In memoriam
Kari S. Tikka
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The geographical scope of the distributive articles of the OECD Model[1]

Introduction

Chapter III ('Taxation of income') of the OECD Model contains the so-called distributive income articles. The articles of this core chapter of the OECD Model cover any type of income or gain that may be subject to taxation by both treaty states. Virtually all articles deal with a particular income or gain category, while the last article (Article 21 'Other Income') covers income that belongs to any category that is not dealt with by the preceding articles. In paragraph 1 of the 1963 Commentary it is stated that Article 21 aims at providing:

> "a general rule relating to items of income not *expressly mentioned* in the preceding Articles of the Convention". [*italics* KvR]

In the 1977 Commentary these words have been replaced by:

> "a general rule relating to items of income not *dealt with* in the foregoing Articles of the Convention. The income concerned is not only income *of a class* not expressly dealt with but also income *from sources* not expressly mentioned". [*italics* KvR]

Early tax treaty commentaries confirm what is often understood as the meaning of the sentence quoted above from the 1963 OECD Commentary. In this view, Article 21 covers only income such as alimony payments, prizes, awards, and social security payments, i.e. income items that are outside the scope of the preceding articles as that scope appears from the headings of these articles, such as 'income from immovable property' (Article 6), 'business profits' (Article 7), etc.

A simple example, however, illustrates that this approach is too narrow. Let us assume that a US resident rents an Amsterdam apartment from a Dutch resident, and that under US domestic tax law a nonresident person who receives rental payments from a US resident person is subject to US taxation on such payments. As the residence country of the recipient person (The Netherlands) will typically include such payments in the recipient's worldwide income,

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double taxation will occur. If between the US and The Netherlands a treaty applies that is identical to the OECD Model, one would be inclined to apply Article 6 (Income from immovable property) to solve this double taxation. However, when substituting the names of the countries involved, the provision turns out not to be applicable:

> "Income derived by a resident of [The Netherlands] from immovable property – – situated in the *other Contracting State* – – ".

Since the Amsterdam apartment is not located in the other state (United States), the rental income of the example is not covered by Article 6 (Income from immovable property), despite the unrestricted-looking title of the article. It covers only rental income that is derived by a resident of one state from immovable property situated in the other state. If a state (like the United States in the example) taxes nonresidents on immovable property rental income not because the situs of the property is in the United states but because the payor is a US resident, the income concerned is not covered by Article 6 and, consequently, the article does not restrict the United States in its taxation. The 1977 wording of the Commentary on Article 21 expresses this: while the rental income in the example is of a *class* (i.e., income from immovable property) that is expressly dealt with, it is income from a *source* (the residence of the payor) that is not recognized by the provision as relevant for the allocation of the taxing right. The 1977 Commentary on Article 21 therefore explains that the scope of this provision is wider than one would perhaps assume on the basis of (the Commentary to) the 1963-version of Article 21.

Two types of distributive articles: global or bilateral

Article 6 is an example of a distributive provision with a restricted geographical scope: it only deals with immovable property income that a resident of one of the treaty states derives from a source (as defined in that article by reference to the situs of the property) in the other state. Immovable property income that a resident of one treaty state receives from a resident of the other state as payment for the use of immovable property situated in a third state or in the residence state of the recipient, it is not covered by the article.

If we analyze the distributive provisions of the Articles 6 through 21 of the OECD Model there turn out to be four other articles that, in the same way as Article 6, are restricted in their geographical scope of application:

- Article 10 (Dividends)
- Article 11 (Interest)
- Article 16 (Director's fees)
- Article 17 (Artistes and sportsmen).

They only apply if the income that is earned by a resident of one of the states, is derived from a defined source in the other state. While, as we saw, the defined source for income from

immovable property is the location (situs) of the property, the source used in the other articles varies:

- residence of the payor: see Articles 10 and 11;
- location of the permanent establishment that bears the cost of the payment made to the resident of the other state: see Article 11 which provides this as a second source (alternative to the residence of the payor)
- residence of the company of which the recipient is a director (Article 16)
- place where the sports or artistic activity takes place (Article 17).

If the income is *not* derived from a source in the other country as defined in these four groups of articles, the given article does *not* apply.

Other distributive articles[2] are not restricted in this way and have a worldwide scope:

- Article 7 (Business profits)
- Article 8 (Shipping)
- Article 13 (Capital gains)
- Article 15 (Income from employment)
- Article 18 (Pensions).

These five articles all take care of any double taxation issues that a resident of one state earning the pertinent sort of income or gain may encounter as a result of overlapping residence and source state taxation. E.g., paragraph 1 of Article 15 (Income from employment) gives in respect of any income from employment wherever exercised the exclusive taxing right to the residence state of the employee. Paragraph 2 provides for an exception if the employment is exercised in the other state *and* there is (at least) one of the three additionally listed connections with that other state (presence of the employee in the other state exceeding 183 days, employer being a resident of that other state, salary borne by an employer's PE in the other state). If one treaty state under its domestic tax law wants to tax the employment income of a resident of the other state e.g. on the (sole) ground that work is being done for a business operation of the employer in the former state (and the salary is deducted from profits taxable in that state), the treaty prohibits that (source) state from taxing, and the exclusive taxing right remains with the residence state of the employee. The same occurs if the first state wants to tax the employment income of a nonresident employee simply on the ground of the employer being a resident of that state and irrespective of whether the employment activities are performed in that state. There is no way employment income can escape from being covered by Article 15. And this is the common characteristic of these five distributive articles each of which has a truly unrestricted (i.e., 'global' or 'worldwide') scope.

[2] The Articles 19 and 20 are not included in either list because they have a special geographical reach.

Treaty application when the income is of a nature covered by a given distributive article but outside the geographical scope of that article

In the 'Introduction', above, the example was used of a US resident renting an Amsterdam apartment from a Dutch resident. It was assumed that under US domestic tax law rental income that is received by a nonresident person from a US resident is subject to US taxation. We found that Article 6 of the US-Netherlands tax treaty does not apply since, where Dutch resident recipients are concerned, the scope of that article is restricted to rental payments received in respect of US-located immovable property. Another example where Article 6 of the US-Netherlands would not be applicable would be a rental payment made by a US resident to a Dutch resident in connection with an apartment in Berlin (Germany, i.e. a third country under the US-Netherlands tax treaty) . Under its assumed domestic rule the United States would tax and Article 6 of the US-Netherlands treaty would not cover it as the rental income received by the Dutch resident concerns immovable property situated not in the United States but this time in a third country.

When Article 6 does not apply, does that mean that the treaty is not applicable (as it sometimes assumed) and that the source state is not restricted in applying its domestic tax law? To answer this question accurately, it is helpful to go one step back and to review the steps that need to be taken when applying a tax treaty. A tax treaty is applicable to any item of income of a resident of one of the treaty states no matter where the income is derived from: the other country, the residence country or a third country (Article 1 OECD). Next, one needs to establish which of the distributive articles (Articles 6–21 OECD) is or are applicable. Not exceptionally, two articles may be applicable, particularly when business income is involved. A dividend received by a company that carries on a business, will under the law of may countries constitute business income as covered by Article 7 and at the same time it will be dividend income covered by Article 10. In such an instance it must be determined which article has priority over the other (paragraph 7 of Article 7 provides the answer: Article 10 has priority). But (initial) overlaps may also occur involving other treaty articles, such as Article 15. Where such an overlap concerns the Articles 16, 17, 18 or 19, it is taken care of by the articles involved (see, e.g., the opening words of Article 15). As a side observation, it should be noted, however, that not all overlaps are taken care of by the treaty: E.g., the overlap that occurs between the Articles 15 (Income from employment) and 20 (Students) where a business apprentice as such receives employment income, is not solved.

Where initially two articles appear to be applicable, such as rental income received by a Dutch resident entrepreneur (Articles 6 and 7), it may happen that at closer scrutiny one of the articles turns out not to apply. If in our immovable property example the Dutch resident that receives rental income from a US resident in respect of an Amsterdam apartment, earns this income in a business capacity, initially both Article 6 and Article 7 seem to be applicable. Since, as a result of the restricted geographical scope of Article 6, the latter article does not apply, the exception

referred to above that is laid down in paragraph 7 of Article 7, does not come into play, and Article 7 will be the (solely) applicable provision. If the rental income in the hands of the Dutch recipient is not business income but private investment income, in the absence of Article 6 being applicable, Article 21 will apply. So this is an example where the 'Other income' article covers a category of income (immovable property income) that as a category is dealt with by Article 6 but is restricted in that provision to such income within a particular geographical setting: it must concern immovable property situated in the other treaty state. So where the property is located in a third state or in the residence state of the recipient, and constitutes non-business income in the hands of this recipient, it is covered by Article 21. The result of the applicability of Article 21 is that the residence state of the recipient has the exclusive taxing right (the same result is obtained under Article 7: if this income does not happen to be attributable to a PE of the recipient in the other state, it is only the recipient's residence state that may tax).

Examples from judicial practice

In this section two examples are given of judicial instances where the restricted geographical scope of treaty provisions was not correctly understood. The first one (A, below) concerns a 2001 decision by of Dutch *Hoge Raad (*Supreme Court), and the other one (B) is derived from an Opinion submitted in 2006 by one of the Advocates General of the same court.

A. The 2001 *Hoge Raad* decision is of 21 February 2001 (nr. 35 557, reported in BNB 2001/295). It involved a company incorporated under Dutch law – and for that reason a (resident) company subject to taxation on its worldwide income by The Netherlands – which paid a dividend to a shareholder resident in Belgium. The Netherlands wanted to apply its dividend withholding tax to this dividend. The company was effectively managed in another (treaty) country and as a result of the tie-breaker rule in that treaty the company was for purposes of that treaty a resident of the other country. The Dutch *Hoge Raad* took the view that, since The Netherlands could therefore not effectively tax the worldwide income of its resident company anymore, the company could not be considered a company resident in The Netherlands for purposes of the Dutch treaty with Belgium. Let us leave aside the correctness of that view. The issue is that the court, in its next step, disregarded that Art. 10 (Dividends) is a strictly bilaterally operating article that applies to a dividend by a company that is a (treaty) resident of one treaty state (here supposedly: The Netherlands) to a shareholder that is a (treaty) resident of the other state (here: Belgium). The court took the view that the article applies to any dividends but *permits* the application of a withholding tax (reduced to 15 % or 5 %) only in cases where the requirements laid down in Article 10 are met, including that the distributing company is a (treaty) resident of The Netherlands. As the company was not such a resident in the view of the court (also here: the correctness of that view is left aside), the court concluded that The Netherlands was not entitled to levy any withholding tax.

This is, in my view, a clearly erroneous decision where the court, in addition to failing to recognize that treaties operate vis-à-vis source countries by *imposing restrictions* on the application of their domestic taxing rules (rather than *permitting* countries to apply their domestic law), failed to understand that Art. 10 does not take care of just any dividend received by a resident of one of the treaty states, but only of dividends that meet the requirements with regard to the source of the dividend as indicated in the article: it must be paid by a company that is a (treaty) resident of one state to a shareholder resident in the other treaty state. As the court had determined that the dividend paying company was *not* a treaty resident of The Netherlands, Article 10 simply could not be applied anymore: there is not a dividend paid by a resident of one state to a resident of the other state. The same nonapplicability of Article 10 would occur if the Netherlands-incorporated company would have been effectively managed in Belgium and thereby would have been a treaty resident of Belgium. In that case the distributing company would have been a resident of one of the treaty states (Belgium) but the requirement of Article 10 that the shareholder be a resident of the other treaty state (The Netherlands), would not have been met. In any event, Article 10 not being applicable, Art. 7 or Art. 21 – depending on the nature of the income in the hands of the recipient – would typically be applicable and these articles would prohibit The Netherlands from imposing any tax.

B. The second illustration is derived from the Opinion submitted on 22 December 2005 in case nr. 41 392 that was pending before the *Hoge Raad*. It concerned a company resident of the Netherlands that had as a (managing) director a person who was a resident of the Netherlands Antilles under the law of that country and, at the same time, of The Netherlands under Dutch law. Under tie-breaker rule of the treaty-like 'Arrangement' between The Netherlands and the Netherlands Antilles the person was a resident of The Netherlands. In his Opinion the Advocate General examined the application of the provision in the Arrangement that corresponds with Article 16 OECD Model (Director's fees). It provides that director's fees received by a resident of one country as a director of a company that is a resident of the other country may be taxed by that other country. In the case under examination, however, the director was for purposes of the Arrangement a resident of the same country (The Netherlands) as the company. Instead of finding that the provision therefore could not be applied and examining which article should be applied instead (e.g., in OECD numbers, Article 15 (Income from employment) and Article 7 (Business Profits)) the Advocate General took the view that, since The Netherlands would have the taxing right if the director would have been a resident (for purposes of the Arrangement) of the Netherlands Antilles, it would be absurd to conclude otherwise in a case where the director is a resident of The Netherlands. Consequently, he took the position that the provision should be applied also to the case where the director is a resident of the same country as the company whose director he is, and that The Netherlands therefore is not restricted by the Arrangement in taxing the director's fee.

Another – in my view – obviously erroneous viewpoint. If the provision should produce the result as desired by the Advocate General, the provision would need to contain the following

additional text: "Director's fees – – derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the same Contracting State, shall be taxable only in that State." In the absence of such an additional clause in Article 16 it would need to be established on the basis of the facts whether Article 15 should have been applied (often in the case of a managing director, as this person is usually employed by the company), resulting in the exclusive taxing right of the director's residence state (The Netherlands) except to the extent the director did his work in the other state (Article 15, paragraph 2, under b would then leave the taxation to the company's residence state: the Netherlands Antilles). Alternatively – and typically when it concerns a supervisory director – Article 7 could be applicable. That article also leaves the exclusive taxing right with the director's residence state (i.e., The Netherlands) except to the extent his remuneration would be attributable to a permanent establishment he would maintain in the other state (the Netherlands Antilles), perhaps an office he may have at his disposition at the company's headquarters.

Conclusion

It is surprising to observe that a fundamental feature of the OECD Model – i.e. different geographical scopes among the distributive articles – is neither well documented nor (and perhaps as a consequence thereof) generally correctly understood. At the same time it is clear that it is an essential feature, since it may give rise to incorrect treaty application and, consequently, unrelieved double taxation. I am interested to learn whether this issue has also arisen in the (judicial) tax practice in other countries and would be grateful for reactions from readers.

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