the treaty residence of the taxpayer; the example does not deal with the treaty classification of an item of income and is not a case where each state agrees that the other has applied the treaty correctly.

In "Response by Prof. Vogel", which appeared at the end of John's article,[4] Klaus admitted "that the case is a little far-fetched, and I should have looked for a better one".

3. The Discussion on Conflicts of Qualification is not Finished

I would like to use a different example to show that Klaus was absolutely right when he suggested, in the title of his original article, that the discussion on conflicts of qualification is not finished.

Unlike Klaus' example, which dealt with double non-taxation, I would like to deal with a situation of possible double taxation. As mentioned above, Art. 23 A(4), which was added when the OECD adopted the "new approach", can address some cases of double non-taxation that do not arise from "conflicts of qualification", and this complicates the analysis if one uses a double non-taxation example.

I have already noted that Para. 32.5 of the Commentary on Art. 23 makes a clear distinction between, on the one hand, the situation where the two states apply different articles to the same item of income because of the correct treaty application of different domestic law meanings and, on the other hand, the situation where the two states apply different articles to the same item of income because of different interpretations of the facts or of the treaty provisions. In other words, the "new approach" does not force the residence state to eliminate double taxation if it does not agree with the interpretation given by the other state.

Clearly, if the residence state does not agree with the interpretation given by the source state, it should not be bound to apply the treaty on the basis of that interpretation.

There are different situations where this could happen. One is where the residence state does not agree that the source state has correctly determined the facts on which it based its tax assessment. For instance, the source state may have taxed the employment income of a resident of the residence state on the basis that the person was present in the source state for more than 183 days in a given 12-month period, but the residence state believes that the person was not present in the other state during all those days. In that case, the residence state would not consider that the relevant employment income has been taxed by the source state "in accordance with the provisions of the Convention" and would not be forced to exempt that income, or give a credit for the tax levied by the source state, as long as there is no agreement on the facts.

Another situation is where the residence state does not agree that the source state has correctly interpreted the treaty. For instance, the source state may have taxed the remuneration of a non-resident engineer on the basis that the reference, in Art. 15(2)(b), to an "employer who is not a resident of the other State" does not cover a situation where the non-resident engineer works under the direct control and supervision of a client who is a resident of the source state even though the engineer's formal employer is a non-resident engineering firm that seconded the engineer's services to the client for a short period of time. The residence state, however, may consider that this is not a correct interpretation of Art. 15. In that case, as in the previous case, the residence state would not consider that the relevant employment income has been taxed by the source state "in accordance with the provisions of the Convention" and would not be forced to exempt that income, or give a credit for the tax levied by the source state, as long as there is no agreement on how to interpret Art. 15.

The disagreement between the states may, of course, involve both the interpretation of the facts and the interpretation of the treaty provisions. Assume, for instance, that a non-resident employee receives stock options during a period of employment in the source state. The source state may tax the benefits derived from the exercise of the stock options on the basis that the benefits constitute other remuneration similar to salaries and wages and are related to the services rendered in the source state. The residence state, however, may disagree with both assumptions, which involve questions relating to the facts and to the interpretation of the treaty.

These examples refer to various aspects of Art. 15 on which the OECD has done some work in order to try to reduce the possibility of different interpretations.

4. Id.

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Indeed, changes have been made to the Commentary to clarify how to compute the 183-day period and to determine to what extent benefits derived from stock options constitute employment income and may be considered to relate to employment services performed in a country; the OECD has also worked for a long time on clarifying how Art. 15 applies to seconded employees.

These clarifications, however, do not address purely factual issues (e.g. was the person really present in a state on a particular day, what were the terms under which the stock options were granted, etc.). Also, in some cases, such as the interpretation of the reference to the concepts of "employment" and "employer" in Art. 15, it has not yet been possible to agree on a single interpretation.

These situations, of course, constitute an important source of possible double taxation. The mutual agreement procedure is available to address these cases but, as is well known, the mutual agreement procedure found in most treaties only requires the competent authorities to "endeavour to resolve" the cases that are presented to them, without any obligation to reach an agreement. This is why the recent addition to the OECD Model of Art. 25(5) providing for the mandatory arbitration of unresolved issues arising in a mutual agreement procedure case is such an important development. It is, in fact, a logical follow-up to the OECD's work on conflicts of qualifications.

As much as I support arbitration, however, I realize that it will be some time before arbitration is generally applicable to resolve most cases where the two contracting states adopt different interpretations of the facts or of the treaty provisions. It is therefore important that the OECD continue its work in order to address cases where countries adopt different interpretations of the tax treaty in order to determine which interpretation should prevail. Of course, the OECD is not an arbitral body, and each country remains free to disagree with the interpretations the OECD has adopted, but unless a country does so expressly (e.g. through an observation), it should be expected to follow an interpretation to which it agreed at the OECD, and the courts of many countries will require tax administrations to do so.

As long as most tax treaties do not include arbitration provisions, the cases where the OECD has not agreed on a single interpretation will continue to present important risks of double taxation. The Commentary includes only a few cases where different interpretations are put forward without any indication as to which interpretation should prevail (see, for instance, Paras. 8.5 and 8.6 of the Commentary on Art. 4). In such cases of conflicting interpretations, a residence state that adopted one interpretation would be unlikely to agree that the other state has taxed in accordance with the provisions of the treaty if it taxed on the basis of another interpretation of the treaty.

This brings me to the difficult situation of applying the "new approach" where more than one interpretation is considered to be correct.

I think we can all agree that it is possible for different people to interpret the same words in different ways. Lawyers are very good at doing this. That is different, however, from saying that the different interpretations are all correct.

In a purely domestic tax context, if lawyers or academics propose two different interpretations of the same provision of a tax law, either the judicial process will ultimately decide what the highest court considers to be the correct interpretation, which will normally bind everyone retroactively, or (and this is more likely to be the case with interpretations proposed by academics!) no decision will ever be rendered as to what is the correct interpretation because the issue has no practical significance.

In the tax treaty context, no judicial process will usually be available to decide what the correct interpretation is if two different interpretations are put forward by the contracting states. If the two states cannot agree on a single interpretation through the mutual agreement procedure (and arbitration, when available), each state will apply its own interpretation with possible unfortunate consequences.

In these cases, the "new approach" will not help to eliminate double taxation because that approach deals with cases where the residence state agrees with the interpretation of the treaty provisions given by the source state. The different treaty qualification of an item of income will be the result of domestic law differences rather than different interpretations.

But to what extent, if any, should the "new approach" apply in a case where both states agree that their interpretations of the treaty are different, but equally correct?

This is where were Schrödinger's cat comes into the picture.

4. Schrödinger's Cat

As we are in Vienna, I suspect that many of you have heard about the Austrian physicist Erwin Schrödinger.

At the end of the 1920s, Werner Heisenberg developed his famous uncertainty principle to explain why, in quantum mechanics, it was not possible to determine both the definite position and momentum of an electron in an orbit around the nucleus of an atom and why, therefore, the electron was everywhere in a "probability cloud". (My superficial understanding – or lack thereof – of the uncertainty principle is not crucial for the rest of this article.)

Albert Einstein and many others were not convinced by the uncertainty principle and thought that there was something missing in quantum theory. In 1935, Einstein co-authored a paper that attempted to challenge the uncertainty principle.

In preparing that paper, he exchanged letters with Schrödinger, and they started exploring some of the strange consequences of the suggestion that an electron

could have many positions at the same time, the exact position being determined only when it was observed.

In the course of the exchange, Schrödinger designed a thought experiment to show how bizarre that idea was. He may or may not have had a cat, but what may or may not have happened to the cat in the thought experiment suggests that he was a dog lover!

In the thought experiment, a cat, along with a flask containing a poison gas, was placed in a sealed box together with a Geiger counter and a tiny bit of radioactive substance. The substance was small enough so that, in one hour, perhaps one of the atoms decayed, but also, with equal probability, perhaps none. If the Geiger counter detected radiation, a relay released a hammer which shattered the flask, releasing the poison which would kill the cat. Quantum mechanics suggests that, after a while, the cat was simultaneously alive and dead. Yet, when one looked into the box, he saw the cat either alive or dead, not a mixture of alive and dead.[5]

I do not know what others think, but I tend to agree that if quantum mechanics resulted in a cat being both alive and dead at the same time, this would be a rather counter-intuitive result.

I would like to move to transfer pricing, where it is recognized that a "range" of prices can all satisfy the arm's length standard.

I am not suggesting that transfer pricing is governed by quantum mechanics, but it strikes me that the concept of a "range" of arm's length prices is somewhat similar to that of quantum superpositions, i.e. the combination of all the possible states of a system such as the combination of all the possible positions of an electron. Until there is a final agreement between the competent authorities, which would correspond, in Schrödinger's experiment, to the opening of the box that triggered the collapse of the quantum superpositions and the determination of whether the cat was dead or alive, a "range" of different prices constitutes a correct interpretation of the treaty words that correspond to the arm's length principle.

The idea that many different interpretations of the same words may be correct at the same time also strikes me as being a counter-intuitive result. It is also a result that creates a difficult issue for the application of the "new approach". This issue is whether the residence state of an enterprise that has a permanent establishment in another state is required to apply Art. 23 (Elimination of double taxation) based on the arm's length transfer price or method used by the source state even though that price or method differs from the arm's length transfer price or method used by the residence state.

This issue is best illustrated by a simple example involving RCO, a company resident in State R, that has a manufacturing plant in State S which produces tables that RCO will sell to independent retailers in State R. For a given taxable period, the actual costs of producing the tables, taking into account all direct and indirect costs, are 1 million, and the tables are sold by RCO at 1.5 million. In selling the tables, RCO incurs marketing and distribution costs of 200,000, leaving profits of 300,000, as illustrated by Table 1.

Table 1

sales	1,500,000
minus: cost of goods sold	(1,000,000)
	500,000
minus: marketing and distribution costs	(200,000)
profits	300,000

Art. 7 (Business profits) of the tax treaty between States R and S allocates the taxing rights on these profits. In accordance with Art. 7, State S will be allowed to tax the profits that the permanent establishment would have made if it had been a separate and independent enterprise. Quite clearly, the permanent establishment, if it had been a separate and independent enterprise, would not have sold the tables to RCO at a price of 1 million or less since this represents RCO's direct and indirect manufacturing costs for producing the tables in State S. It is also clear that RCO would not have paid more than 1.3 million if it had acquired the tables from an independent enterprise since that amount represents the maximum amount that it could pay in order to break even when it sells the tables to independent retailers.[6]

In order to determine the profits that are attributable to the permanent establishment under Art. 7(2), it will therefore be necessary to determine the arm's length price at which the tables would have been sold by the permanent establishment, and acquired by the rest of RCO, if the permanent establishment had not been a part of RCO but, instead, a separate and independent enterprise. That arm's length price, which will be somewhere between 1 million and 1.3 million (this is not a suggestion of a possible arm's length range!), will determine, for purposes of the tax treaty between States R and S, which part of the profits is considered to arise in each state.

This is clearly relevant for State S as Art. 7 prevents it from taxing the profits that are not attributable to the permanent establishment. It is also very relevant for State R since Art. 23 will require it either to exempt the part of the profits attributable to the permanent establishment in State S or to give a credit for the tax levied by State S on that part of the profits (which will normally mean that little or no tax will be collected in State R on that part of the profits).

5. This description is adapted from the one found at en.wikipedia.org/wiki/Schrodingers_cat.
6. For purposes of simplification, this example assumes that the circumstances do not justify predatory pricing or another loss-making strategy that either the permanent establishment or the rest of the enterprise could undertake for a limited period of time (e.g. to penetrate a new market).

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Both states therefore have a direct interest in making sure that the arm's length standard is properly applied in determining the profits attributable to the permanent establishment situated in State S.

In determining the transfer price of the tables transferred from the permanent establishment in State S to the rest of the enterprise in State R, RCO may have an interest in choosing either a high transfer price that will maximize the share of profits allocated to State S or a low transfer price that will maximize the share of profits allocated to State R. This will depend on the tax rates and various other tax factors (e.g. loss utilization) in each state and, if all the tax factors are relatively equal, RCO may have no interest at all in determining the transfer price of the tables. States S and R, however, will both be interested in what the transfer price is, but their interests will go in opposite directions: State S will want to make sure that the price is not too low to deprive it of tax revenues; conversely, State R will want to make sure that the price is not too high to reduce the amount of profits on which State R has exclusive taxing rights.

It will therefore not be surprising if the three parties who are required to determine the transfer price of the tables (i.e. the taxpayer RCO, the tax administration of State S and the tax administration of State R) end up with different amounts.

Ultimately, any difference between the taxpayer and the tax administration of one of the states may be resolved through the judicial process in that state. In other words, both the taxpayer and the tax administration may have correctly applied the treaty as both chose a transfer price that is in the range of acceptable arm's length prices, but a final determination by the courts of that state will produce, in quantum mechanics' parlance, a collapse of the quantum superpositions of correct transfer prices and the observation of a single correct transfer price. To paraphrase Schrödinger, the judge will open the box and find out whether the cat is dead or alive.

A difference between the tax administrations of the two states, however, is more problematic. If the tax administrations end up with different transfer prices for the tables and both prices satisfy the arm's length requirement of Art. 7(2), what will happen?

If the result is double taxation, one can easily imagine that the taxpayer will consider the mutual agreement procedure in Art. 25 of the treaty. Art. 25(1) indicates that a person may initiate a mutual agreement procedure if he "considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of ... [the] Convention". If, however, both tax administrations used a correct transfer price in applying Art. 7(2), can it be said that there is taxation "not in accordance with the provisions of ... [the] Convention"?

If we conclude that this is not the case, the "weaker" form of mutual agreement procedure provided by Art. 25(3) would, of course, still be available. The problem, however, is that the arbitration provision in new Art. 25(5) is not available in the case of a mutual agreement procedure that falls within Art. 25(3).

This is where the possible application of the "new approach" comes into play. If one were to consider that the different prices used by the two tax administrations result in a conflict of qualification, the result would be that State R, in applying Art. 23, would have to agree that State S has taxed in accordance with the provisions of the treaty and would have to eliminate double taxation accordingly. If State R did not agree, its failure to comply with the obligation imposed by Art. 23 would allow the taxpayer to go to court in State R and would also mean that taxation by State R was not in accordance with the treaty, thereby allowing the taxpayer to present its case under Art. 25(1).

The big question, however, is whether the different arm's length prices used by the tax administrations can be viewed as producing a conflict of qualification. This issue was discussed extensively during the drafting of new Art. 7, which was released in July 2008 as a discussion draft.[7]

Draft new Art. 7(3) and Paras. 40 to 69 of the proposed Commentary on draft new Art. 7, which are included in the discussion draft, discuss extensively what happens where the taxpayer and the two contracting states use transfer prices or methods that are different, but that equally satisfy the arm's length requirement of Art. 7(2). The main purpose of these paragraphs is to explain how Art. 23 will apply in such cases.

Draft new Art. 7(3) deals with one specific situation, i.e. where the domestic law rules of the contracting states require the use of different acceptable approaches to attribute an arm's length amount of "free" capital to the permanent establishment. As explained in Para. 44 of the proposed Commentary:

> Paragraph 3 deals with this issue, which is especially problematic for financial institutions. It provides that a Contracting State must accept, for the purposes of determining the amount of interest deduction that will be used in computing double taxation relief, the attribution of "free" capital derived from the application of the approach used by the other State in which the permanent establishment of an enterprise of the first State is located if the following two conditions are met. First, the difference in capital attribution between the two States must result from conflicting domestic law choices of capital attribution methods. Second, the States must agree that the State in which the permanent establishment is located has used an authorised approach to the attribution of capital and that that approach produces a result consistent with the arm's length principle in the particular case.

Draft new Art. 7(3) basically achieves the same function as Para. 45 of the current Commentary on Art. 7 (added through the 2008 Update), which is to deal with the difficulties created by the recognition that there is more than one acceptable method of allocating "free" capital to a permanent establishment. These difficulties were particularly acute for banks, which have many foreign branches to which "free" capital must be allocated; this led the OECD to deal expressly with the issue.

7. Available at www.oecd.org/dataoecd/37/8/40974117.pdf.

Draft new Art. 7(3) therefore has a rather limited scope. It does not, for instance, deal with the above example. Paras. 51 to 69 of the proposed Commentary suggest another way to deal with that example. As indicated in Para. 53:

> Where the taxpayer has not used conditions or methods that conform to paragraph 2, each State is entitled to make an adjustment in order to ensure that the profits have been attributed to the permanent establishment in conformity with paragraph 2. If that is the case, a different amount of profits may be attributed to the permanent establishment in each State with a risk of double taxation. Where one State has made an adjustment in conformity with paragraph 2, that paragraph certainly authorises the other State to make a reciprocal adjustment so as to avoid such double taxation through the combined application of paragraph 2 and of Article 23 A or 23 B (see paragraph 65 below). It may be, however, that the domestic law of that other State may not allow it to make such a change or that State may have no incentive to do it on its own if the effect is to reduce the amount of profits that was previously taxable in that State. This problem could be addressed bilaterally by an additional paragraph, drafted along the following lines, that would provide a corresponding adjustment mechanism similar to the one provided for in paragraph 2 of Article 9 to deal with the comparable situation that could arise following the adjustment of the profits of an associated enterprise:
>
> > Where, in accordance with this Article, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other State shall, to the extent necessary to eliminate double taxation on these profits, make an appropriate adjustment to the amount of the tax charged on those profits. In determining such adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall if necessary consult each other. For the purposes of this paragraph, where the profits that are attributable to the permanent establishment are determined in one State through the use of a method that is provided by the domestic law of that State and that results in profits that are different from those attributed to the permanent establishment in the other State, the first-mentioned State shall be deemed to have adjusted the profits attributable to the permanent establishment.

Notwithstanding this proposed solution, could it considered that the problem is in fact solved differently by applying the "new approach"?

I do not know whether the discussions that led Schrödinger to come up with the cat's hypothetical situation were as lively as those that took place on this issue, but I can say that there are strongly held views on this matter.

The problem is that "conflict of qualification" is a rather loose concept, and it is not clear to what extent the determination of an arm's length price relates to the classification of income between the two parts of Art. 7(1), to the computation of income, to the interpretation of the treaty provisions, to the determination of the facts, or to all of the above.

As noted above, Para. 32.5 of the Commentary on Art. 23 recognizes that there is a fundamental difference between conflicts of qualification and conflicts on the interpretation of the facts or the treaty provisions:

> Such conflicts resulting from different interpretation of facts or different interpretation of the provisions of the Convention must be distinguished from the conflicts of qualification described in the above paragraph where the divergence is based not on different interpretations of the provisions of the Convention but on different provisions of domestic law.

One could argue, however, that Para. 32.5 does not restrict the meaning of "conflict of qualification" and that a conflict of qualification arises in the example I used since State S, when it determined the transfer price of the tables in accordance with its domestic law and with Art. 7(2), qualified one part of RCO's business profits as profits attributable to the permanent establishment, which State S may tax in accordance with the provisions of the treaty. Although State R qualified the same part of the business profits as profits not attributable to the permanent establishment, State R is still required to acknowledge that State S has taxed in accordance with the provisions of the treaty.

This view would have the result of extending the approach to conflicts of qualification, which deals with states qualifying the same income differently, to cover a case where the two states qualify the income in the same way (e.g. as business profits), but measure differently what is attributable to a permanent establishment.

One possible problem with this approach is that the word "income", as used in Art. 23, does not have an autonomous meaning and allows each state to determine what is the amount (subject to the obligation to conform to Art. 7(2)) on which tax relief will be granted. The approach to conflicts of qualification only intervenes if the qualification of a given amount is different so that one state argues that the amount is taxable and the other that it is not. The principle that the residence state uses its own rules for computing the income on which double taxation relief must be granted under Art. 23 is expressly recognized in Para. 39 of the Commentary on Art. 23:

> The amount of income to be exempted from tax by the State of residence is the amount which, but for the Convention, would be subjected to domestic income tax according to the domestic laws governing such tax. It may, therefore, differ from the amount of income subjected to tax by the State of source according to its domestic laws.

Regardless of the merits of these conflicting interpretations of Art. 23, it should be noted that the result of applying the "new approach" in the above example is that the transfer price used by State S is "imposed" on State R for purposes of Art. 23. State R, if it also used a transfer price that is at arm's length, might be reluctant to accept that result, especially if State R's tax administration was the first to discover that RCO had not used an arm's length price and the first to adjust the profits accordingly. In such a case, State R's tax administration would probably look at an equivalent situation between two associated enterprises and conclude that the approach adopted in Art. 9(2) is a much better way to address the differences in how the pie has to be shared between the two states.

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5. Conclusion

As I have already mentioned, this is a difficult issue, and it triggered many discussions when new Art. 7 was drafted. I have the feeling that these discussions are not over and that Klaus Vogel was therefore right when he wrote "Conflicts of Qualification: The Discussion is not Finished".

I would like to add, however, that this issue may well be, to a large extent, more theoretical than practical. Para. 41 of the discussion draft on draft new Art. 7 recognizes the principle that if the taxpayer has used an arm's length price or method which conforms to the treaty and the domestic law of each state, the tax administrations should refrain from using a different arm's length price or method:

> Indeed, risks of double taxation will usually be avoided because the taxpayer will determine the profits attributable to the permanent establishment in the same manner in each Contracting State which will ensure the same result for the purposes of Article 7 and Article 23. Insofar as each State agrees that the taxpayer has done so in conformity with paragraph 2 and with its domestic law, it should refrain from adjusting the profits on a different arm's length basis.

There may certainly be cases, however, where the domestic laws of the two states will require the use of different arm's length prices or methods or where the states will not agree that the taxpayer has used an arm's length price or method. In those cases, I think it is rather unlikely that if the tax administrations are confronted with a situation where they used different transfer prices or methods, they will readily agree that both prices or methods satisfy the arm's length standard, e.g. in my example, that the transfer prices used by the tax administrations of both States R and S are within an acceptable arm's length range. It is more likely that the tax administration of each state will take the initial position that the other state's transfer price is not at arm's length and that, through the mutual agreement procedure, a single transfer price will be agreed to. If they are unable to do so, however, my hope is that the relevant treaty will allow judges or arbitrators to open the box and determine whether the cat is dead or alive.

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