For Ann, Isak and Tilde
Methods for Elimination of Double Taxation under Double Tax Treaties
– with Particular Reference to the Application of Double Tax Treaties in Sweden

DAVID KLEIST

IUSTUS FÖRLAG
Abstract


The study deals with the methods for elimination of double taxation that are applied in double tax treaties.

The first aim of the study is to systematise and analyse the methods for elimination of double taxation under double tax treaties in order to gain a better understanding of how they work. A number of issues relating to the application of these methods are analysed. Since double tax treaties are applied by tax authorities, courts, and taxpayers in a domestic law context, i.e. within the framework of the legal system of a particular state, the analysis focuses on the application in Sweden of the methods for elimination of double taxation under double tax treaties.

The second aim of the study is to evaluate in a few selected situations the two main methods for elimination of double taxation recommended by the OECD, namely exemption with progression and ordinary credit, on the basis of whether tax neutrality is achieved. For the purpose of this study, tax neutrality is deemed to be achieved when the taxation of income relating to a cross border transaction corresponds to the tax that would have been levied in either the state of residence (i.e. capital export neutrality, “CEN”) or in the other contracting state (i.e. capital import neutrality, “CIN”), had the cross border element not been present. Furthermore, for the purpose of this study, tax neutrality is deemed to be achieved if the taxation of income relating to a cross border transaction is within the range set by CEN and CIN. The evaluation shows that ordinary credit stands a greater chance than exemption with progression of achieving an outcome which is consistent with the goal of tax neutrality in the situations selected for study.

Keywords: double taxation, double tax treaty, capital export neutrality, CEN, capital import neutrality, CIN, exemption, exemption with progression, modified exemption, limitation of the tax rate, credit, full credit, ordinary credit, tax sparing credit, foreign tax credit limitation, maximum deduction, interpretation of double tax treaties, model tax convention on income and on capital, the OECD Model, the Commentaries of the OECD Model, subject identity, timing mismatch, attribution of income, allocation of expense, RÅ 1996 ref. 84, RÅ 2008 ref. 24, RÅ 2010 ref. 112, dubbelbeskattning, dubbelbeskattningssavtal, skatteavtal, kapitalexportneutralitet, kapitalimportneutralitet, alternativ exempt, OECD:s modellavtal.

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Contents

List of Abbreviations 13

1 The Subject 15
  1.1 Introduction 15
    1.1.1 The Object of the Study in Brief 15
    1.1.2 Elimination of Double Taxation by Concluding
        DTTs 15
    1.1.3 Basic Structure of DTTs 16
    1.1.4 The Methods for Elimination of Double Taxation 18
  1.2 Aims of the Study 19
    1.2.1 The First Aim of the Study 19
    1.2.2 The Second Aim of the Study 20
    1.2.3 The Relevance of the Aims of the Study 24
  1.3 Delimitations 24
    1.3.1 Unilateral Double Tax Relief 24
    1.3.2 Conflicts of Qualification and Other Issues Leading to
        the Application of the Methods 24
    1.3.3 Corresponding Adjustment 25
    1.3.4 EU Law 26
    1.3.5 Wealth Tax and Inheritance Tax 28
    1.3.6 Procedural Rules 29
  1.4 Method and Material 29
    1.4.1 Method and Material Relating to the First Aim
        of the Study 29
    1.4.2 Method and Material Relating to the Second Aim
        of the Study 32
  1.5 Previous Research 33
  1.6 Terminology 37
  1.7 Outline of the Study 38
2 Capital Import Neutrality and Capital Export Neutrality

3 The Relation between DTTs and Internal Law

3.1 Introduction

3.2 The Dual Nature of DTTs

3.3 Entering into DTTs and Incorporation into Domestic Law; a Swedish Perspective

3.4 Conflicts between DTTs and Internal Law

3.4.1 Interpretation in Conformity with International Law as a Means of Reconciling DTT Provisions and Internal Law

3.4.2 Priority over Internal Law by Reference to Legal Maxims such as Lex Specialis Derogat Legi Generali and Lex Posterior Derogat Lex Priori

3.4.3 Priority over Internal Law by Reference to the Presumption that the Legislator Did Not Intend to Act in Breach of Its Treaty Obligations

3.4.4 Summary

3.5 The Principle That DTT Provisions May Not Increase the Tax Burden

3.6 International Law vs. Domestic Law Approach to DTT Interpretation

3.7 The Interpretational Rules of the VCLT

3.8 Some Remarks on Sources of Law in a DTT Context

3.8.1 Introduction

3.8.2 The Treaty Text

3.8.2.1 What Material Constitutes the Treaty?

3.8.2.2 Different Language Versions

3.8.3 The OECD Model

3.8.3.1 The Work of the OECD

3.8.3.2 The Commentaries of the OECD Model

3.8.3.3 Reservations to the Articles, Observations to the Commentaries, and Positions Expressed by Non-Member States

3.8.3.4 Ambulatory or Static Reference to the Commentaries

3.8.4 The UN Model

3.8.5 Mutual Agreements
4 Elimination of Double Taxation under the Distributive Rules and the Double Tax Relief Article

4.1 Introduction 124

4.2 Attribution of Income to a Person – the Requirement for Subject Identity 125

4.3 Elimination of Double Taxation under the Distributive Rules 129
   4.3.1 Introduction 129
   4.3.2 Exemption of Income under the Distributive Rules According to the OECD Model 130
   4.3.3 Timing Issues 134
      4.3.3.1 Introduction 134
      4.3.3.2 Temporal Limitations to the Allocation of Taxing Rights 135
      4.3.3.3 Timing Mismatch in Combination with a Change of Residence 139
   4.3.4 Attribution of Income and Allocation of Expense to R or N 144
   4.3.5 Quantification of Income 147

4.4 Elimination of Double Taxation under the Double Tax Relief Article 148
   4.4.1 Introduction 148
   4.4.2 The Double Tax Relief Article of the OECD Model 150
      4.4.2.1 General on the Double Tax Relief Article of the OECD Model 150
      4.4.2.2 Article 23 A of the OECD Model 151
      4.4.2.3 Article 23 B of the OECD Model 154
   4.4.3 The Term Income 155
   4.4.4 The Term Source 158
   4.4.5 Taxation in Accordance with the Provisions of the DTT 163

4.5 Summary 166
5 The Methods For Elimination of Double Taxation 170

5.1 Introduction 170

5.2 The Principle of Exemption 173
  5.2.1 Introduction 173
  5.2.2 Relation to Internal Law 174
  5.2.3 Subject-to-Tax Clauses 175
  5.2.4 Deduction of Losses in N from Income in R 178
  5.2.5 Full Exemption 180
  5.2.6 Exemption with Progression 183
  5.2.7 Modified Exemption 197
  5.2.8 Tax Sparing Exemption/Matching Exemption 202

5.3 Limitation of the Tax Rate 203
  5.3.1 Introduction 203
  5.3.2 Relation to Internal Law 205
  5.3.3 Economic Double Taxation 208
  5.3.4 DTT Provisions on Limitation of the Tax Rate 210

5.4 The Principle of Credit 213
  5.4.1 Introduction 213
  5.4.2 Relation to Internal Law 216
  5.4.3 Deduction of Losses in N from Income in R 220
  5.4.4 Full Credit 221
  5.4.5 Ordinary Credit 222
  5.4.6 Tax Sparing Credit/Matching Credit 226
  5.4.7 Reverse Credit 234
  5.4.8 Tax Paid in Respect of Exempted Income 237
  5.4.9 The Types of Taxes that are Creditable 241
  5.4.10 Exchange Rate 244
  5.4.11 When Are the Taxes Creditable 245
  5.4.12 The Meaning of “Tax Paid” 249
  5.4.13 The Foreign Tax Credit Limitation 251
    5.4.13.1 Introduction 251
    5.4.13.2 Different Forms of Limitation 253
    5.4.13.3 Income Exempted under a DTT 263
    5.4.13.4 Income Exempted under Internal Law 266
    5.4.13.5 Losses 270
    5.4.13.6 Carry Forward and Carry Back of Excess Credits 272

5.5 Summary 274
6 Evaluation in Selected Situations of the Methods Recommended by the OECD 286
   6.1 Introduction 286
   6.2 Income Taxed at Progressive Rates 286
      6.2.1 Introduction 286
      6.2.2 Examples 287
      6.2.3 Evaluation 287
   6.3 The Effect of Income Derived From a Third State 292
      6.3.1 Introduction 292
      6.3.2 Example 293
      6.3.3 Evaluation 293
   6.4 Timing Mismatch 296
      6.4.1 Introduction 296
      6.4.2 Examples 296
      6.4.3 Evaluation 297
   6.5 Differing Attribution of Income and Allocation of Expense to R or N 299
      6.5.1 Introduction 299
      6.5.2 Example 300
      6.5.3 Evaluation 300
   6.6 Losses 307
      6.6.1 Introduction 307
      6.6.2 Examples 307
      6.6.3 Evaluation 307
   6.7 Summary 311

7 Conclusions 313
   7.1 Conclusions Relating to the First Aim of the Study 313
   7.2 Conclusions Relating to the Second Aim of the Study 327

Appendix – The Double Tax Relief Article of Swedish DTTs 331

List of References 354
   Official Documents 354
      European Union 354
      OECD 354
List of Abbreviations

AvrL  Lag (1986:468) om avräkning av utländsk skatt
       (Eng. Swedish Foreign Tax Credit Act)
BIFD  Bulletin for International Fiscal Documentation
BTR   British Tax Review
CFA   Committee on Fiscal Affairs
CFC   Controlled Foreign Company
Ds    Departementsserien (Eng. Ministry Communication)
DTT   Double tax treaty
EC    European Community
ECJ   European Court of Justice
ET    European Taxation
EU    European Union
FT    Förvaltningsrättslig tidsskrift
HFD   Högsta förvaltningsdomstolen, formerly named Regeringsrätten (Eng. Swedish Supreme Administrative Court)
IBFD  International Bureau of Fiscal Documentation
IFA   International Fiscal Association
LSK   Lagen (2001:1227) om självdeklarationer och kontrolluppgifter (Eng. Swedish Tax Returns and Statements of Income Act)
N     The state of non-residence, i.e. the contracting state of which the taxpayer is not a resident under the DTT
OECD Model  OECD Model Tax Convention on Income and on Capital, OECD, 22 July 2010
PE    Permanent establishment
<table>
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<tr>
<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>Prop.</td>
<td>Proposition (Eng. Swedish Government Bill)</td>
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<tr>
<td>R</td>
<td>The state of residence, i.e. the contracting state of which the taxpayer is a resident under the DTT</td>
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<td>Rskr.</td>
<td>Riksdagsskrivelse (Eng. Swedish Parliamentary Communication)</td>
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<td>RF</td>
<td>Regeringsformen (1974:152) (Eng. Instrument of Government, which is a part of the Swedish Constitution)</td>
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<td>RÅ</td>
<td>Regeringsrättens Årsbok (Eng. Swedish Supreme Administrative Court Annual Report)</td>
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<tr>
<td>SFS</td>
<td>Svensk författningssamling (Eng. Swedish Code of Statutes)</td>
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<tr>
<td>SkU</td>
<td>Skatteutskottet (Eng. Parliamentary Committee on Taxation)</td>
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<tr>
<td>SN</td>
<td>SkatteNytt</td>
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<tr>
<td>SvSkT</td>
<td>Svensk Skattetidning</td>
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<tr>
<td>SÖ</td>
<td>Sveriges överenskommelser (Eng. Sweden’s Agreements)</td>
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<tr>
<td>TL</td>
<td>Taxeringslagen (1990:324) (Eng. Swedish Tax Assessment Act)</td>
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<tr>
<td>UN Model</td>
<td>United Nations Model Double Taxation Convention between developed and developing countries of 1980, taking into account amendments made as a result of the 1999 revision</td>
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<tr>
<td>US Model</td>
<td>United States Model Income Tax Convention of November 15, 2006</td>
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1 The Subject

1.1 Introduction

1.1.1 The Object of the Study in Brief
The imposition of tax by more than one state in respect of the same subject matter, so-called international double (or triple etc.) taxation, presents a significant obstacle to the cross border exchange of goods and services and movement of capital, technology, and persons. In order to eliminate, or at least mitigate, the problem posed by international double taxation, many states enter into so-called double taxation treaties (abbreviated below as “DTTs”). In the DTTs, the contracting states undertake, on a mutual basis, to eliminate international double taxation in certain situations. Elimination of double taxation under DTTs is achieved according to two main principles (or three, if limitation of the tax rate is considered as a separate principle), which in turn can be divided into a number of methods that are applied in practice. These methods for elimination of double taxation and the many issues that arise in connection with their application is the object of this study.

The study comprises a traditional legal analysis of the methods for elimination of double taxation under DTTs in the sense that a systematisation of the methods and an analysis of problems in the application of the methods are made. In addition, an evaluation of the two main methods recommended by the OECD is made on the specific basis of tax neutrality. Ultimately, the goal of the study is to gain a better understanding of how the methods for elimination of double taxation under DTTs work.

1.1.2 Elimination of Double Taxation by Concluding DTTs
International double taxation can arise where a resident of one state derives income from another state. The person in question will normally be taxed on its worldwide income in the state of residence according to that state’s internal law and, at the same time, taxation may take place in the other state according to that state’s internal law on the basis of the fact that the income is derived from an activity or property which is considered to be connected with that state. International double taxation of a taxpayer can also take place where a person is a resident of two states according to their internal laws and therefore liable to tax on the person’s worldwide income in both states. Finally, double taxation of a taxpayer can occur where a person is liable to tax in two states,
not based on residence, but on the basis that income is derived from an activity or property that both states under their internal laws consider to be connected with the respective state in a way that gives rise to tax liability.

International double taxation can also occur where one state increases the taxable income of a person due to the fact that it considers the person to have entered into an agreement with a person in another state on other than normal open market commercial terms, without a corresponding decrease of the taxable income of that other person being made in that other state.

International double taxation is generally regarded as having a detrimental effect on the cross border exchange of goods and services and movement of capital, technology, and persons. *Inter alia* for the purpose of eliminating international double taxation, most industrialised countries, and also many developing countries, have concluded DTTs with other states with which they have substantial economic relations. DTTs are treaties under international law whereby the contracting states, among other things, agree to limit their respective powers to tax. By concluding such treaties, the obstacles of international double taxation and its harmful effects on international trade and investment can often be removed or alleviated. Sweden depends heavily on international trade and has concluded a high number of DTTs.

### 1.1.3 Basic Structure of DTTs

International organisations, in particular the OECD, have played a significant role in the development of a standard format for DTTs. To a large extent, most bilateral tax treaties follow both the structure and the detailed provisions of the OECD Model Tax Convention on Income and on Capital (the “OECD Model”). Indisputably, the OECD Model has exerted a considerable influence on the bilateral treaties between both OECD member countries and non-member countries and has been a driving factor to increase uniformity in DTTs entered into by states all over the world.

Usually, the first articles of a DTT describe the scope of the treaty with regard to persons and taxes covered by the treaty.¹ Furthermore, DTTs generally include definitions of some of the terms that are used in the treaty.²

In a DTT, the contracting states agree that the taxation rights of one or both of, on the one hand, *the state of residence*, and, on the other hand, *the other state*, shall be restricted in respect of certain categories of income, the state of residence being the state with which the taxpayer has the closer con-

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¹ Cf. Arts. 1–2 of the OECD Model.
² Cf. Arts. 3–5 of the OECD Model.
nection.\textsuperscript{3} Thus, one of the first steps in the application of a DTT is to determine which of the contracting states constitutes the state of residence of the taxpayer claiming benefits under the treaty. If a person is liable to tax under the internal law of one of the contracting states by reason of residence or of certain other criteria, such person will be regarded as a resident of that state under the DTT. If the taxpayer is liable to tax according to such criteria in both states, the conflict of residence is normally solved on the basis of the taxpayer’s personal attachment to each state (as regards individuals) or the place of effective management (as regards legal entities). In this study, the state of residence under the DTT is referred to as “R”, while the other state, the state of non-residence, is referred to as “N”.\textsuperscript{4}

The main part of a DTT is made up of the articles on taxation of different classes of income,\textsuperscript{5} often referred to as the “distributive rules”, and the article on the methods for elimination of double taxation,\textsuperscript{6} hereinafter referred to as the “double tax relief article”. Occasionally, there is also a distributive rule on taxation of capital.\textsuperscript{7}

Depending on the nature of the income and in some cases also on the source of the income, the item of income in question is categorised as one of the classes of income dealt with by the distributive rules. As regards some classes of income, the relevant provisions of the distributive rules state that the income in question “shall be taxable only” in one of the contracting states, i.e. taxed exclusively by that state. Thus, according to the distributive rules, the other state is precluded from taxing the income in question and is under an obligation to exempt it from taxation regardless of its internal tax laws. For other classes of income, the relevant provisions of the distributive rules state that the income in question “may be taxed” in the contracting state of which the taxpayer is not a resident (sometimes subject to a tax rate limitation). In these cases, the taxing right of either state in respect of the income in question is not exclusive according to the distributive rules. To the extent that double taxation is not eliminated under the distributive rules, i.e. in a situation where the taxing right is not allocated exclusively to one of the contracting states, elimination of double taxation may take place under the double tax relief article in accordance with the principle of exemption or the principle of credit.

\textsuperscript{3} In the OECD Model, the term “resident of a contracting state” is defined in Art. 4.
\textsuperscript{4} For further comments on terminology, see sub-ch. 1.6.
\textsuperscript{5} Cf. Arts. 6–21 of the OECD Model.
\textsuperscript{6} Cf. Art. 23 of the OECD Model.
\textsuperscript{7} Cf. Art. 22 of the OECD Model.
Furthermore, DTTs usually contain special provisions on *inter alia* non-discrimination, mutual agreement procedure\(^8\), exchange of information, assistance in the collection of taxes, entry into force, and termination.\(^9\)

### 1.1.4 The Methods for Elimination of Double Taxation

The techniques for relieving double taxation, either under the distributive rules or under the double tax relief article, can be said to fall under two main principles. Under the principle of exemption, one of the contracting states refrains from taxing the item of income in question. Under the principle of credit, one of the states allows the taxpayer to credit tax paid in the other state against the tax which is payable in the first-mentioned state. In almost all cases, that credit is limited to the amount of tax in the state that provides double tax relief which is attributable to the income that may be taxed in the other state. The principles of exemption and credit can be broken down into a number of different methods which are used to eliminate or reduce double taxation. In virtually all DTTs currently in force, both the principle of exemption and the principle of credit are used, but the emphasis may vary considerably. There is no requirement for the contracting states to adopt the same method or even the same principle on the same class of income.

In addition to these principles, double taxation of certain payments may be relieved, but not eliminated, by means of DTT provisions that set a ceiling on the tax rate applied in the state out of which the payment is made, for instance where an interest payment is made by a debtor in one contracting state to a lender in the other contracting state.\(^10\)

Furthermore, where the tax authorities of one contracting state have made an adjustment of the taxable income of an enterprise in that state on the basis that transactions have been entered into with an associated enterprise in the other contracting state on other than arm’s length terms, there may be an obligation for the other contracting state to eliminate double taxation by making an appropriate adjustment of the tax charged on the profits of the associated enterprise, often referred to as a “corresponding adjustment”.\(^11\)

However, that obligation applies only insofar as the other state considers the adjustment by the first-mentioned state to correctly reflect what the taxable income would have been if the transactions had been at arm’s length.

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\(^8\) i.e. on a procedure for reaching an agreement between the contracting states in cases where a taxpayer is subjected to taxation not in accordance with the DTT.

\(^9\) Cf. Arts. 24–31 of the OECD Model.

\(^10\) Cf. Arts. 10 and 11 of the OECD Model.

\(^11\) Cf. Art. 9 of the OECD Model.
1.2 Aims of the Study

1.2.1 The First Aim of the Study

The object of this study is the methods for elimination of double taxation under DTTs which are found in the so-called distributive rules (with the exception of the provision on corresponding adjustment) and in the double tax relief article. Typically, it is the state of residence that applies the methods and provides double tax relief, but in some cases it is the other contracting state which is obliged under the DTT to eliminate double taxation. Consequently, the study comprises methods for elimination of double taxation under DTTs applied by both the state of residence and the other contracting state.

The first aim of the study is to systematise and analyse the methods for elimination of double taxation under DTTs in order to gain a better understanding of how they work. The first step will therefore be to group the variations on the principles of exemption and credit commonly found in DTTs into different methods on the basis of differences and similarities in the technique used for achieving double tax relief. The systematisation is intended to give a structured overview of the methods that are applied and how they relate to each other. The second step is to identify and examine the issues that are inherent in the various forms of methods, i.e. the questions and problems that will typically have to be faced by tax authorities, courts, and taxpayers in connection with their application. Since DTT provisions are applied by tax authorities, courts, and taxpayers in a domestic law context, i.e. within the framework of the legal system of a particular state, the analysis will focus on the application of the methods for elimination of double taxation under DTTs in Sweden.

The research questions can thus be formulated as follows.

1. What methods for elimination of double taxation are commonly found in DTTs and how can they be systematised on the basis of differences and similarities in the technique used for achieving double tax relief?
2. What issues will typically have to be dealt with by tax authorities, courts, and taxpayers in connection with the application of the methods for elimination of double taxation?
3. How are the issues that have been identified under the second question dealt with in a Swedish context?
1.2.2 The Second Aim of the Study

The second aim of the study is to evaluate in a few selected situations the two main methods for elimination of double taxation recommended by the OECD, namely exemption with progression and ordinary credit. The situations that serve as a basis for the evaluation have not been selected at random. Rather, the situations have been chosen because they illustrate the complexity in the outcome of the methods in concrete situations.

Methods for elimination of double taxation can be evaluated on the basis of how they affect general goals of the contracting states’ income tax systems such as an equitable distribution of the tax burden, low administration and compliance costs, and a minimal excess burden (i.e. a low level of distortions in the marketplace caused by the tax). Since DTTs operate in an international context it would also be possible to evaluate the methods by other standards, such as to what extent they promote an equitable distribution of tax revenue between the contracting states.

In this study, however, evaluation of the methods will only take place on the basis of whether tax neutrality is achieved. Tax neutrality is not an unambiguous term, in particular not when it relates to taxation in a cross border situation in which two states are entitled to exercise taxing rights under their internal laws, since the two states may determine the tax base differently and are likely to apply different tax rates. For the purpose of this study, tax neutrality is deemed to be achieved when the effective taxation of income relating to a cross border transaction corresponds to the tax that would have been levied in either the state of residence or in the other contracting state, had the cross border element not been present. These forms of tax neutrality are usually referred to as “capital export neutrality” (“CEN”) and “capital import neutrality” (“CiN”) respectively. Furthermore, for the purpose of this study, tax neutrality is deemed to be achieved if the effective taxation of income relating to a cross border transaction is somewhere in between CEN and CiN. If income relating to a transaction is taxed more heavily than if it had been taxed in the contracting state with the highest tax or if it is taxed more lightly than...
in the contracting state applying the lowest tax, then tax neutrality, as defined above, is not achieved. In my view, this is a more sophisticated approach than to look merely at whether international juridical double taxation is eliminated. For instance, in a situation where the R tax exceeds the N tax, the application of the principle of credit by R results in a reduction but not an elimination of the tax payable in R, which means that tax is payable in both states. An evaluation made on the basis of the existence of international juridical double taxation, as defined for instance by the OECD Model, would conclude that the double tax relief is insufficient since international juridical double taxation is not eliminated, despite the fact that the effective taxation is brought down to a level which is equal to the tax burden that would have applied if the item of income in question had been taxed in R only. Thus, for the purpose of this study, the scope provided by CEN and CiN serve as a “bottom line” for measuring the success of the DTT methods for elimination of double taxation.

Successful application of the methods in this sense is not necessarily the same as taxation which is in accordance with the object and purpose of DTTs in general or of any particular DTT (and there are different views as to what that object and purpose may be). For instance, unresolved double taxation or double non-taxation may in a particular case be a consequence of a deliberate choice with regard to the design of a DTT and therefore not in conflict with the object and purpose of that DTT, regardless of the fact that neutral taxation is not achieved. However, taxation which is within the range of CiN and CEN can be assumed to result in less obstacles to international trade and investment than taxation which exceeds that range and less distortions in the market place than taxation which falls below that range. Thus, the evaluation standard relates to taxation at a level which can be regarded as beneficial to the economy on a general level.

International double taxation was considered to be at hand if “the same person or the same object (income, wealth, etc.) due to taxing rights exercised by different states is subject to higher aggregate taxation than if the person or object under otherwise similar conditions would have been subject to tax in only one of the states [author’s translation]”, see Sandström, Svenska dubbelskattningavtal i vad de avse skatt å inkomst eller förmögenhet (1949), p. 27. The OECD Model, Introduction, para. 1.

16 Cf. Shaviro, ‘Rethinking Foreign Tax Creditability’ in Lang and others (eds.), Tax Treaties: Building Bridges between Law and Economics (2010), p. 374, who points out that the issue is one of relative tax rates, not of how many times a tax is levied.

The evaluation standard can be illustrated graphically as follows.

<table>
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<th>non-neutral taxation</th>
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<tr>
<td>unsuccessful application of the DTT method for elimination of double taxation</td>
<td>CEN successful application of the DTT method for elimination of double taxation</td>
<td>CIN unsuccessful application of the DTT method for elimination of double taxation</td>
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</tbody>
</table>

Since tax neutrality is defined as a situation where the effective taxation of income relating to a transaction equals the tax that would have been levied in either the state of residence or in the other contracting state, had the cross border element not been present, it is a matter of comparing, on the one hand, the tax imposed by the contracting states, subject to the effects of the application of the methods for elimination of double taxation, and, on the other hand, the taxation that would have occurred had there been no cross border element. It is therefore relevant to look not only at the income derived from the cross border transaction, but to look also at the consequences of the cross border element on the taxation of other income derived by the taxpayer. For instance, in order to determine whether income which is taxed at progressive rates is taxed in accordance with CEN or CIN, it is not sufficient to look solely at the taxation of the income earned as a result of the cross border activity, but it would also be relevant to look at the taxation of other income in the same category derived by the taxpayer and to compare it with the tax on that other income which would have been imposed in the absence of the cross border element. Similarly, in order to determine whether a loss in one of the contracting states prevents taxation which is in line with CEN or CIN, it would be relevant not only to look at the (non-)taxation of the loss, but to look also at the taxation of other income and in particular the possibilities of deducting the loss against other income that might have been available had there been no cross border element.

In addition to evaluating the two main methods recommended by the OECD in the selected situations, I will try to determine the relevance of the research results in a Swedish context. For instance, it may be possible to draw certain conclusions concerning the application of exemption with progression and ordinary credit where income is taxed at progressive rates. However, in a Swedish context the conclusions may only be relevant in some respects as Sweden often unilaterally refrains from taking into account exempted income
for the purpose of determining the tax on the remaining income, regardless of whether a right to take into account such income has been expressly reserved under the DTT in question.

It is important to emphasise that it is not an aim of the study to rank the two main methods, i.e. to conclude that one method is better than the other, but rather to contribute to the understanding of how the two methods work. First, this study only deals with a few types of transactions and is therefore not extensive enough to allow a conclusion to be made on whether one of the methods is in general better than the other at achieving tax neutrality. The multitude of conceivable transactions makes it difficult to determine which of the two methods is best suited for this purpose. Second, the choice of method is not dependent solely on the capacity of the methods for achieving tax neutrality, but also on many other factors such as administrability, susceptibility to tax planning and tax avoidance, allocation of tax revenue between the states concerned, etc. An extensive, multi-disciplinary study would be needed to cover all factors of relevance for evaluating the merits and disadvantages of the methods. Third, different weight may be attributed to these merits and disadvantages depending on for instance political preferences or the design of the tax system in the jurisdiction in which the methods are to be applied. Indeed, it is possible that given the number of factors involved and the difficulties of determining their relative weight, a definitive answer to the question of which method is best is unattainable.

On a more general note, this reasoning is linked to a weakness inherent in the entire discipline of law and economics, namely that efficiency considerations can be broken down into a multitude of factors and that it is very difficult to take them all into account and to weigh them against each other. As pointed out by Hanson et al there are in principle two ways to escape this dilemma. First, the scholar can do sufficient empirical research to weigh the various efficiency considerations properly. This option has rarely, if ever, been taken since the costs of such research are likely to outweigh the benefits. Instead, scholars usually offer their own views of how the countervailing efficiency considerations stack up without presenting any persuasive empirical evidence. Second, the scholar can narrow the focus of the model until something unequivocal can be said about the model’s simplified world, excluding potentially significant efficiency effects. In consequence, the narrow approach taken by this study can be criticised for leaving out potentially

significant efficiency considerations. However, it is my view that the narrow approach is justified in the current context, since it is consistent with the relatively limited objective of my study, namely to make a contribution as regards the understanding of how the two methods work and not to conclude that one method is better than the other.

1.2.3 The Relevance of the Aims of the Study
Although various aspects of the methods for elimination of double taxation have been dealt with by a number of writers, no overview of the subject as a whole has been made. Therefore, it is my belief that the systematisation of methods and review of problems in their application can help provide a clearer picture of the many techniques that are available for achieving double tax relief as well as some of their pros and cons. Further, the evaluation of the main methods from the perspective of tax neutrality can provide valuable insights into the functioning of the methods. Ultimately the goal is to gain a better understanding of how the methods work.

1.3 Delimitations

1.3.1 Unilateral Double Tax Relief
As the topic dealt with by this study is the methods for elimination of double taxation under DTTs, unilateral measures to eliminate double taxation without any underlying DTT obligations are not covered by the study. However, this does not mean that the study focuses solely on DTT provisions. Since DTTs have a character of framework legislation, internal law often plays a significant complementary role. The relation between DTTs and specific provisions in internal law aimed at fulfilling DTT obligations concerning double tax relief (which may coincide with unilateral measures that would have been applied, had there been no DTT) are therefore central to the study. In particular, the study will deal with the interaction between provisions in DTTs entered into by Sweden that impose an obligation on Sweden to provide double tax relief and provisions in Swedish law for carrying out that obligation.

1.3.2 Conflicts of Qualification and Other Issues Leading to the Application of the Methods
As a central purpose of entering into DTTs is typically the elimination of double taxation, it is possible to subsume most if not all DTT provisions under the general subject “elimination of double taxation”. Double tax relief
requires that the prerequisites of several provisions are satisfied: the taxpayer must fall within the personal scope of the DTT, the taxes levied must be covered by the DTT, and the taxpayer must be a resident of one of the contracting states for the purpose of the DTT. Furthermore, the outcome of the DTT will depend on the subsumption of an item of income under a DTT provision based on the characterisation of that item of income by the contracting states. In addition, elimination of double taxation may in some cases require the application of a non-discrimination clause or a mutual agreement procedure. However, these precursor steps and other issues leading to the application of the methods for elimination of double taxation will not be dealt with, as that would render the study fragmented and shallow. Rather, the focus will be on the methods for elimination of double taxation themselves.

A result of this delimitation is that the characterisation of an item of income for the purpose of subsuming it under a particular distributive rule and the problems connected with the application of different DTT provisions by the contracting states in respect of the same item of income due to differences in characterisation, so-called “conflicts of qualification”, will not be dealt with by this study. However, although the DTT regulation of attribution of income and allocation of expense to R or N and in some cases quantification of income can also be regarded as precursor steps to the application of the methods for elimination of double taxation, I consider that they are too closely linked to the application of the methods to be excluded. These topics are therefore dealt with to some extent (see sub-chapters 4.3.4 and 4.3.5).

1.3.3 Corresponding Adjustment
Most DTTs contain an article which states that a contracting state shall eliminate double taxation by making an appropriate adjustment of the tax charged on the profits of an enterprise where the tax authorities of the other contracting state have made an adjustment of the taxable income of an associated enterprise in that state on the basis that transactions have been entered into with the enterprise in the first-mentioned state on other than arm’s length terms. This article differs from other DTT articles in a number of ways. First, it is the only DTT article which is concerned with transfer pricing, in itself a subject that merits separate study. Second, it deals with the imposition of tax
by two states on two different taxpayers due to the adjustment of the taxable income of a taxpayer in one of these states, whereas the other distributive rules and the double tax relief article deal with the imposition of tax by two states on the same taxpayer. As a consequence, double taxation can only be eliminated under this article if the adjustment of income in one state is considered by the other state to correctly reflect what the taxable income would have been if the transactions had been at arm's length.\textsuperscript{24} Therefore, mutual agreements by the competent authorities of the contracting states play a significantly greater role in resolving such double taxation. Third, the article does not normally specify the method by which an adjustment is to be made.\textsuperscript{25} In the absence of bilateral agreements on the method for making corresponding adjustment, the method will therefore be determined solely on the basis of the internal law of the contracting state which makes such an adjustment. The same can be said of so-called secondary adjustments made in order to establish the situation exactly as it would have been if transactions had been at arm's length. As a result of these substantial differences, it is in my opinion not possible to deal in depth with this DTT article within the framework of this study. It has therefore been left out.

\subsection*{1.3.4 EU Law}

EU law has become a very important factor in the area of international tax law insofar as Member States of the European Union (and also states belonging to the European Economic Area) are concerned and is an integrated part of the internal tax laws of the Member States. As such, it is also relevant to the elimination of international double taxation. For instance, the EC Parent-Subsidiary Directive prohibits the Member State of a subsidiary from levying withholding tax on dividends distributed to a parent company in another Member State and also imposes an obligation on the Member State of the parent company to either exempt the profits distributed by the subsidiary from any taxation or impute the tax already paid in the Member State of the subsidiary against its own tax, thereby eliminating international double taxation of associated companies in the European Union in the area of profit distribution.\textsuperscript{26} Furthermore, the EC I+R Directive provides for an exclusive right to tax interest and royalty in the beneficiary’s state of residence if the

\textsuperscript{24} The OECD Model, Commentary to Art. 9, para. 6.
\textsuperscript{25} The OECD Model, Commentary to Art. 9, para. 7.
\textsuperscript{26} Arts. 4–5 of the EC Parent-Subsidiary Directive.
beneficiary is an associated company in another Member State. And above all, the case law of the ECJ on the free movement of goods, services, capital, and labour has significantly reduced the sovereignty of the Member States with regard to the exercise of taxing rights. Thus, insofar as there is case law from the ECJ affecting the methods for elimination of double taxation under DTTs, this will have to be taken into account for the purpose of this study.

However, although EU law has had a considerable impact on the internal tax laws of the Member States, it has so far not had any major impact on the DTTs entered into by the Member States. It is another matter that the above mentioned Directives and the case law of the ECJ in many situations limit the taxing right of a Member State provided under its internal law and, as a consequence, effectively reduce the need for elimination of double taxation under DTTs insofar as transactions between taxpayers in different Member States are concerned. Furthermore, the relation between DTTs and internal law and the question whether or not a contracting state fulfils its obligations under a DTT has been deemed to fall outside the scope of EU law and thus outside the competence of the ECJ.

DTTs are not dealt with by any EU legislation. Before the entry into force of the Treaty of Lisbon on 1 December 2009, DTTs were expressly mentioned in Article 293 of the EU Treaty, which required Member States, so far as was necessary, to enter into negotiations with each other with a view to securing for the benefit of their nationals the abolition of double taxation within the Community. However, the ECJ ruled in its judgement C-336/96 Gilly that Article 293 did not have direct effect. Furthermore, the ECJ has ruled that the four freedoms of the EU Treaty do not in themselves impose an obligation on the Member States to eliminate double taxation. The disadvantages which could arise from the parallel exercise of tax competences by different Member States do not in themselves constitute restrictions prohibited by the EU Treaty. In the absence of any unifying or harmonising Community measures, Member States retain the power to define, by treaty or unilaterally,

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27 Art. 1 of the EC I+R Directive.
28 See for instance C-298/05 Columbus Container Services, paras. 46–47, and C-128/08 Jacques Danseux, paras. 20–22.
29 Potentially, the repeal of Art. 293 of the former EU Treaty may widen the ECJ’s competence to decide on the compatibility of international double taxation with the EU Treaty, cf. Monsenego, Taxation of Foreign Business Income within the European Internal Market (2011), pp. 353–357, with further references.
30 C-336/96 Gilly, paras. 15–17.
the criteria for allocating their powers of taxation, particularly with a view to eliminating double taxation.\textsuperscript{31}

On the other hand, when DTT\textsc{\textsuperscript{s}} are entered into, it is clear that the provisions of the DTT, just as any other domestic legislation, must not be contrary to EU law and that the primacy of EU law, in particular the four freedoms set out in the EU Treaty, is relevant for DTT\textsc{\textsuperscript{s}} just as it is for other domestic laws of the Member States.\textsuperscript{32} There may be situations where the provisions of a DTT must be interpreted in the light of EU law or even disregarded in order not to contradict EU law.\textsuperscript{33}

Even so, the ECJ seems to have been reluctant to challenge DTT provisions.\textsuperscript{34} First, this may be due to the fact that discriminatory taxation does not normally follow from the DTT provisions themselves as these provisions limit the taxing rights granted under internal law. For the ECJ, it is therefore often more relevant to scrutinise and possibly dismiss the internal laws of the Member States setting out such taxing rights. Second, the ECJ’s reluctance to challenge DTT provisions is probably connected with the fact that DTT\textsc{\textsuperscript{s}} are the result of bilateral negotiations and that the provisions of each DTT depend on the internal tax laws, economic policies, and negotiating powers of the contracting states. Thus, the ECJ may be unwilling to alter the balance achieved through such negotiations.\textsuperscript{35}

\subsection*{1.3.5 Wealth Tax and Inheritance Tax}

Double taxation of capital (i.e. wealth tax) is covered by many DTT\textsc{\textsuperscript{s}}. However, taxation of capital is excluded from the study, as the significance of it is decreasing due to the declining number of states that levy tax on capital.

\begin{flushright}
\footnotesize
\begin{enumerate}
\item See for example C-128/08 \textit{Jacques Dameaux}, paras. 27–30 and 35.
\item It is another matter that the effects of a DTT are taken into account for the purpose of determining whether internal legislation infringes the freedoms set out in the EU Treaty, as was done in C-170/05 \textit{Denkavit}, para. 45, C-524/04 \textit{Thin Cap Group Litigation}, para. 54, and C-379/05 \textit{Amurta}, para. 80, see Hilling, ‘Skatteavtalen i EG-domstolens praxis: Skatteavtalens inverkan vid prövning av interna reglers förenlighet med den fria rörligheten’, \textit{SvSkT}, 2008, No. 9, pp. 608–625.
\item C-385/00 \textit{de Groot} provides an example of such a situation; see in particular paras. 94–98.
\item See for example C-336/96 \textit{Gilly}, in particular paras. 30–35 and, as regards the methods for elimination of double taxation under the DTT in question, paras. 40–54. See also Hilling, ‘Skatteavtalen i EG-domstolens praxis: Skatteavtalens förenlighet med EG-fördragets regler om fri rörlighet’, \textit{SvSkT}, 2008, No. 10, p. 734.
\item Cf. for instance the court’s reasoning in C-374/04 \textit{ACT Group Litigation}, paras. 87–91. See also Stähl and others, \textit{EU-skatterätt} (2011), p. 170.
\end{enumerate}
\end{flushright}
Special DTTs are concluded for dealing with double taxation of inheritance and gifts. Although there are many similarities with DTTs on income and capital, significant differences also exist. Elimination of double taxation under such DTTs is therefore also excluded from the study.

1.3.6 Procedural Rules

DTTs do not generally concern themselves with procedural issues, for instance time limits and required actions for claiming treaty benefits. Instead, procedural rules are normally found in the internal laws of the contracting states. Thus, strictly speaking they are not a part of the methods found in DTTs for elimination of double taxation, although they may of course be of fundamental importance in a concrete situation. As a consequence, procedural issues are not the focus of this study, although they are touched upon when relevant.

1.4 Method and Material

1.4.1 Method and Material Relating to the First Aim of the Study

As stated above, the first aim of the study is to systematise and analyse the methods for elimination of double taxation under DTTs in order to gain a better understanding of how the methods work. The systematisation will be made by means of grouping the variations on the principles of exemption and credit into different methods on the basis of similarities and differences in the technique that is applied to achieve double tax relief. For this purpose, I will draw on classifications made by other authors and, where helpful, add new categories. Furthermore, in order to get an overview of Swedish DTT policy in respect of the methods for elimination of double taxation, a survey will be made of the double tax relief article of all DTTs on income taxation entered into by Sweden, excluding such DTTs as are limited to only certain categories of income. This will enable me to relate the methods identified during the systematisation process to the choices made by Sweden in respect of the methods for elimination of double taxation under DTTs. It will also provide some concrete examples for the analysis of the methods. Thus, as regards this part of the study, the material consists of legal literature and Swedish DTTs, except such DTTs as are limited to certain categories of income.

The analysis of the methods will focus on issues that are typically faced by tax authorities, courts, and taxpayers in connection with the application of the methods. Thus, the first step of the analysis is to identify these issues. This will be made by studying legal literature dealing with DTTs. As the Swedish
literature in this regard is sparse, I will draw mainly upon legal literature by non-Swedish writers. Problems in the application of the methods may also be identified on the basis of court cases dealing with the application of the methods for elimination of double taxation under DTTs. Thus, for the purpose of identifying issues that arise in connection with the application of the methods, a review of all HFD cases dealing with DTT application will be made. Although foreign court cases may also be of aid in identifying issues that arise in connection with the application of the methods, it would not be feasible to make a similar review of foreign court cases. Therefore, foreign court cases will be used for this purpose only where they are referred to in the foreign legal literature. As regards the identification of issues that arise in connection with the application of the methods, the material applied for the study is thus Swedish and foreign legal literature on application of DTTs and Swedish HFD cases.

As regards the first aim of the study, it can be noted that legal literature and case law is not used solely as a traditional source of law, i.e. for the purpose of carrying out a legal analysis, but also to systematise the methods by grouping the variations on the principles of exemption and credit into different methods and to identify issues in connection with the application of the methods which are then subject to a legal analysis.

The substantive analysis of issues that arise in connection with the application of the methods for elimination of double taxation under DTTs can be referred to as a traditional legal analysis and utilises sources of law that are generally applied in respect of DTTs: the DTTs themselves (including protocols), the Commentaries to the Articles of the OECD Model, the VCLT, internal law relevant to the application of DTTs (including preparatory works), case law (mainly cases from HFD), and legal literature. The analysis will first be made from a general perspective, i.e. without the legal system of any particular state in mind, and then from a specific Swedish perspective. The analysis will typically be presented in that order.

Although the focus of this study is on DTTs and not on the internal laws of the contracting states, the effects of a DTT often cannot be understood without studying how DTTs are given effect in domestic law and how DTT provisions and internal law interact. The issues that have been identified will therefore be exemplified by (and sometimes contrasted with) Swedish DTT

36 As regards the use of court cases and other sources for the purpose of identifying problem areas, see Lavin, ‘Är den förvaltningsrättsliga forskningen rättstogmatisk?’, FT, 1989, No. 3, pp. 120–122.
provisions and Swedish legislation which gives DTTs effect in domestic law and the analysis of the interaction between Swedish DTT provisions and Swedish internal law will constitute an integral part of the study. Consequently, Swedish internal law and Swedish court cases are relevant as material for the study.

The investigation that relates to the first aim of the study is rule-oriented in the sense that it seeks to systematise and analyse methods for elimination of double taxation set out in DTT provisions and, to some extent, to analyse provisions in Swedish internal law. However, it is the subject, methods for elimination of double taxation under DTTs, which governs the selection of the provisions and not the other way around. Thus, the rules are not the starting point. Rather, the selection of relevant provisions in itself constitutes an important part of the study.

In most states, DTTs are applied by courts, tax authorities, and taxpayers in their capacity as domestic law. However, as DTTs are also state-to-state agreements under international law, there are other sources of law available than is typically the case concerning the application of domestic law. To what extent it is appropriate to refer to these additional sources of law and how they shall be weighed against each other, and against sources that are applied for the purpose of interpreting domestic law in general, is far from clear and is the subject of a continuously on-going debate in the legal literature. Furthermore, the fact that DTTs are agreements under international law brings up questions concerning (i) the relation between international law and domestic law, (ii) the incorporation of DTTs into domestic law, and (iii) how to deal with conflicts between DTTs and internal law. In order to clarify my own position in this regard, and provide a solid foundation for the legal analysis in chapters 4 and 5, these issues are given substantial attention in the study and are dealt with in a separate chapter, namely chapter 3.

The analysis relating to the first aim of the study takes into account legislative changes up until 1 January 2012.

37 Cf. Westberg, ‘Avhandlingsskrivande och val av forskningsansats – en idé om rättsvetenskaplig öppenhett’ in Heuman, Festskrift till Per-Olof Bolding (1992), pp. 421–446, who distinguishes between, on the one hand, rule-oriented studies and, on the other hand, problem- and interest-oriented studies.
1.4.2 Method and Material Relating to the Second Aim of the Study

The second aim of the study is to evaluate the main methods recommended by the OECD Model, i.e. exemption with progression and ordinary credit, in a few selected situations on the basis of how well tax neutrality is achieved.

For the purpose of the evaluation, a definition of "successful" accomplishment of tax neutrality is made (see sub-chapter 1.2.2). As the definition builds upon the concept of tax neutrality in an international tax law context, comprising the concepts of capital export neutrality and capital import neutrality, these concepts are discussed in a separate chapter as background to the evaluation. The concepts of capital import neutrality and capital export neutrality are also of relevance for the systematisation and analysis relating to the first aim of the study.

DTTs are mainly aimed at eliminating what is usually referred to as “international juridical double taxation” which according to the OECD Model can be defined as “the imposition of comparable taxes in two (or more) States on the same taxpayer in respect of the same subject matter and for identical periods”.38 However, the existence of “international juridical double taxation” in accordance with the above or any other definition is not used as a prerequisite for the application of a DTT. Therefore, it is not possible to conclude that double taxation which can be subsumed under such a definition can be solved by means of applying a DTT or that double taxation falling outside the definition is in no case covered by the provisions of a DTT. The definition of international juridical double taxation is included in the OECD Model merely as a starting point. Furthermore, “international juridical double taxation” is not used as a prerequisite in any Swedish internal legislation and does not have any direct implications for the application of Swedish internal law.39 Thus, for the purpose of this study, which focuses on elimination of double taxation under DTTs and not on elimination of double taxation in general,


\[39\] In other words, the definition is not used in a constructive sense (i.e. as a general prerequisite for the applicability of DTTs). Rather, the scope of a DTT will have to be determined on a case by case basis with reference to the provisions of the DTT, see Flick, ‘Das Erfordernis der Subjektidentität bei Doppelbesteuerungsnormen’, Steuer und Wirtschaft, 1960, pp. 332–333, and Mössner, ‘Grundfragen des Doppelbesteuerungsrechts: Die Methoden zur Vermeidung der Doppelsteuerung – Vorzüge, Nachteile, aktuelle Probleme’ in Vogel (ed.), Grundfragen des Internationalen Steuerrechts (1985), p. 137.
there is in my opinion no point in attempting to define “international juridical double taxation” or to evaluate the definition of the OECD Model.

Five situations have been selected for the evaluation of the methods. The idea has been to choose situations which may illustrate the complexity of the outcome of the methods. Furthermore, in order to deal with the many variables that are present and to increase readability, the evaluation in each situation is made with reference to concrete examples where certain variables have been assumed.

The material relating to this aim of the study is primarily the provisions of the OECD Model that set out the two methods which are evaluated. Furthermore, some parts of the result of the analysis relating to the first aim of the study are applied for determining the outcome of the methods in the selected situations. To some extent, the material of the first aim of the study is therefore, indirectly, also relevant as material for the second aim of the study.

1.5 Previous Research

In an international perspective, there is a considerable amount of literature on DTTs. A standard work in the field is Klaus Vogel’s commentary on the model treaties of the OECD, the UN, and the USA.40 This is an important source of guidance for both tax practitioners and academics. Another reference source worth mentioning is Philip Baker’s manual on the OECD Model.41

In recent years, the International Bureau of Fiscal Documentation has published several monographs dealing with various aspects of DTTs, for instance the relation between DTTs and internal law and the relevance of the OECD Model in connection with interpretation of DTTs.42 Several topics relating to DTTs have also been covered by the Cahiers de droit fiscal international of the International Fiscal Association (“IFA”), which each year consist of a general report and a number of country reports on a subject chosen for the IFA’s annual congress. In addition, there are a number of text books that give

41 Baker, Double Taxation Conventions (2005).

The literature dealing specifically with the methods for elimination of double taxation under DTTs is much more limited. Earlier research on the methods includes Alfred Philipp's \textit{Befreiungssystem mit Progressionsvorbehalt und Anrechnungsverfahren}.\footnote{Philipp, \textit{Befreiungssystem mit Progressionsvorbehalt und Anrechnungsverfahren} (1971).} In recent years, the topic has been dealt with by a number of German-speaking authors who have contributed to a research project presented at a seminar in Vienna in 1995. Their findings have been published in a volume entitled \textit{Die Methoden zur Vermeidung der Doppelbesteuerung}\footnote{Gassner, Lang & Lechner (eds.), \textit{Die Methoden zur Vermeidung der Doppelbesteuerung} (1995).}. To my knowledge, this is the most ambitious and comprehensive project to date aimed at studying the methods for elimination of double taxation.

A number of scientific studies on various topics relating to international tax law have been published by Michael Lang within the framework of \textit{Schriftenreihe zum Internationalen Steuerrecht}. In volume 8 of this series, the findings made and the discussion that took place at a symposium on international tax law held in Munich in 1995, focusing on the principle of exemption, have been summarised.\footnote{Vogel (ed.), \textit{Freistellung im internationalen Steuerrecht} (1996).} Several issues relating to the methods for elimination of double taxation under DTTs have also been dealt with in volume 24 of this series. Volume 24 is a compilation of essays written as a part of the Post Graduate Program at the Vienna University of Economics and Business Administration in 2001/2002, which in that year focused on the principles of exemption and credit.\footnote{Sutter & Wimpissinger (eds.), \textit{Freistellungs- und Anrechnungsmethode in den Doppelbesteuerungsabkommen} (2002).}

All three of these compilations on the methods for providing double tax relief are written primarily from an Austrian and German perspective, but of course the conclusions can often be applied to other legal systems as well. There are also studies made from the legal perspective of other states, for instance Elisabeth A. Owens’s study of the unilateral foreign tax credit under...
United States tax law.\textsuperscript{48} Although it was written over fifty years ago and does not concern itself with elimination of double taxation under DTTs, it still provides valuable insights into the functioning of the principle of credit. The methods for elimination of double taxation have, from a US perspective, also been dealt with in a study by the “Task Force on International Tax Reform”, which was convened by the American Bar Association’s Section of Taxation “to provide policymakers with objective criteria by which to evaluate reform proposals and to identify and analyse possible specific modifications to the US international tax rules”.\textsuperscript{49}

Although not focusing on DTTs, some aspects of the methods for elimination of double taxation have been dealt with in the IFA report to the 2011 congress in Paris, consisting of a number of national reports and a general report on key practical issues to eliminate double taxation of business income.\textsuperscript{50} Furthermore, Timo Viherkenttä has made an in-depth study of the impact of tax incentives on the tax burden of a foreign investor. For this purpose, the author deals with the DTT methods for elimination of double taxation and in particular such methods as are designed to accommodate the double tax relief article to the offering of tax incentives by a contracting state.\textsuperscript{51} There are also several articles written on particular aspects of the subject.\textsuperscript{52}

In Sweden, several dissertations and monographs have been written within the field of international tax law. Tax treaty interpretation and other topics relating to DTTs have been dealt with within the framework of these studies. As far back as 1949, K.G.A. Sandström made a study of the DTTs entered into by Sweden.\textsuperscript{53} In his dissertation \textit{Skatter och Kapitalflykt},\textsuperscript{54} Gustaf Lindencrona examined the impact of taxation on the movement of capital and persons. In this context, Lindencrona touched upon issues such as the relation between DTTs and internal law, the interpretation of terms that have not been defined

\textsuperscript{48} Owens, \textit{The Foreign Tax Credit} (1961).
\textsuperscript{50} Blanluet & Durand (general reporters), \textit{Key Practical Issues to Eliminate Double Taxation of Business Income} (2011).
\textsuperscript{51} Viherkenttä, \textit{Tax Incentives in Developing Countries and International Taxation} (1991).
\textsuperscript{53} Sandström, \textit{Svenska dubbelbeskattningsavtal i vad de avse skatt å inkomst eller förmögenhet} (1949).
\textsuperscript{54} Lindencrona, \textit{Skatter och kapitalflykt} (1972).
in the DTT, and certain aspects of the use of the so-called mutual agreement procedure, a special procedure under DTTs for resolving double taxation. The concepts of capital import neutrality (“CIN”) and capital export neutrality (“CEN”), which are central to this study, their relation to the goals underlying the internal market of the EC, and inter alia the question whether CIN or CEN is achieved through application of certain Swedish DTTs was the subject of Kristina Ståhl’s doctoral thesis, Aktiebeskattning och fria kapitalrörelser. In his doctoral thesis Svensk skatteavtalspolitik och utländska basbolag, Mattias Dahlberg made a study of Swedish tax treaty policy in relation to off-shore companies. Dahlberg analysed anti-avoidance provisions in the Swedish tax treaty network and in Swedish internal law aimed at preventing the use of companies in low tax jurisdictions for tax planning purposes. Dahlberg’s dissertation also includes a section on interpretation of DTTs from a Swedish point of view. Another example is Maria Hilling’s dissertation Free Movement and Tax Treaties in the Internal Market, which dealt with the impact of Community law on DTTs. This study includes an overview of the functioning of tax treaties and a brief description of DTT provisions for the elimination of double taxation. Double taxation of income derived through partnerships in so-called asymmetrical situations, i.e. where one state regards the entity as transparent for tax purposes whereas the other state regards the entity as a corporate body, was the subject of Jesper Barenfeld’s dissertation Taxation of Cross-Border Partnerships. Barenfeld studied the applicability of the OECD Model in asymmetrical situations and the Swedish approach to double tax relief in such cases. More recent additions are Maria Nelson’s study Utflyttnings av aktiebolag, which analyses migration of limited liability companies in relation to EU law, internal law, and DTT provisions, Katia Cejc’s dissertation on taxation of capital gains in connection with emigration from Sweden, Utflyttningsbeskattning och kapitalökningar, and Jérôme Monsenego’s dissertation Taxation of Foreign Business Income within the European Internal Market, which deals with the conflict between the objective of achieving a European

56 Dahlberg, Svensk skatteavtalspolitik och utländska basbolag (2000).
59 Nelson, Utflyttnings av aktiebolag (2010).
60 Cejc, Utflyttningsbeskattning och kapitalökningar (2010).
61 Monsenego, Taxation of Foreign Business Income within the European Internal Market (2011).
internal market and the overlapping taxation imposed under the national legislation of the Member States.

However, the methods for elimination of double taxation under DTTs have not been the subject of any in-depth Swedish study, although the subject has been addressed in a few articles.\footnote{For example Lindencrona, ‘Juridik och Matematik – nyare praxis på den svenska avräkningslagen’, SN, 2007, No. 1-2, pp. 2–12, and Mutén, ‘Credit-metod eller exempt-metod i dubbelbeskattningsavtal – en principfråga?’, SvSkT, 1993, pp. 302–312.} Considering its relevance, I think it is fair to say that not that much has been written, particularly not from a Swedish point of view.

1.6 Terminology

The first part of the title of this study is “Methods for Elimination of Double Taxation”. In practice, the application of the methods does not always lead to a complete elimination of double taxation, but rather to a reduction of double taxation. Strictly speaking, the methods applied should thus be referred to as the “methods for elimination or reduction of double taxation”. For the sake of readability, the term elimination is used, in the title and elsewhere, to indicate both elimination (in full) and reduction (i.e. elimination in part) of double taxation.

The titles given to DTTs vary and include such terms as treaty, agreement, and convention. This study adopts the standard term “double tax treaty”. This term is abbreviated as “DTT”.

In this study, as is the case in the OECD Model, the state in which the taxpayer is resident for the purpose of applying the DTT is referred to as the “state of residence”, abbreviated to “R”. The other contracting state is referred to as the “state of non-residence”, abbreviated to “N”. In the legal literature, the other contracting state is often referred to as the “source state”, abbreviated to “S”, as tax liability in that state typically arises on the basis of the income having its source in that state. However, tax liability in the other contracting state may also arise where a taxpayer is a resident of that other state under its internal law, regardless of the source of the income. Insofar as the income is sourced outside the other contracting state it would in such a situation be incorrect to refer to the other contracting state as “S”. Furthermore, tax liability may be due to the existence of a PE in the other contracting state, regardless of the source of the income which is attributable to the PE. Where the income which is attributable to the PE is sourced in a third state, the abbreviation “E”
is sometimes used to denote the state in which the PE is situated and it would be incorrect to refer to that state as “S”. For the sake of simplicity, I have chosen to refer to the contracting state in which the taxpayer is not a resident for the purpose of the DTT as “N”.

The term “municipal law” is an international law term used to denote the national, domestic, or internal law of a sovereign state as opposed to international law. Municipal law includes not only law at the national level, but law at the state, provincial, territorial, regional or local levels. In many countries, international law and municipal law are regarded as separate legal orders. In these countries, treaties may be incorporated into municipal law by means of specific municipal legislation. Thus, DTTs may constitute state-to-state-agreements as well as municipal law. Where DTTs constitute municipal law, there is a need to distinguish between, on the one hand, municipal law that includes DTTs in their capacity as municipal law and, on the other hand, other municipal law. For the purpose of this study, the term “domestic law” is therefore used to denote all kinds of municipal law, including DTTs in their capacity as domestic law, and the term “internal law” denotes municipal law other than DTTs.

The credit allowed by R under the principle of credit is usually limited to that part of the tax in R which is attributable to the foreign income. In the OECD Model, this limitation is referred to as the “maximum deduction”. In this study, the limitation is instead referred to as the “foreign tax credit limitation”, which is the expression used in US tax law, so as not to confuse the credit allowed under the DTT with a deduction from taxable income that may be allowed under internal law.

All Swedish DTTs are cited by the name of the treaty partner. All Swedish DTTs currently in force (with the exception of DTTs that are limited to certain categories of income) and their year of signature are listed in the Appendix.

1.7 Outline of the Study

Chapter 1 gives a brief introduction to the subject and describes the aims of the study.

Chapter 2 is devoted to a fundamental issue for understanding the effects of the methods for elimination of double taxation, namely the concepts of

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63 See for instance the OECD Model, Commentary to Art. 23, para. 3, footnote 1.
capital import neutrality and capital export neutrality. These concepts are mainly of relevance for the second aim of the study, but as they are also relevant to the systematisation and analysis of the methods, the chapter has been placed before the chapters that relate to the first aim of the study.

Chapter 3 deals with the relation between DTTs and internal law as well as sources of law in a DTT context and is intended to serve as a background to the analysis that occurs in chapters 4 and 5. Moreover, it serves the purpose of clarifying my own position with respect to some important issues relating to the material on which this study is based.

Chapter 4 discusses some fundamental issues relating to the application of the methods for elimination of double taxation.

Chapter 5 contains the systematisation of the methods as well as a presentation and analysis of issues connected with the application of the methods. These issues are discussed both from a general perspective and from the specific perspective of Swedish law.

Chapters 4 and 5 relate to the first aim of the study defined in sub-chapter 1.2.1, namely to systematise and analyse the various forms of the methods for elimination of double taxation under DTTs in order to gain a better understanding of how the methods work.

In chapter 6, the evaluation of the two main methods for elimination of double taxation recommended by the OECD, exemption with progression and ordinary credit, on the basis of tax neutrality takes place. The purpose of chapter 6 is to fulfil the second aim of the study as defined in sub-chapter 1.2.2.

Finally, the main conclusions of the study are presented in chapter 7.
2 Capital Import Neutrality and Capital Export Neutrality

As described above in subchapter 1.2.2, the second aim of the thesis is to evaluate the methods for elimination of double taxation in a few selected situations on the basis of how well tax neutrality is achieved. As a background to the evaluation, which is presented in chapter 6, this chapter seeks to analyse the meaning of tax neutrality in the context of international tax law. The concept of tax neutrality is also valuable for understanding the general functioning of DTTs and is therefore to some extent relevant for the analysis in chapters 4 and 5 as well.

The term tax neutrality is sometimes used to describe a tax system that does not create a bias that could influence a taxpayer to choose one production or exchange alternative over another, i.e. it refers to an ideal situation where the choice of investment or course of action is decided solely on the basis of market or personal considerations without influence from the tax laws and where tax laws thus do not interfere with the free flow of capital towards its most productive use. In other words, the neutrality of a tax system refers to its freedom from distorting effects in the marketplace.65 As for instance the choice among different products may be more or less influenced by the imposition of tax at a given rate, it follows that optimal taxation with respect to minimising distortions in the market may require a complex set of taxes and rates. Tax neutrality in this sense is thus not necessarily the same as uniform taxation.66

When it comes to taxation in a cross border situation where two states are entitled to exercise taxing rights under their internal laws, neutrality is not an unambiguous term, since the states determine the tax base differently and are likely to apply different tax rates.67 Thus, international tax neutrality can be defined either in relation to the taxpayer's state of residence or another state.

67 Mössner, 'Grundfragen des Doppelbesteuerungsrechts: Die Methoden zur Vermeidung der Doppelbesteuerung – Vorzüge, Nachteile, aktuelle Probleme' in Vogel (ed.), *Grundfragen des Internationalen Steuerrechts* (1985), p. 138. In fact, even in a domestic context, tax neutrality is hardly an unambiguous term, since neutrality can be defined in relation to different choices, such as the choice of type of business organisation, the choice of object of investment, the choice between work and leisure, etc., see Gunnarsson, *Skatterättvisa* (1995), pp. 135–144.
In a situation where the total tax burden on a cross border investment made by a resident of one state, R, in another state, N, is equal to the tax burden on an identical investment made by domestic investors within N, fair competition within the N market is ensured. This is referred to as capital import neutrality (“CiN”).

In a situation where an investment abroad is subject to the same tax burden as an identical investment within the state of residence of the investor, there is no tax-related incentive or disincentive to conduct business abroad. This is referred to as capital export neutrality (“CEN”).

As pointed out, the concept of tax neutrality is sometimes used to describe an ideal situation where a taxpayer’s choices are unaffected by tax laws. However, tax neutrality in the sense of CiN and CEN does not require that the taxation is optimal with regard to freedom from distorting effects in the marketplace. Rather, the word *neutrality* in CiN and CEN refer to the fact that a cross border investment is taxed equal (uniform) to domestic investment or to investments made within the other state. Although this does not meet the criteria for tax neutrality in a narrow sense, it would be reasonable to assume that CiN or CEN (or a tax burden in between these two) will generally result in less distortion in the marketplace than if a cross border transaction is subject to a higher or lower tax burden than the range set by CiN and CEN.

Double (and triple etc.) taxation may occur where the taxing rights of more than two states overlap, but as such situations may, in addition to the application of the DTT between R and N, involve double tax relief in relation to a third state based on the application of DTTs entered into with that third state, I will, for the sake of simplicity, deal with the concepts of CiN and CEN using situations where the taxing rights of no more than two states overlap.

As is illustrated by the evaluation in chapter 6, the taxation consequences of the application of the methods for elimination of double taxation are rather complex, so it is not possible to comprehensively describe all situations that result in CEN or CiN in just a few sentences. However, in principle, tax neutrality in the forms of CiN and CEN are achieved in the following situations.

CiN is achieved if taxation takes place in N only. This may be due to the exemption of income from investments in N from tax in R. CiN may also be achieved if taxation takes place in R only or in both N and R, in the rather unlikely situation that the total tax imposed is equal to the tax that would have been imposed if the income had been taxable only in N.

CEN is achieved if income derived from the investment is exempt from tax in N, as taxation would in that case only take place in R. CEN may also
be achieved if taxation takes place in N only or in both R and N, provided that the total tax imposed is equal to the tax that would have been imposed if the income had been taxable only in R. For instance, CEN can be achieved through the application of the principle of credit by R. Two situations can be distinguished: (i) the tax in N falls below the tax in R which is attributable to the foreign income or (ii) the tax in N exceeds the tax in R which is attributable to the foreign income. Where the tax in N falls below the tax in R which is attributable to the foreign income, the entire tax paid in N typically can be credited, meaning that the post-credit tax in R becomes equal to the excess of the R tax over the N tax. The aggregate taxation in such a situation will correspond to the tax burden on domestic investment within R, meaning that CEN is achieved. Where the tax in N exceeds the tax in R on the foreign income so that the credit cancels the R tax liability it is also possible to achieve CEN, but only if R allows unrestricted crediting of the tax paid in N, i.e. not restricted to the part of the income tax in R which is attributable to the foreign income, and if the total tax in R (on the taxpayer’s worldwide income) is as high or higher than the amount of tax paid abroad, so that the entire amount of foreign tax can be credited. In such case, the total tax burden on a cross border investment in N becomes equal to the tax burden on investment made within R, meaning that CEN is achieved even though the tax in N exceeds the tax in R which is attributable to the foreign income. Thus, if CEN is desired, it would be logical for R to allow unrestricted crediting of the tax paid in N. However, DTTs almost never provide for unrestricted crediting, as that would effectively result in a subsidy to investments in countries that impose higher tax than the investor’s country of residence by means of allowing credits against tax on domestic income. Instead, the credit is usually restricted to the part of the tax in R which is attributable to the income derived from N. If the taxation in N is more burdensome than the taxation in R, the credit cancels the R tax liability, but the entire tax paid in N cannot be credited in R. As a consequence,

68 Referred to as “full credit”, see sub-ch. 5.4.4.
69 Theoretically it would be possible to achieve CEN even though the tax paid in N exceeds the total tax paid in R, provided that R applies a “negative tax”, i.e. a subsidy to investments in N corresponding to the difference in tax.
71 The income derived from N is normally determined in accordance with the tax law of R to assure that the taxpayer will at a minimum pay tax at the effective R tax rate, cf. Shay and others, ‘Report of the Task Force on International Tax Reform’, Tax Lawyer, 2006, No. 3, p. 757.
the effective taxation will equal the taxation of an investment made within N, i.e. CIN.

As there is no harmonised global tax system and, consequently, differences in the tax bases or tax rates of two countries almost always exist, it is normally impossible to simultaneously achieve CEN and CIN. It is also important to emphasise that the above discussion refers to ideal situations. As is shown by the evaluation in chapter 6, in practice case specific factors often result in deviations from CIN and CEN.

CIN is generally assumed to encourage the most efficient competition within a given country, as the tax burden is equal for all activities within that country, regardless of the investor’s residence. CEN on the other hand is assumed to result in the most efficient international allocation of capital as the decision whether to invest within the investor’s country of residence or abroad can be made without influence from tax laws. Although CEN may facilitate the free flow of capital towards its most productive use and thus may tend to enhance worldwide welfare, it can be argued that national welfare is a more appropriate goal for a national tax policy and that CEN may not necessarily enhance national welfare in all cases. Furthermore, it can be argued that the effect of CEN on worldwide welfare in a world where most capital investments are investments in paper assets such as bonds and shares is uncertain as the linkage between the yield on paper assets and productivity can be disputed.

In addition to the discussion whether efficient use of capital is best promoted by CIN or CEN, there is a discussion as to whether equity is best served by CIN or CEN. No definite answer can be given to that question.

75 According to Vogel and others, who are themselves strong proponents of CIN, most legal scholars that have expressed their view on the subject have been in favour of CIN, see Vogel and others, *Doppelbesteuerungabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Einleitung, para. 26. As regards the question whether equity speaks in favour of CEN or CIN, see also Vogel, ‘Worldwide vs. source taxation of income – A review and re-evaluation of arguments (Part III)’, *Intertax*, 1988, Issue 11, pp. 393–402, and Harald Schaumburg, ‘Die Befreiungsmethode im deutschen Steuer-
Developing countries tend to be in favour of CIN as it increases their chances of attracting foreign capital by offering low taxation (on a long term basis or in the form of tax holidays). Capital exporting countries on the other hand tend to favour CEN as it reduces the incentive to move capital abroad to low tax jurisdictions.

Partly as a result of the lack of international consensus regarding CIN and CEN, the OECD Member States have not been able to agree on one single method for elimination of double taxation in the double tax relief article of the OECD Model. Instead, the OECD Model provides for two alternative methods, where one (exemption with progression) is directed at CIN and the other (ordinary credit) at CEN.

Even in countries that are proponents of CEN, it is often possible to structure business activities such that CIN is achieved. In most countries, a shareholder may operate free from current tax in the shareholder’s state of residence to the extent that the operations are conducted through a foreign company without a PE in the shareholder’s state of residence. Thus, taxation in the shareholder’s state of residence can be deferred by making an investment through a foreign company. Internationally, such “deferral” is largely accepted, although exceptions may apply, in particular where the subsidiary derives low taxed passive income. Thus, as long as the profits of the foreign company are not distributed to the shareholder, CIN can typically be achieved for the business income. Furthermore, provided that the investment abroad can be repatriated by means of tax exempt dividends, i.e. without withholding tax in N and without taxation of the dividend income in R, CIN can effectively be achieved on the investment abroad.

As an example, Sweden does not generally subject foreign companies to tax unless and to the extent that they have a PE in Sweden. However, in order to combat tax avoidance, an exception applies to substantial holdings in foreign companies in low tax jurisdictions under the Swedish Controlled Foreign Company (“CFC”) legislation. In cases where the CFC legislation applies, the Swedish shareholder is taxed as if the foreign company were a flow-through type entity such as a partnership. Furthermore, dividends

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recht’ in Gassner, Lang & Lechner (eds.), Die Methoden zur Vermeidung der Doppelbesteuerung (1995), pp. 276–277, with further references, who argues that CIN better serves equity as foreign investments are taxed at a level that is adapted to the ability to pay of enterprises in N.

76 Cf. the OECD Model, Commentary to Art 23, para. 28.

77 Cf. Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschlan Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Einleitung, para. 23.

78 Ch. 39 a IL.
paid by a non-resident subsidiary to a Swedish parent company are generally exempt from tax in Sweden. Thus, as regards the establishment by Swedish companies of subsidiaries abroad, the focus is on CIN.79

As pointed out above, CIN is not achieved if the profits of a subsidiary abroad are taxed twice in the subsidiary’s country of residence, once in the hands of the subsidiary and once again in the hands of the parent company upon distribution. DTT negotiations aimed at reducing or eliminating withholding tax on dividend payments from subsidiaries abroad therefore play an important role in achieving CIN.

In order to achieve CEN on investments made abroad through foreign companies, it would be necessary to prevent deferral by taxing investments through foreign companies on a flow-through basis and, as a consequence, to give credit for foreign tax paid by the foreign companies (so-called indirect credit). The reluctance to do so is probably due to factors such as the desire to uphold the competitiveness of domestic enterprises operating in foreign markets and difficulties in administering such a system.80 This reluctance demonstrates that not even countries that are proponents of CEN consider it to be an overriding objective. Rather, the advantages of CEN are weighed against its disadvantages and a compromise is made.

As follows from the above, unless it is a matter of direct investment, it may be necessary to look at the taxation of more than one person in order to determine whether a transaction results in taxation in accordance with the CEN or CIN principle. For instance, an investment in a foreign company may lead to taxation both at the level of the company and at the level of the investor. In such case, the aggregate amount of tax must be taken into account for the purpose of determining whether CEN or CIN is achieved.81

Although the terminology of CIN and CEN is connected with the cross border investment of capital and usually refers to business income derived from such investments, the concepts of CIN and CEN can be applied also to business transactions that do not necessarily require investment, such as the sale of products abroad, and to non-business income, such as employment income derived from work abroad. For instance, the question whether employment exercised abroad is taxed neutrally with employment exercised

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80 Viherkenttä, Tax Incentives in Developing Countries and International Taxation (1991), p. 97, with further references.
in the state of residence may influence the decision of a wage earner to work in the country of residence or in a foreign country.82

As follows from sub-chapter 1.2.2, the second aim of this study is to evaluate the main methods for elimination of double taxation, exemption with progression and ordinary credit on the basis of tax neutrality. For the purpose of this study, tax neutrality is deemed to be achieved when the effective taxation of a transaction corresponds to the tax that would have been levied in either the state of residence (CEN) or in the other contracting state (CIN), had the cross border element not been present. Furthermore, tax neutrality is deemed to be achieved if the effective taxation of a transaction lies somewhere between CEN and CIN. If a transaction is taxed more heavily than if it had been taxed in the contracting state with the highest tax or if it the tax burden is lower than in the contracting state applying the lowest tax, then tax neutrality is deemed not to be achieved. The concepts of CEN and CIN are thus central to the evaluation undertaken in chapter 6.

3 The Relation between DTTs and Internal Law

3.1 Introduction

The primary aim of this thesis is to study the methods for elimination of double taxation under DTTs. However, on a more general level it is also an investigation into how DTTs interact with internal law, exemplified in this case by the interaction between DTT provisions on methods for elimination of double taxation and internal law provisions.

DTTs and internal law interact in several different ways. First, they may conflict with each other. Internal law may provide for the imposition of tax in a specific situation whereas a DTT provision may provide that the contracting state in question is not allowed to exercise the taxing right set out in internal law. For instance, the internal law of a state may provide for taxation of capital gains on shares derived by a taxpayer, while a DTT entered into by that state may provide that the state in question is obliged to exempt the capital gain from taxation since the taxpayer shall be considered as a resident of the other state under the DTT and since under the DTT only the state of residence is entitled to tax such capital gains. Second, internal law may complement DTT provisions. For instance, internal law typically provides detailed rules on credit of foreign tax, which complement the general principle for credit of foreign tax provided under DTTs. Third, internal law may be of relevance for interpreting DTT provisions. The use of internal law for interpretational purposes may be due to an express reference to internal law in the DTT, for instance in the interpretational rule of the DTT, which applies to the interpretation of undefined DTT terms, or it may simply be a consequence of the fact that the DTT provides insufficient information for interpretation of a term, inducing the interpreter to fall back on internal law. Furthermore, the principles for legal interpretation of the contracting state in which the DTT is applied may induce for instance a court to interpret a DTT with reference to internal law and case law, preparatory works, and so on relating to internal law. Fourth, DTT provisions may have an influence

83 Cf. Art. 3.2 of the OECD Model.
on the application and interpretation of internal law provisions, for instance where internal law has been modelled on a DTT provision.\(^4\)

This chapter deals mainly with the first and the third above-mentioned ways that DTTs and internal law interact by analysing the dual nature of DTTs – as both international agreements between states and domestically applicable legislation – and its implications for (i) solving conflicts between DTT provisions and internal law and (ii) interpretation of DTTs. The issue of conflicts between DTTs (or legislation that gives domestic law effect to a DTT) and internal law provisions that provide for imposition of tax is of fundamental importance to all DTT application and is therefore of relevance to any study of this subject, not least in Sweden when recent HFD cases are taken into account. As regards DTT interpretation, the fact that DTTs are treaties under international law while at the same time being national legislation means that additional sources of law may play a role in their interpretation than is typically the case concerning internal tax law. This chapter deals with the most important of these additional sources. Some of these sources are central to the legal analysis carried out in chapters 4 and 5 and, indirectly, are also important for the evaluation of the main methods carried out in chapter 6 insofar as it builds on the conclusions of the previous chapters. As there is no consensus regarding the weight that shall be attributed to the various sources, neither in an international perspective nor in a Swedish context, the chapter also seeks to clarify the author's position in this regard. Some parts of the analysis of the sources of law may not be directly relevant to the analysis in chapters 4 and 5, but have been included for the sake of completeness, as it is my aim to make a contribution to the on-going discussion on the use of sources of law in connection with application of DTTs.

The chapter is structured in the following way. In sub-chapter 3.2, a background is given to the dual nature of DTTs as international law and domestic law. Sub-chapter 3.3 provides an overview of the procedure by which Sweden enters into DTTs and by which DTTs are incorporated into Swedish domestic law. In order to resolve cases of double taxation, DTT provisions that limit

\(^4\) An example of this is the definition of PE in Swedish internal law (ch. 2 sec. 29 IL), which essentially conforms to the PE definition of the OECD Model and which has been interpreted with reference to the meaning of the term in DTTs, see RÅ 2009 ref. 91. The categorisation of the way in which internal law and DTT provisions interact builds on Winther-Sørensen’s distinction between the relevance of internal law for, on the one hand, interpretation of DTT terms, and on the other hand, carrying out the double tax relief, see Winther-Sørensen, Beskatning af international erhvervsindkomst (2000), pp. 114–117.
the taxing right of a contracting state needs to be given priority over internal law provisions of that state that set out such taxing rights. States may argue differently as to why DTT provisions shall be given priority. Moreover, there may be situations where the DTT provisions are overridden by internal law. The question of how to deal with conflicts between DTT provisions and internal law is discussed in sub-chapter 3.4. A general principle for DTT application that seems to have won widespread acceptance is the principle that DTT provisions may not increase the tax burden provided for under internal law. This principle is discussed in sub-chapter 3.5. Sub-chapters 3.6–3.8 deal with DTT interpretation. In sub-chapter 3.6, two fundamentally different approaches to DTT interpretation are described and contrasted, namely, on the one hand, interpretation in line with the rules and the principles applicable under international law and, on the other hand, interpretation according to the rules and principles of the contracting state applying the DTT for interpreting internal tax law. Where interpretation is made on the basis of the principles of international law, the interpretational rules laid down in the VCLT plays a particularly important role. The interpretational rules of the VCLT are the subject of sub-chapter 3.7. Sub-chapter 3.8 deals with a number of sources of law which are available and often referred to in connection with DTT interpretation. Finally, in sub-chapter 3.9, I will try to summarise the discussion and draw some general conclusions as regards the application and interpretation of DTTs.

3.2 The Dual Nature of DTTs

The dual nature of DTTs is a consequence of the relation between international law and domestic law. Some countries follow the monistic principle, under which domestic law and international law belong to the same legal order. As such, international law does not need to be given effect in domestic law by means of domestic legislation to apply in the domestic legal order. However, most countries follow the dualistic principle, which regards the international and domestic laws as separate legal orders, regulating different subject-matter. International law regulates the relation between sovereign states whereas domestic law applies within a state and regulates the relations of its citizens with each other and with the state of which they are citizens. Therefore, in countries that follow the dualistic principle, treaties under international law in principle require implementation by the domestic legislator in order to exercise influence on for example taxpayers, tax authorities, and courts. When a domestic law provides that international law applies in whole or in part within
the jurisdiction, this is merely an exercise of the authority of domestic law.\footnote{Brownlie, \textit{Principles of Public International Law} (2003), pp. 31–32.} Thus, it can be argued that a court does not apply the international law as such, but rather the domestic law referring to the international law.

The dual nature of DTTs in states that follow the dualistic approach can be illustrated as follows.

Consequently, in states that follow the dualistic principle, a DTT is binding on the contracting states under international law from the date of entry into force, but may be enforceable under domestic law by the courts only after it has been incorporated into domestic law. The other side of the coin is that it may be possible for a contracting state to give a treaty domestic law effect prior to its entry into force on the international level.

Although international law and domestic law regulate different subject matter, it is not uncommon that international treaties deal with matters that are of relevance not only in the relation between states, but also within states, for instance for taxpayers, tax authorities, and courts. However, since courts from a pure dualist point of view can only apply domestic law and do not have to concern themselves with international law, in theory they do not have to weigh one against the other in a situation where incorporation has not occurred.
A disregard of international law may lead to repercussions (judicial or political) on an international level. Implementation into domestic law of rights and obligations provided under international law can be said to serve the purpose of reconciling international law and domestic law, thereby avoiding conflict between the two. As regards DTTs, it would, in theory, be possible for a state that follows the dualistic principle to fulfil its treaty obligations by aligning its internal law provisions that provide for imposition of tax with the DTTs entered into by that state. However, unless all DTTs entered into by that state are identical that would be very impractical as the state would have to either apply different internal law provisions in respect of similar cross border transactions depending on what foreign state is involved or it would have to align its internal laws based on “the lowest common denominator”. Instead, the DTTs themselves are incorporated into domestic law, either on the basis of constitutional provisions that generally give domestic law effect to DTTs or on the basis of specific legislation. Conflict rules, express or implied, are relied on to deal with differences between DTTs and internal law.86

Two techniques for implementing an international treaty into domestic law by means of specific legislation can be distinguished: (i) the treaty text is translated and adapted to the internal law system and then the adapted version is enacted and (ii) a law is enacted which states that the treaty shall apply as law, either referring to the treaty in extenso or including the treaty set out in extenso as a schedule to the Act.87

Sweden adheres to the dualistic principle.88 DTTs are incorporated into

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87 In Swedish legal literature, the first method is referred to as “transformation” and the second as “incorporation”, see for instance Bring and others, Sverige och folkrätten (2011), pp. 48–49. This is slightly confusing as the “doctrine of transformation” usually refers to the position that any rule or principle of international law must be transformed into domestic law by the use of the appropriate constitutional machinery, such as an Act of Parliament, before it can have any effect within the domestic jurisdiction, whereas “the doctrine of incorporation” refers to the position that rules or principles of international law become part of the domestic law automatically without the necessity for the interposition of a constitutional ratification procedure, see Shaw, International Law (2008), pp. 139–140, and Brownlie, Principles of Public International Law (2003), pp. 41–45.
88 The dualism of the Swedish legal system is based on case law. RF does not say anything expressly about the effect in domestic law of international treaties. See Cameron, ‘Swedish Parliamentary Participation in the Making and Implementation of Treaties’, Nordic Journal of International Law, 2005, No. 3-4, p. 441, and Bring and others, Sverige och folkrätten (2011), pp. 43–52. For a different opinion, see Lysén, Folkäntliga ansvar (2002), pp. 391–397, who argues that the courts are obliged to apply all kinds of rules emanating from the activities of the Swedish Parliament and the Swedish Government, including international treaties.
Swedish domestic law by enactment of a new law which declares that the DTT and, if applicable, protocols that have been attached to the DTT shall apply as law in Sweden. The text of the treaty is set out as a schedule to the Act.

The dualistic approach taken by Sweden is clearly illustrated by the HFD case RÅ83 1:87. HFD ruled that the Decree giving domestic law effect to the DTT of 1928 between Sweden and Germany still applied in 1974 and thus could be applied to income from employment in the German Democratic Republic (East Germany), irrespective of the fact that East Germany did not apply the DTT and disregarding that Sweden had entered into a new DTT with the Federal Republic of Germany (West Germany). The ruling shows that the domestic law effect of a DTT under Swedish law is determined without reference to the DTT’s effect in international law. Another example is HFD’s ruling in RÅ 1964 ref. 28. HFD applied a Government Decree concerning the application of the DTT between Sweden and France of 1936 in spite of the fact that it was incompatible with the DTT text. In other words, HFD applied the Swedish domestic regulation, not the DTT as such.

Similarly, the fact that the effect of an international treaty in Swedish domestic law is independent of its effect in international law is illustrated by the enactment of new legislation in 2006 which provided for the amendment of the DTT between Sweden and Austria in order to quickly close a tax planning opportunity which enabled Swedish residents to move to Austria and dispose of shares without triggering taxation of a capital gain. The amended DTT came into effect on 1 January 2007, irrespective of the fact that the DTT had at this time not become binding between the contracting states due to the fact that Austria had not yet ratified the treaty.


90 As regards German law, there seems to be a widespread opinion in the literature that the incorporation of an international treaty into domestic law gives domestic law effect to the international treaty as such and not just to domestic legislation including or referring to a text which is identical to the international treaty, see for instance Vogel & Prokisch (general reporters), Interpretation of double taxation conventions (1993), p. 59. The same opinion has been expressed in Swedish literature, see Dahlberg, ‘Regeringsrätten och de folkrättsliga avtalen’, SN, 2008, No. 78, pp. 482–489. In Germany, the opinion is a logical consequence of the fact that under German law the domestic law effect of a treaty is dependent on its international law effect, i.e. even where incorporation into domestic law has taken place the treaty will not be deemed to have domestic law effect until it is given international law effect and the domestic law effect automatically ceases when the international treaty is terminated. However, so far this opinion has not gained acceptance in German case law, see Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen
To sum up, many states follow the dualistic approach and distinguish between DTTs in their capacity as international law and in their capacity as domestic law, meaning *inter alia* that a DTT entered into by such a state has to be given domestic law effect in order to apply in relation to tax authorities, courts, and taxpayers in that state. As is shown by the above examples, where DTTs in their capacity as domestic law have been applied with disregard to their effect in international law, Sweden is an example of a country that makes a very clear distinction between DTTs as international treaties and DTTs as domestic law.

### 3.3 Entering into DTTs and Incorporation into Domestic Law; a Swedish Perspective

As this study deals in particular with Swedish DTTs, a description of the procedure applied in Sweden for entering into DTTs and giving domestic law effect to DTTs is given below.91

In Sweden, international treaties are concluded by the Government.92 The work of the Government is supported by ministries that are headed by ministers appointed by the Prime Minister.93 Two ministries are involved in the DTT process, the Ministry of Foreign Affairs and the Ministry of Finance.

Although it is the Government that concludes treaties with other states, the Government may not do so without approval of the Swedish Parliament if the agreement presupposes the amendment or abrogation of an act of law or the enactment of a new law, if it otherwise concerns a matter which is for the Swedish Parliament to determine, or if the agreement is deemed to be of material significance.94 DTTs therefore require approval of the Swedish Parliament.

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92 Ch. 10 sec. 1 RF.

93 Ch. 7 sec. 1 RF.

94 Ch. 10 sec. 3 RF.
Parliament. Furthermore, the incorporation of a DTT into domestic law is required to be made in the form of an enactment of new legislation by the Swedish Parliament, since according to the Swedish Instrument of Government provisions concerning the relations between private subjects and the public institutions which relate to obligations (such as liability to pay tax) incumbent upon private subjects, or which otherwise encroach on the personal or economic circumstances of private subjects, as well as provisions concerning local taxation, shall be laid down in law.95

The formal decision to initiate treaty negotiations is taken by the Ministry of Foreign Affairs. The decision is usually the result of a desire by Swedish trade and industry to conclude a DTT with a specific state or a request made by another state. The entering into of a DTT may also be offered by Sweden in exchange for increased transparency, which for instance may be achieved by the simultaneous conclusion of an agreement on exchange of information in tax matters. Where there is already a DTT in place, renegotiation may be initiated due to changes in the tax legislation of Sweden or the other contracting state or if the DTT currently in place gives rise to extensive tax avoidance.

The Minister of Foreign Affairs has been empowered by the Government to appoint Swedish DTT negotiators,96 normally consisting of a group of three or four employees at the Ministry of Finance, and to empower them to conduct treaty negotiations.

Once the negotiations have been concluded, the DTT is signed by the treaty negotiators of the contracting states and is presented to the Minister of Finance, who refers the DTT for consideration to the relevant bodies, usually an Administrative Court of Appeal97 and the Swedish Tax Agency. If amendments are deemed to be required, new negotiations must be initiated.

95 Ch. 8 sec. 2. Prior to the enactment of the Incorporation Act relating to the DTT with South Korea, which was enacted in 1982, DTTs were given domestic law effect by Government Decree on the basis of a delegation of legislative power made in Swedish law. This practice was deemed to be contrary to the general principles laid down in RF, even though the transitional provisions of RF provided for an exception in regard to DTTs, and the practice was therefore changed, see prop. 1981/82:107, p. 28, and, as regards DTT amendments, prop. 1991/92:45, p. 44, rskr. 1988/89:159, and 1988/89:SkU/25. For a thorough analysis of this issue, see Vogel, ‘Normgivning och Sveriges beskattningsavtal’, FT, 1988, Nos. 5-6, pp. 169–213.

96 Government resolution of 9 January 1975, which can be found in Ds 2007:25 Riktlinjer för handläggningen av ärenden om internationella överenskommelser (Eng. Guidelines for handling matters relating to international agreements), appendix 11.

97 DTTs are referred to the Administrative Court of Appeal in Stockholm. During a number of years, DTTs were instead referred to the Administrative Court of Appeal in Jönköping,
When the contracting states have agreed on the DTT, the Government resolves to sign the DTT. It is usually signed by the Minister of Foreign Affairs, the Minister of Finance or, occasionally, by the Swedish Ambassador to the other contracting state. However, at this stage the DTT is not binding on the contracting states under international law, nor does it have effect in domestic law.

The DTT is presented to the Swedish Parliament in the form of a Government Bill. In this Bill, the Government proposes that the Swedish Parliament shall (i) approve the DTT so that it may be ratified and become binding on the contracting states and (ii) enact legislation (below referred to as the “Incorporation Act”) whereby the DTT becomes binding on taxpayers, the Swedish Tax Agency, and courts in Sweden. The Government Bill includes the proposed Incorporation Act with the treaty set out as a schedule, a brief description of the DTT negotiations and the referral process, as well as an overview of the tax law of the other contracting state. It also includes comments on the DTT provisions, sometimes explaining the choices made by the Government in connection with the conclusion of the DTT and the Swedish Government’s view with regard to the interpretation of the provisions. Finally, the Government Bill presented to the Swedish Parliament includes the Government resolution relating to the Bill.

Before the Swedish Parliament decides whether to adopt a proposed Incorporation Act, the proposal must be considered by members of the Parliamentary Committee on Taxation. The composition of the committee in principle reflects the balance of power in the Swedish Parliament. Experts and representatives of different organisations are sometimes invited to give input to the committee. The committee drafts a report containing its recommendation to the Swedish Parliament in respect of the decision on the matter. Members of the committee are given the opportunity to present dissenting opinions in the committee report.

As regards DTTS, it is either “take it or leave it” for the Swedish Parliament. The Swedish Parliament does not have the opportunity to make amendments, as any amendments would require new treaty negotiations in order to be effective in relation to the other contracting state.

The DTT usually states that the DTT shall be ratified, that the instruments of ratification shall be exchanged as soon as possible, and that the DTT shall enter into force upon the exchange of instruments of ratification or when a

due to the expertise of its then president Jan Francke, former chairman of the Committee on Fiscal Affairs of the OECD.
specified period has elapsed after the exchange of instruments of ratification.\(^{98}\) Following approval by the Swedish Parliament, the DTT is ratified by the Government. The instruments of ratification are exchanged either at a meeting of representatives of Sweden and the other state or by exchange of diplomatic notes. In the latter case, the DTT becomes binding on the states when both states have received diplomatic notes from the other state.

The Incorporation Act declares that the DTT and, if applicable, protocols that have been attached to the DTT shall apply as law in Sweden. The text of the treaty is set out as a schedule to the Act.\(^{99}\) This procedure follows from the Swedish Act on Publication of Statutes, which states that where a statute provides that an international agreement or an amendment to an international agreement shall apply as law in Sweden, it shall be made public in the same way as the statute itself, unless the Government decides that it shall be published elsewhere.\(^{100}\) Thus, as a main principle, a DTT is published in the same way as the Incorporation Act itself, i.e. by publication in the Swedish Code of Statutes.

The timing of entry into force of the Incorporation Act is decided by the Government.\(^{101}\) Accordingly, Incorporation Acts typically state that the DTT shall take effect as of the date decided by the Government or they may contain transitional rules of a general nature, for instance stating that the DTT shall apply to income earned in years following the year of entry into force decided by the Government. The reason for not specifying the date of entry into force in the Incorporation Act is that the DTT’s international law effect is subject to ratification in accordance with the applicable procedures of each contracting state and there is usually no intention that the DTT shall enter into force for domestic law purposes prior to it becoming binding on the contracting states.\(^{102}\) The Incorporation Act may also declare that certain legislation, such as the Incorporation Act relating to a previous DTT with the same state, shall no longer apply. Furthermore, the Incorporation Act

\(^{98}\) Cf. Art. 30 of the OECD Model.

\(^{99}\) Generally, only the Swedish and an English version of the text are set out as a schedule to the Incorporation Act. This raises some interesting questions as to the domestic law effect of other language versions, see sub-ch. 3.8.2.2.

\(^{100}\) Sec. 14 para. 1 lagen (1976:633) om kungörande av lagar och andra författningar.

\(^{101}\) The Swedish Parliament’s right to delegate this power to the Government follows from ch. 8 sec. 5 RF.

\(^{102}\) However, this was the intention as regards the DTT with Austria, see sub-ch. 3.2 above.
typically states that the DTT provisions shall only be applied insofar as they limit the tax liability in Sweden that would otherwise apply.103

Finally, the Government issues a Government Decree on the effective date of the DTT. The Decree may also contain transitional rules. Thus, although the DTT is in principle given domestic law effect by the Incorporation Act, the actual starting date for the application of the DTT for domestic law purposes follows from a Government Decree.104

3.4 Conflicts between DTTs and Internal Law

3.4.1 Interpretation in Conformity with International Law as a Means of Reconciling DTT Provisions and Internal Law

In a situation where an international treaty such as a DTT has been concluded, but no domestic law effect has been given to the treaty, it would from a dualistic point of view be possible to argue that there is no conflict between the treaty and domestic law as they regulate different subject matter; the treaty in its capacity as international law deals with the relationship between states whereas the domestic law of a state regulates the relations of persons with each other and with the state. However, as the area regulated by international treaties and domestic law frequently overlap, a complete disregard of the international treaty for the purpose of applying domestic law increases the risk that the contracting state in question acts in breach of its international obligations.

In practice it is not uncommon that international law is allowed to exercise at least some influence on the domestic law in states that follow the dualistic principle even where no transformation or incorporation of international law into domestic law has taken place. This can occur by so construing domestic law as to avoid a conflict with international law.105 For instance, there are several Swedish court cases where domestic legislation has been construed so as to avoid conflict with Sweden’s international obligations.106 This can be

103 As regards the principle that DTT provisions may not increase the tax burden provided for under internal law, see sub-ch. 3.5.
104 Cf. Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Einleitung, para. 62.
described as another way of reconciling international treaties and domestic law, in addition to the implementation of treaties into domestic law by means of enactment of legislation.\textsuperscript{107}

Interpretation in conformity with international law also operates where domestic legislation which is intended to give a treaty domestic law effect is ambiguous by ensuring that an interpretation which is consistent with the treaty is given preference to interpretations that are not, based on a presumption that the legislator intended to fulfil the international obligations of the state in question.\textsuperscript{108}

Of course, interpretation of domestic law in conformity with international law has its limitations as a means of reconciling international law and domestic law, as unambiguous words of an internal law have to be applied irrespective of any conflict with international agreements.\textsuperscript{109} For instance, an exemption provided by a DTT from a clear and unambiguous obligation to pay tax set out in the internal tax law of a state that follows the dualistic principle undoubtedly requires implementation into domestic law to be effective.

### 3.4.2 Priority over Internal Law by Reference to Legal Maxims such as Lex Specialis Derogat Legi Generali and Lex Posterior Derogat Lex Priori

Where a DTT has been given domestic law effect, conflicts between the DTT in its capacity as domestic law and provisions in internal law that provide for imposition of tax frequently arise and have to be dealt with by use of some form of conflict rules. First, conflict rules may take the form of constitutional provisions that give a general priority to treaty provisions in case of conflict with internal law. This approach is obviously the most likely to ensure conformity with the principle of \textit{pacta sunt servanda}.\textsuperscript{110} Second, conflict rules may be found in the provisions of the domestic tax law that give domestic law effect to the treaty.\textsuperscript{111} Third, there may be no conflict rules in the domestic legislation, as is the case in Sweden. The priority of conflicting DTT provisions and internal legislation will in this case have to be determined on the basis of general principles of statutory interpretation, for instance on the basis

\textsuperscript{107} Bring and others, \textit{Sverige och folknitten} (2011), pp. 48–49.


\textsuperscript{110} This approach is applied for instance in France, see Sasseville, 'A Tax Treaty Perspective: Special Issues' in Maisto (ed.), \textit{Tax Treaties and Domestic Law} (2006), p. 41.

\textsuperscript{111} For example in the United Kingdom, see ibid, pp. 41–42.
of legal maxims such as *lex posterior derogat lex priori* and *lex specialis derogat legi generali* or on an uncodified hierarchy of law.\(^\text{112}\)

Being restricted to cross border taxation of residents of the two taxing states, it may be argued that a DTT in its capacity as domestic law constitutes special legislation (*leges speciales*) compared to the contracting states’ general tax law (*lex generalis*). Thus, according to the legal maxim *lex specialis derogat legi generali*, treaties would override the internal law that is effective at the time of their implementation.\(^\text{113}\) As regards internal law that is enacted after the implementation of a DTT, the situation is more complex as the principle of *lex specialis derogat legi generali* must be weighed against the principle of *lex posterior derogat lex priori*. Thus, the application of the maxim *lex posterior derogat lex priori* can induce a court to apply a later law instead of an earlier law incorporating the treaty provisions. Furthermore, the conclusion that DTTs constitute “*lex specialis*” in relation to internal law provisions that provide for imposition of tax is by no means self-evident. Thus, where such legal maxims are relied upon, the outcome will depend to a large extent on the way the court decides to reason and will therefore contain an element of uncertainty unless the highest court clearly and consistently argues in favour of giving priority to DTT provisions.

The fact that legal maxims may be applied to give priority to internal law over DTT provisions instead of the other way around is illustrated by two rulings delivered by HFD in 2008, RÅ 2008 ref. 24 and RÅ 2008 not. 61. The issue at stake was whether the DTT between Sweden and Switzerland precluded Sweden from taxing Swedish companies holding shares in low-taxed Swiss companies on the basis of the Swedish CFC legislation. HFD held that a law relating to the incorporation of a DTT is no different from other laws and that a conflict with other Swedish tax laws was to be solved on the basis of the principles applied for solving conflicts of laws. Furthermore, HFD established that the CFC provisions in question were not only enacted subsequent to the incorporation of the DTT with Switzerland into Swedish law, but that they were also aimed at the kind of activities conducted by the Swiss company. HFD concluded that, under such circumstances, there could be no doubt that the CFC legislation was to be given priority and applied regardless of what would be the result of application of the provisions of the treaty. Thus, no analysis as to whether the DTT provisions precluded

\(^{112}\) Ibid, p. 42.

Sweden from applying the CFC legislation was considered to be required.\textsuperscript{114}

The judgments of HFD reflect a very clear dualistic approach. HFD regarded the situation as a conflict between the two Swedish laws, the Incorporation Act relating to the DTT and the applicable CFC rules. The court did not consider that the international law dimension of the DTT was relevant for dealing with the conflict. For the purpose of solving the conflict, HFD instead referred to general legal maxims for giving one law priority over another. Since the CFC legislation in question had been enacted after the incorporation of the DTT into Swedish domestic law, the CFC legislation was to be given priority according to the maxim \textit{lex posterior derogat legi

114 The statement made in RÅ 2008 ref. 24 read as follows: “When a double tax treaty is entered into, Sweden abstains from taxing rights provided for under Swedish law. In an international law perspective, Sweden is bound by the treaty. The obligations under the treaty are given domestic law effect by incorporation. As regards the treaty with Switzerland, this was made by means of the law (SFS 1987:1182) on the double tax treaty between Sweden and Switzerland. A law on a double tax treaty is no different from other laws. Where sec. 2 of the law as amended by SFS 1992:856 says that ‘the provisions [of the treaty] shall be applied only insofar as they limit the tax liability that would otherwise apply’, this merely means that the treaty cannot extend the taxing rights provided for by law. The regulation does not prevent Sweden from extending its taxing rights in a later law, which may give rise to implications in an international law perspective. In a situation where two laws are incompatible, the question of what law is to prevail shall be answered on the basis of the principles applied for solving conflict of laws. In this regard, it can be established that the CFC provisions in question were enacted subsequent to the incorporation of the double tax treaty with Switzerland into Swedish law and are aimed at the kind of activities conducted by the Swiss company. Under such circumstances, there can be no doubt that the CFC legislation shall be given priority and shall be applied regardless of what would be the result of application of the provisions of the treaty. Thus, no analysis of the treaty is required. [author’s translation]” The original text, in Swedish, read as follows: “När ett skatteavtal ingås avstår Sverige från skatteanspråk som följer av svensk lag. Folkrättsligt är Sverige bundet av avtalet. Åtagandena enligt avtalet får internrättslig verkan genom att tas in i svensk lag. Vad avser avtalet med Schweiz har detta skett genom lagen (1987:1182) om dubbelbeskattningsavtal mellan Sverige och Schweiz. En lag om skatteavtal har ingen särställning i förhållande till andra lagar. När det i 2 § i den aktuella lagen i lydenl enligt SFS 1992:856 sägs att ‘[Avtalets] beskattningsregler skall tillämpas endast i den mån dessa medför inskränkning av den skattningslighet i Sverige som annars skulle föreligga’ innebär detta bara att avtalet inte kan utvidga de skatteanspråk som följer av lag. Bestämmelsen hindrar alltså inte i sig att Sverige i en senare tillkommen lag utvidgar sina skatteanspråk med de folkrättsliga verkningar detta kan få. Om två lagar skulle visa sig vara sinsemellan oöverensstämmiga får frågan om vilken lag som har företräde lösa med utgångspunkt i de principer som tillämpas vid regelkonkurrens. I detta hänseende kan konstateras att de aktuella CFC-reglerna har tillkommit efter det att skatteavtalet införlivades med svensk rätt och tar sikte på just det slag av verksamhet som det schweiziska bolaget bedriver. Vid sådant förhållande står det klart att CFC-reglerna har företräde och ska tillämpas oberoende av vad en tillämpning av bestämmelserna i avtalet kan ge för resultat. Någon analys av avtalet behöver därfor inte göras.” An essentially similar statement was made in RÅ 2008 not. 61.
priori. Furthermore, HFD pointed out that the CFC legislation was aimed at the kind of activities conducted by the Swiss company, which indicates that the CFC legislation was considered as more specific than the DTT in its capacity as domestic law and was therefore also given priority on the basis of the maxim *lex specialis derogat legi generali*.

The judgments of HFD have been subject to considerable criticism.\textsuperscript{115} If a law on the incorporation of a DTT is deemed to be no different from internal laws lacking such international law dimension, the DTTs will quickly become more or less obsolete. New laws on taxation of international transactions are enacted on a continual basis. In general, there will be internal law provisions which have been enacted after the incorporation of the applicable DTT and which can be given priority over the DTT on the basis of the *lex posterior derogat legi priori* principle. As a consequence, unless courts would consistently consider DTTs to be *lex specialis* in relation to internal law, many taxpayers would risk losing protection under DTTs and the contracting state in question would risk frequently acting in breach of its obligations under international law. This may in its turn lead to the termination of DTTs by treaty partners and a reduced interest for entering into new DTTs with the state that repeatedly acts in breach of its obligations.

### 3.4.3 Priority over Internal Law by Reference to the Presumption that the Legislator Did Not Intend to Act in Breach of Its Treaty Obligations

Relying on legal maxims such as *lex specialis derogat legi generali* alone for solving conflicts between DTT provisions and internal law does not seem to provide the stability needed for taxpayers to be able to rely on DTTs. Furthermore, in addition to the uncertainty of the outcome of legal maxims such as *lex specialis derogat legi generali*, it can be noted that Swedish DTTs concluded

before the beginning of the 1980s were given effect in domestic law by means of Government Decree, whereas internal law provisions providing for tax liability were (and still are) enacted by the Swedish Parliament and therefore have a higher normative value according to the hierarchy of norms. Where there is such a difference in normative value, the maxims *lex specialis derogat legi generali* and *lex posterior derogat legi priori* can hardly be applied to give priority to DTT provisions.116

A solution can be found in the presumption that the legislator did not intend to violate the international obligations of the state.117 This solution appears to be justified where the DTT and, consequently, the obligations under international law that follow from the DTT have been approved by the legislator, as is typically required before ratification of the DTT can occur. In my view, this solution does not necessarily imply a “will” of the legislator in a metaphysical sense. Rather, the intent of the legislator to avoid violation of the international obligations of the state follows from an assumption of coherence in the actions of the legislator, i.e. on the one hand the enactment of legislation which gives rise to tax liability and, on the other hand, the approval of a DTT which imposes an obligation on the state to refrain from levying tax in certain situations, which only makes sense if the obligation is given priority over internal law.

Thus, it can be argued that the national courts should apply the law incorporating the DTT, unless there is a clear statement evidencing the legislator’s intent to abrogate the international obligations.118 On the other hand, if it is clear that the legislation is intended to apply regardless of the state’s obligations under international law, there is in my view, in the absence of constitutional provisions that give priority to DTTs, no overriding principle that can declare such legislation invalid. Rather, the possibility to enact legislation in breach of the state’s international obligations, sometimes referred to as “treaty override”, is a logical consequence of the dualistic approach.

It has been argued that a conflict between a DTT in its capacity as domestic law and internal law is merely “illusory” as it follows from the purpose of the DTT and the context in which it is applied that the DTT must be given priority over domestic law.116

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priority.\textsuperscript{119} Put differently, DTTs function by limiting the taxing rights of the contracting states on a mutual basis and becomes non-functioning if the DTT is not given priority. In my view, this argument is difficult to distinguish from the above presumption regarding the legislator’s intent. The only difference seems to be that the legislator’s intent to give priority to DTTs is not based on the legislator’s approval of the DTT in its capacity of international treaty and, as a consequence, its approval of obligations under the DTT, but on the fact that the legislator has enacted a law on a DTT that would be pointless unless the DTT is given priority.

The issue of whether priority could be given to internal law over DTTs was once again dealt with by HFD in RÅ \textsuperscript{112}.\textsuperscript{120} This time, the question was whether Swedish legislation on taxation of capital gains on shares derived by individuals who had been resident in Sweden at any time during the previous ten years was to be given priority over the applicable DTTs. Up until 2007, the legislation covered only capital gains on shares in Swedish companies. Many DTTs entered into by Sweden reserve Sweden’s taxing right in respect of capital gains on such shares, albeit for a shorter period than ten years. Effective from 1 January 2008, the legislation was amended so as to cover also capital gains on shares in foreign companies. Since Sweden typically has not reserved in its DTTs its taxing right in respect of such capital gains, this gave rise to the question whether the new legislation could be applied in spite of the wording of the relevant DTT provisions.

In RÅ \textsuperscript{112}, HFD stated that it is an established principle that limitations on Sweden’s taxing rights provided for by a DTT shall apply, regardless of whether the internal law is later in time compared to the DTT or concerns specific income or specific circumstances. Further, HFD stated that RÅ \textsuperscript{24} according to the view of HFD did not change that principle. However, HFD also pointed out that the legislator is not precluded by any formal or constitutional restraint from enacting legislation which is contrary to a DTT.

HFD also made a statement of fundamental importance for conflicts between DTTs entered into by Sweden and Swedish internal law. HFD held that if the legislator “has clearly expressed that the intention is that an item of income shall be taxable in Sweden or that a new internal law provision shall


\textsuperscript{120} On the same day, two other essentially similar judgments were delivered by HFD in case Nos. 2662-09 and 216-10.
apply without regard to the provisions of a DTT, then that new rule shall be
given priority. If the intentions of the legislator in this respect are not entirely
clear, it can be assumed that it was not the intent of the legislator to alter
the application of the DTTs.” HFD held that neither the words of the act
nor the preparatory works show that the rules on taxation of capital gains on
shares in foreign companies derived by individuals shall be applied without
regard to DTT provisions and therefore concluded that the limitations on
Sweden’s taxing rights provided for under the DTT shall be honoured. In
other words, there is according to HFD a presumption that the legislator,
which has approved the DTTs in their capacity of international treaties, does
not intend to violate the obligations under the treaty. HFD did not refer to
the legal maxim *lex specialis derogat legi generali*. It is not clear under what
circumstances the presumption that the legislator does not intend to violate
the obligations under the DTT is rebutted.

Further, an additional complication arises due to the fact that HFD did
not distance itself from the ruling in RÅ 2008 ref. 24. Instead, this ruling
was explained as an example of a situation where it was justified to make an
exception to the main rule. That would imply that the legislator has clearly
expressed an intention that the Swedish CFC rules shall be applied with-
out regard to DTT provisions. However, the problem is that there is, at
least in my view, no evidence of such intention. The only indication that
the issue was at all considered can be found in a Government Bill relating
to an amendment of the CFC legislation. In this Government Bill, an
analysis of the potential conflict between the CFC legislation and the DTTs
entered into by Sweden was made. The Government came to the conclusion
that there was no conflict. However, in my view that cannot be sufficient to
hold that it was the legislator’s intent to give priority to the CFC rules over
DTT provisions. First, the statement does not say anything as to whether
the Government intended the CFC legislation to apply even if the analysis
proved to be wrong. Second, it is highly questionable whether a statement
in a Government Bill says anything about the Swedish Parliament’s intent to
introduce legislation potentially in breach of Sweden’s international obliga-
tions. Furthermore, even if the statement in the preparatory works could be

121 The author’s translation. In Swedish, the statement read as follows: “Om lagstiften emel-
ler tid gett klart uttryck för att avsikten är att en viss typ av inkomst ska beskattas i Sverige eller
att en viss ny bestämmelse ska tillämpas oberoende av innehåll i ett skatteavtal så ska den nya
regeln ges företräde. Om lagstiftenes intentioner i nu aktuellt hänseende inte är helt tydliga
för däremot antas att lagstifaren inte avsett att rubba tillämpningen av skatteavtalen.”
interpreted as evidence of the legislator’s intent in this regard, it must be out of the question to consider the legislator to have clearly expressed the intent, when an interpretation of the preparatory works is needed to conclude that intent existed. Consequently, the reasons stated for the rulings in RÅ 2008 ref. 24 and RÅ 2008 not. 61 seem impossible to reconcile with the grounds of the judgment in RÅ 2010 ref. 112. The question then becomes whether the legal maxims referred to in the 2008 rulings still have some bearing and can be applied to give priority to internal law over DTT provisions, in spite of HFD’s statements in RÅ 2010 ref. 112.123

3.4.4 Summary

To sum up, rules and principles for dealing with conflicts between internal law provisions that provide for tax liability and DTT provisions that limit a state’s taxing rights may take different forms. In Sweden, there are no conflict rules in the domestic legislation. Instead, conflicts have to be dealt with by application of general principles for statutory interpretation. In 2008, the application of such principles (more specifically, the legal maxims lex posterior derogat legi priori and lex specialis derogat legi generali) by HFD resulted in internal law being given priority over DTT provisions. The HFD rulings caused substantial uncertainty as regards the relation between DTTs and internal law. The uncertainty has been lessened by a new ruling in 2010, which made clear that DTTs shall normally be given priority over internal law. However, it remains unclear under what circumstances internal law may prevail.

3.5 The Principle That DTT Provisions May Not Increase the Tax Burden

In most states, DTT provisions are considered not to be able to give rise to tax liability, meaning that DTT provisions only apply insofar as they limit taxing rights otherwise provided for by internal law provisions.124 For

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instance, the US Model states that “[t]his Convention shall not restrict in
any manner any benefit now or hereafter accorded: a) by the laws of either
Contracting State; or b) by any other agreement to which the Contracting
States are parties”. According to the Treasury Department, this provision
“means that the Convention may not increase the tax burden on a resident
of a Contracting State beyond the burden determined under domestic law”.
Thus, a right to tax reserved by the DTT cannot be exercised unless that
right also exists under internal law.

In states where the executive (Government, President, etc.) is entitled to
conclude DTTs without involvement of the legislative branch (Parliament,
Congress, etc.), this principle is a logical consequence of constitutional pro-
visions or principles giving the legislator exclusive competence to enact leg-
islation for the imposition of tax, but it is prevalent in many other states
as well.

The principle that DTT provisions may not increase the tax burden does
not follow from any generally applicable principle or rule under interna-
tional law. Furthermore, it can, at least in my view, not be regarded as
international custom. First, it is doubtful whether the application of the
principle by national courts and tax administrations can constitute such
state practice as is required in order for an international custom to develop.
Second, although the principle is accepted in many states, it may be inter-
preted differently and, in some states, it is not accepted at all. Third, in order
for a customary rule to develop, it is not sufficient that states act in a certain
manner. They must act in that manner due to a belief that there is a legal
obligation to do so. There is no evidence that in general states apply the
principle because they believe themselves to be bound by it. Instead, the

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125 Art. 1.2 of the US Model.
126 US Model Technical Explanation accompanying the US Model Income Tax Convention
of November 15, 2006, p. 2.
127 Baker, Double Taxation Conventions (2005), Introductory Topics, B.05.
128 Winther-Sørensen, Beskatning af international erhvervsindkomst (2000), p. 48. See also
Hohenwarter, ‘Austria’ in Maisto (ed.), Tax Treaties and Domestic Law (2006), pp. 185–188,
with further references.
129 International custom is an accepted source of international law, as shown by Art. 38.1
of the Statute of the International Court of Justice, which is annexed to the Charter of the
United Nations.
130 In the words of Art. 38.1 of the Statute of the International Court of Justice, the Court
shall apply “international custom, as evidence of a general practice accepted as law”. The Latin
term for this subjective element of customary rules is “opinio juris sive necessitatis”.

p. 49, Winther-Sørensen, Beskatning af international erhvervsindkomst (2000), pp. 47–48, and
principle that DTT provisions may not increase the tax burden provided for under internal law is a principle under domestic law that is found in the domestic laws of many states. Consequently, if tax liability arises as a result of the existence of a DTT, this does not mean that the state in question acts in breach of its obligations under international law as long as the limitations to the taxing right of that state that follow from the DTT are respected.

The existence of a DTT may give rise to tax liability where DTT provisions are construed as giving rise to tax liability or, which happens more frequently, where DTT provisions are relevant for determining tax liability under internal law provisions, for instance where tax according to internal law provisions is triggered as a result of a taxpayer becoming resident in another state under a DTT or where costs relating to income which is exempt from tax under a DTT are deemed non-deductible. The principle that DTT provisions may not increase the tax burden is usually considered as meaning that the DTT shall be applied only in cases where it works in favour of the taxpayer, but not that the taxpayer can require the tax authorities to disregard the existence of a DTT when internal law provisions are applied.131 Accordingly it would be contrary to the principle that DTT provisions may not increase the tax burden to construe DTT provisions as giving rise to tax liability, but it would not be regarded as contrary to that principle to impose tax on the basis of internal law provisions that take into account the existence of a DTT.

Thus, tax liability may be triggered, indirectly, by a DTT where internal law provisions give rise to tax liability subject to the applicability of a DTT or subject to the exemption of income under a DTT, and this is generally not perceived as being contrary to the principle that DTT provisions may not increase the tax burden under internal law. For instance, ch. 9 sec. 5 para. 1 of the Swedish Income Tax Act provides that costs relating to income which is exempt under a DTT are non-deductible. Similarly, subject to certain additional conditions, ch. 14 sec. 19 of the Swedish Income Tax Act provides for adjustment of the taxable income where the taxpayer has entered into a contract with an enterprise on other than market terms if these terms increase the income of the enterprise and the enterprise, in accordance with the provisions of the Swedish Income Tax Act or as a result of a DTT, is not taxed in Sweden. Another example is the provisions in ch. 22 sec. 5 items 4–5 of the Swedish Income Tax Act, which provide for taxation as if assets had been sold at market value where income relating to a business becomes

exempt under a DTT or where the assets of a business are transferred to a part of the business which is exempt from tax under a DTT.\textsuperscript{132}

With regard to Sweden, the principle that DTT provisions may not increase the tax burden provided for under internal law is usually codified in the Incorporation Acts of Swedish DTTs. The Incorporation Acts typically contain a provision which states that the DTT provisions shall only be applied insofar as they limit the tax liability in Sweden that would otherwise apply. The provision does not state that the DTT provisions shall \textit{always} be applied insofar as they limit the tax liability and therefore in my view cannot be taken as a conflict rule that gives DTT provisions priority over internal law. Consequently, the principle codified in the Incorporation Acts does not prevent Sweden from enacting legislation which extends Sweden’s right to tax in contradiction to the DTT.\textsuperscript{133}

3.6 International Law vs. Domestic Law Approach to DTT Interpretation

Since DTTs in states that follow the dualistic principle are applied by taxpayers, tax authorities, and courts in their capacity as domestic law it would seem natural that they were applied just as any other domestic legislation. However, the reality is not that simple. The classification of states as either monistic or dualistic is a simplification, as states rarely follow either principle in its pure form. The legal sources and interpretational methods connected with DTTs in their capacity as international law also play a significant role in states that follow the dualistic principle. In most countries, DTTs are interpreted by courts with reference to principles applicable under interna-

\textsuperscript{132} In these examples, the internal law provisions expressly state that they apply where income is exempt from tax under a DTT. The question whether taxation is contrary to the principle that DTT provisions may not increase the tax burden is less clear when tax liability under internal law is triggered as a result of DTT provisions without such an express reference. For instance, according to the Swedish transfer pricing regulation in force prior to 1 January 2000, adjustment of the income was, subject to certain additional conditions, provided for if the contracting party was exempt from tax, but it was unclear whether the income had to be exempt under internal law or if the regulation could be applied where income was exempt under a DTT, see Lindencrona, ‘Förhållandet mellan dubbelbeskattningsavtal och intern rätt’, SvSkT, 1992, pp. 130–131, and prop. 1999/2000:2, part 2, pp. 187–188.

\textsuperscript{133} This view was confirmed in RÅ 2008 ref. 24 and RÅ 2008 not 61. A different opinion has been expressed by Boström & Tyllström, ‘Sweden’ in Vogel & Prokisch (general reporters), \textit{Interpretation of double taxation conventions} (1993), p. 559, and Fensby, ‘Ingående och införlivande av dubbelbeskattningsavtal’, SvSkT, 1995, No. 6-7, p. 416.
tional law for interpreting treaties and not just by application of principles applicable to interpretation of internal law.\textsuperscript{134} However, the legal justification for taking into account principles of international law for the purpose of interpreting DTTs in their capacity as domestic law in states that follow the dualistic principle may be more or less clear.

In a state that adheres to the dualistic principle, it is possible to argue that a DTT in its capacity as domestic law, in the absence of a constitutional basis for a different approach, should be applied in exactly the same way as any other internal legislation, i.e. based on those legal principles and traditions that have developed in that state for interpreting internal legislation. However, although in many states there is no express statutory basis for taking into account other principles or legal sources in connection with the application of a DTT in its capacity as domestic law than that which exists in connection with the application of internal law provisions, this is in fact done as it is recognised that an application of DTTs based solely on internal law traditions and principles would have serious disadvantages. First, there is a substantial risk that the obligations of a contracting state under a DTT in relation to, on the one hand, its taxpayers, and on the other hand, the other contracting state, would differ if the DTT in its capacity as domestic law is not applied on the basis of similar principles as would apply in the relation between the contracting states. Such differences increase the risk that the state does not fulfil its obligations under international law, potentially leading to repercussions at an international level. Second, the risk of different application by the contracting states in the relation to their respective taxpayers would increase if the contracting states interpret the DTT without taking into account principles for interpreting treaties under international law. For instance, the states would be more likely to apply different distributive rules in respect of the same item of income, potentially obstructing the elimination of double taxation under the DTT or giving rise to double non-taxation.

As regards Sweden, support for interpretation of DTTs in their capacity as domestic law based on principles for interpreting treaties under international law can be found mainly in the HFD court case RÅ 1996 ref. 84. HFD made the following statement:

The goal of DTT interpretation is to establish the common intention of the contracting states. This shall be done by way of those methods and means as are pointed out by Articles 31–33 VCLT. Although what has been said primarily applies to the relation between the contracting states, the same

\textsuperscript{134} Baker, \textit{Double Taxation Conventions} (2005), Introductory Topics, E.02.
principles … should normally apply also as regards DTT interpretation in connection with a dispute between a taxpayer and the tax authority.\textsuperscript{135}

This position has been confirmed by HFD in other cases as well.\textsuperscript{136} HFD has not provided any explanation as to why the principles under international law may be applied. As follows from sub-chapter 3.4.3 above, the legal basis for giving priority to DTT provisions over internal law in cases of conflict according to RÅ 2010 ref. 112 seems to be that it can be assumed that the legislator does not normally intend new legislation to override obligations under a DTT. A similar argument could be used to justify the use of principles under international law for DTT interpretation. The legislator’s intent to act in conformity with the state’s obligations under international law can only be ensured if the DTT is interpreted in the same way in the relation between a taxpayer and a contracting state as in the relation between the contracting states, i.e. on the basis of the same interpretational principles. However, the legal basis in Sweden for reference to principles of international law in connection with DTT interpretation remains unclear.

3.7 The Interpretational Rules of the VCLT

As follows from the above, principles under international law play an important role for DTT interpretation. To a large extent, the principles for interpreting international treaties can be found in the Vienna Convention on the Law of Treaties of 1969 (below “VCLT”). The interpretational rules of the VCLT are therefore analysed below.

The VCLT entered into force on 27 January 1980, more than twenty years after it was opened for signature. The VCLT was signed by Sweden in 1970 and ratified in 1975.\textsuperscript{137} DTTs in their capacity as international law, whatever
the name given to them by the parties – convention, agreement, protocol, etc. – are subject to the rules of the VCLT.\textsuperscript{138}

The VCLT was concluded under the auspices of the United Nations on the basis of prior drafts prepared by the International Law Commission. The object of the International Law Commission is “the promotion of the progressive development of international law and its codification”\textsuperscript{139}, in line with the aims of the United Nations to “initiate studies and make recommendations for the purpose of … encouraging the progressive development of international law and its codification”.\textsuperscript{140}

As it is generally perceived that many of the provisions of the VCLT codify existing international law, the VCLT’s provisions can to a large extent be applied not just where the contracting states are bound by the VCLT, but also where one or both contracting states are not signatories, as is for instance the case concerning the United States, or where a treaty has been concluded prior to the entry into force of the VCLT.\textsuperscript{141}

The International Law Commission confined itself to isolating “the comparatively few general principles which appear to constitute general rules for the interpretation of treaties”.\textsuperscript{142} Moreover, the preamble of the VCLT itself proclaims that “the rules of customary international law will continue to govern questions not regulated by the provisions of the present Convention”. Thus, the interpretational rules of the VCLT are not exhaustive, but exist alongside customary international law.

The VCLT articles on the interpretation of treaties, Articles 31–33, are worded as follows:

\textit{Article 31}

\textit{General rule of interpretation}

1. A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose.
2. The context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes:
   \textit{(a)} any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty;

\textsuperscript{138} Art. 2.1 (a) VCLT.
\textsuperscript{139} Art. 1.1 of the Statute of the International Law Commission.
\textsuperscript{140} Art. 13.1 of the Charter of the United Nations.
(b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty.

3. There shall be taken into account, together with the context:
   (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions;
   (b) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation;
   (c) any relevant rules of international law applicable in the relations between the parties.

4. A special meaning shall be given to a term if it is established that the parties so intended.

**Article 32**

*Supplementary means of interpretation*

Recourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31:
   (a) leaves the meaning ambiguous or obscure; or
   (b) leads to a result which is manifestly absurd or unreasonable.

**Article 33**

*Interpretation of treaties authenticated in two or more languages*

1. When a treaty has been authenticated in two or more languages, the text is equally authoritative in each language, unless the treaty provides or the parties agree that, in case of divergence, a particular text shall prevail.

2. A version of the treaty in a language other than one of those in which the text was authenticated shall be considered an authentic text only if the treaty so provides or the parties so agree.

3. The terms of the treaty are presumed to have the same meaning in each authentic text.

4. Except where a particular text prevails in accordance with paragraph 1, when a comparison of the authentic texts discloses a difference of meaning which the application of articles 31 and 32 does not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

A fundamental question concerning the interpretation of international treaties is whether the emphasis shall be put on the treaty text (textual or objective approach), the intention of the parties (subjective approach), or the purpose of the treaty (teleological approach).
Under a teleological approach, the interpreter aims to interpret the treaty so as to give effect to its object and purpose. Insofar as DTTs are concerned, the elimination of double taxation is indisputably a fundamental object and purpose of the treaty. However, a DTT may have more than one purpose and there may be widely different opinions as to what other purposes exist and where the emphasis shall be placed. A taxpayer is likely to view the prevention of double taxation (or potential double taxation) as the main purpose of the treaty whereas fiscal authorities may view the prevention of fiscal evasion as an equally important purpose.\textsuperscript{143} Other purposes include the prevention of discrimination between taxpayers and, possibly, the prevention of double non-taxation\textsuperscript{144}. A teleological approach can therefore be criticised for letting the interpreter’s definition of the object and purpose of the treaty decide the outcome of the interpretational process.\textsuperscript{145}

Under a subjective approach, the intention of the parties is recognised as an element distinct from the text. Evidence of the parties’ intention can be found in other material than the treaty, such as in preparatory works relating to the treaty in question.

A provisional draft of the International Law Commission declared that “[t]he article is based on the view that the text must be presumed to be the authentic expression of the intentions of the parties; and that, in consequence, the starting point of interpretation is the elucidation of the meaning of the text, not an investigation \emph{ab initio} into the intentions of the parties”. Thus, the International Law Commission was clearly in favour of a textual approach and expressly rejected a subjective approach. This was partly due to the jurisprudence of the International Court of Justice, which according to the International Law Commission contained many pronouncements from which it was permissible to conclude that the textual approach to treaty interpretation is regarded by it as established law.\textsuperscript{146} The intention of the parties can play a role in the interpretational process, but only insofar as it is expressed in the text.\textsuperscript{147}

\textsuperscript{143} Baker, \textit{Double Taxation Conventions} (2005), Introductory Topics, B.06.
\textsuperscript{144} OECD Partnership Report (1999), para. 52.
Article 31.1 VCLT states that a treaty shall be interpreted “in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”. As the interpreter according to Article 31.1 VCLT is bound by the ordinary meaning of the treaty terms, it is clear that this provision gives preference to a textual approach over a subjective or teleological approach, as pointed out by the International Law Commission.\textsuperscript{148} However, elements of the teleological approach can also be found, as the meaning is not to be determined in the abstract but in the light of the object and purpose of the treaty. Further, the ordinary meaning of the treaty terms shall be determined \textit{in their context}. Thus, the interpretation is not limited to a strict linguistic analysis. Other elements may be taken into account as long as the interpretation does not depart from the frames set by the ordinary meaning of the text.

From a practical point of view, it can be noted that the text of a treaty (including systematic considerations) may not provide a lot of information concerning the interpretation of a particular term. For instance, DTTs do not provide nearly the same level of detail as is found in internal tax law. The reference to the context and to the object and purpose of the treaty seems to be intended to provide a balance between a purely textual approach and an approach that allows taking into account other material while pointing out that such material is only secondary to the treaty text.

According to Article 31.1 VCLT, a treaty shall be interpreted “in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in the light of its object and purpose”. The phrase “its object and purpose” refers to the object and purpose of \textit{the treaty}. In my view, it is thus clear that Article 31.1 VCLT does not provide for the taking into account of the object and purpose of a particular provision, only the object and purpose of the treaty as a whole.\textsuperscript{149}

The requirement of the first part of Article 31.1 VCLT that a treaty is to be interpreted in good faith is derived from the general interpretational rule \textit{pacta sunt servanda}.\textsuperscript{150}

It can be argued that the ordinary meaning of a term in the sense of Article 31.1 VCLT is not necessarily the same as the meaning in an everyday


\textsuperscript{149} For a discussion on this topic, see Wittendorf, \textit{Armslængdeprincippet i dansk og international skatteret} (2009), p. 144–146.

According to Article 31.1 VCLT it is the ordinary meaning of the terms in their context and in the light of the object and purpose of the treaty which is relevant. Article 31.2 VCLT states that the context shall comprise the text of the treaty, including its preambles and annexes, and any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty as well as any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty. Provided that this is not seen as an exhaustive definition of the context, it can be argued that the field of law etc. dealt with by the treaty constitutes context in the sense of Article 31.2 VCLT. If so, a specific meaning of a term which has developed in that particular field may be regarded as the ordinary meaning of the term for the purpose of Article 31.1 VCLT. In other words, where a technical or special use of a term appears from the context (in a wide sense), as is often the case in tax law, the technical or special meaning becomes the ordinary meaning in the particular context.

Moreover, Article 31.3 VCLT provides that (i) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions, (ii) any subsequent practice in the application of the treaty which establishes the agreement of the parties regarding its interpretation, and (iii) any relevant rules of international law applicable in the relations between the parties shall be taken into account, together with the context.

Article 31.4 VCLT provides for a departure from the ordinary meaning of a treaty term if it is established that such special meaning was intended by the parties. This provision provides for the somewhat exceptional case where, notwithstanding the apparent meaning of a term in its context, it is established that the parties intended it to have a different, special meaning. In order to give a treaty term such a special meaning, there must be evidence of an intention by both (or all) parties to the treaty to give the term this meaning. In connection with the drafting of the VCLT it was even disputed whether there was a need for the provision. The provision may, however, be

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interpreted as a clarification of the fact that the burden of proof lies on the party invoking the special meaning of a term.154

Furthermore, supplementary means of interpretation under Article 32 VCLT may be applied in order to confirm the interpretation made in accordance with the provisions of Article 31 VCLT or to determine the meaning if the interpretation according to Article 31 VCLT is ambiguous or obscure or leads to a manifestly absurd or unreasonable result. This means that supplementary means of interpretation, which according to Article 32 VCLT include the preparatory work of the treaty and the circumstances of its conclusion, are normally only allowed to play a very limited role in the interpretational process. The word “supplementary” emphasises that Article 32 VCLT does not provide for alternative, autonomous, means of interpretation but only for means to aid an interpretation governed by the principles contained in Article 31 VCLT.155 Article 32 VCLT merely provide two examples of supplementary means of interpretation, the preparatory work of the treaty and the circumstances of its conclusion, and it is therefore unclear what other kinds of material can be subsumed under the expression. However, it can be noted that both examples are closely linked to the treaty itself. It therefore seems reasonable to argue that material of a unilateral character may not be taken into account, i.e. the participation by both or all contracting states in the making of the material is required in order for it to count as supplementary means of interpretation in the sense of Article 32 VCLT.156

Finally, Article 33 VCLT provides that for treaties authenticated in two or more languages the text is, unless otherwise agreed, equally authoritative in each language. Furthermore, it provides that if there is a difference of meaning between two or more such equally authoritative texts which cannot be solved by the interpretational rules of Articles 31 and 32 VCLT, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

HFD has referred expressly to the VCLT in its ruling RÅ 1996 ref. 84, where the court held that the goal of DTT interpretation is to establish the common intention of the contracting states and that this shall be done by way of those methods and means as are pointed out by Articles 31–33 VCLT. Thus, HFD recognised the interpretational rules of the VCLT while

154 Ibid, p. 222.
155 Ibid, p. 223.
at the same time making the search for the common intention of the contracting states a primary objective in a way that seems to defy the textual approach of the VCLT.

The intention of the contracting states as a primary objective in DTT interpretation was first articulated in RÅ 1987 ref. 162, which concerned among other things the interpretation of the DTT term “income”. In that ruling, HFD stated that it shared the opinion of the Council for Advance Tax Rulings regarding the interpretational rule of the DTT, namely that “[w]here a term of a treaty, as used in a particular provision, does not give a clear indication of its meaning, it is necessary to try to establish what the intention of the contracting parties might have been” and that “guidance should be sought from the terminology of the treaty as a whole, its structure and systematic approach, the function of the article in question, its making and historical context, as well as other relevant circumstances”. HFD added that “decisive above all in the interpretative process is what the intention of the contracting states were at the time when the provisions of the treaty were made”.157 Thus, HFD put the emphasis on the intention of the contracting states, without any limitation to the intention as it is expressed in the DTT text. This reflects a clearly subjective approach, which in my view is contrary to the textual approach advocated by the VCLT.158 HFD has confirmed the position taken by the court in RÅ 1987 ref. 162 in other rulings.159

157 The translation is, with a few adjustments, taken from Kerstin Boström’s and Rolf Tyllström’s national report on Sweden in Vogel & Prokisch (general reporters), Interpretation of double taxation conventions (1993), pp. 564–565. The statement of the Council for Advance Tax Rulings reads as follows in Swedish: “Om ett avtalsuttryck, såsom det används i en aktuell bestämmelse, inte ger något klart besked, är det nödvändigt att med ledning av avtalets terminologi i övrigt, dess uppbyggnad och systematik, den aktuella bestämmelsens funktion, tillkomst och historiska sammanhang samt andra sådana förhållanden försöka klarrätta vad som kan anses ha varit de avtalsslutande parternas avsikt.” HFD’s addition was formulated as follows: “Avgörande för avtalets tolkning är sålunda främst vad avtalsparterna avsett med bestämmelserna i avtalet, när dessa tillkom.”


159 See for example RÅ 1989 ref. 37 and RÅ 1998 ref 49.
3.8 Some Remarks on Sources of Law in a DTT Context

3.8.1 Introduction

The dual nature of DTTs has fundamental implications for the sources of law that are available and the weight attributed to them. Unless a purely dualistic stance is taken, the interpretation and application of DTTs in their capacity as domestic law will differ from that of other domestic legislation. Therefore, this chapter seeks to comment on some of the most important sources of law for DTT interpretation and application.

For discussions on the relative weight of different legal sources, there is usually an axiom that the content of a legal decision should be a conclusive consequence of a set of pre-existing factual and normative premises and that the normative premises can be derived from the legal sources. This may regarded as an idealised image of legal decision making, as legal knowledge does not always satisfy the conditions required for the solutions to legal problems to be derived from pre-determined rules (the rule-set may be incomplete or inconsistent or the content of the rule-set may be uncertain). Furthermore, the logical, deductive approach may be inadequate in the legal domain, as dealing with concrete cases by means of general pre-established standards only supports some legal values and in particular the ideals of certainty and formal equality, to the disadvantage of other values such as justice and equity, which should also inform the application of the law. However, this does not mean that an analysis of the legal sources becomes irrelevant. Even though legal decision making may in practice involve other factors than the normative premises referred to above, the logical, deductive approach can be regarded as an ideal worth striving for. Another way of arguing is to hold that, although the decision making (context of discovery) may involve other factors than the above referred normative premises, at least the subsequently provided explanation of that conclusion (context of justification) must follow the logical, deductive approach (taking into account the legal sources) in the sense that the decision must be derivable from general legal rules.160

Since DTTs are interpreted at the national level by courts, tax administrations, and taxpayers, the role of the various sources of law are country-specific,

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depending on the legal tradition of each country and the relation between international law and domestic law in that country’s legal system. As this is not a comparative study, I have no intention of comparing the use of sources of law for DTT interpretation in the case law of different countries. Instead, I will take my starting point in the common denominator, international law. As regards Swedish law, the aim is to be more concrete, for instance by referring to the use of different sources of law in Swedish case law.

The discussion will begin with the main object of DTT interpretation, the DTT text, and the implications of the fact that DTTs are usually made in more than one language. Since the Articles of the OECD Model are central to DTT negotiation and since the Commentaries to the articles of the OECD Model in practice play an important role for DTT interpretation, the work of the OECD will be presented and the legal basis for reference to the Commentaries will be analysed. Further, some other legal sources that are special to DTTs will be discussed, such as mutual agreements and the use of internal law by reference in DTT provisions. Finally, the use of unilateral materials, i.e. materials which have been made by one contracting state without the assistance or approval of the other state, is discussed.

3.8.2 The Treaty Text

3.8.2.1 What Material Constitutes the Treaty?
According to Article 2.1(a) VCLT a treaty is “an international agreement concluded between States in written form and governed by international law, whether embodied in a single instrument or in two or more related instruments and whatever its particular designation”. Thus, a DTT is considered as a treaty in the sense of the VCLT regardless of its designation as a treaty, convention, agreement, or otherwise. Furthermore, additional instruments concluded by the contracting states, for instance in the form of protocols or an exchange of notes, are also regarded as “treaty”.

3.8.2.2 Different Language Versions
Where different languages are spoken in the contracting states, the DTT is usually made in more than one language. With regard to plurilingual treaties, there may or may not be a difference in the status of the different language versions. Each of the versions may have the status of an authentic text of the treaty, one or more of them may be merely an “official text”, i.e. a text which has been signed by the negotiating states but not accepted as authoritative, or one or more of them may be merely an “official translation”, i.e. a transla-
tion prepared by one or more of the contracting states or by an organ of an international organisation.\textsuperscript{161}

DTTs are usually authenticated in the languages of the contracting states. It follows from Article 33.1 VCLT that the language versions are equally authoritative, unless the parties have agreed that, in case of divergence, a particular text shall prevail. Occasionally, an additional, “neutral” language version of a DTT may exist (usually in English or French) which shall be consulted in event of discrepancies between the text versions in the languages of the contracting states.\textsuperscript{162}

According to Article 33.3 VCLT, the terms of the treaty are presumed to have the same meaning in each authentic text. Where the texts are equally authoritative, any differences of meaning shall according to Article 33.4 VCLT be removed by application of the interpretational rules of Articles 31 and 32 VCLT. When a comparison of the texts discloses a difference of meaning which the interpretational rules do not remove, the meaning which best reconciles the texts, having regard to the object and purpose of the treaty, shall be adopted.

Thus, unless otherwise is agreed, it is clear that from an international law point of view, the language version of each contracting state is equally authoritative. Where the domestic law that gives effect to a DTT refers to the DTT in its entirety or where the entire DTT is set out as a schedule to the Act, it would in my opinion be reasonable to assume that the language versions are equally authoritative for domestic law purposes as well. Thus, there is no reason to give any of the language versions priority over the other. However, where one or more authentic language versions have been left out, the excluded language versions may not have been given domestic law effect, which means that their role in the interpretation of the DTT becomes less clear.

In order to apply a DTT in conformity with international law, generally speaking there is reason to consider authentic language versions which have not been given domestic law effect when interpreting language versions which have been given such effect (cf. sub-chapter 3.6). Exactly how far one should go in trying to reconcile an incorporated language version with unincorporated versions depends on the relation between international law and domestic law in the state in which the DTT is applied. However, as unambiguous words


\textsuperscript{162} Vogel and others, \textit{Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen} (2008), Einleitung, para. 111.
of a domestic law under a dualistic approach have to be applied regardless of any conflict with international agreements, interpretation in conformity with international law has its limits. Where it is not possible to reconcile the different language versions, the language version or versions which have been given domestic law effect will therefore have to prevail.

The Swedish Instrument of Government requires that Swedish statutes are published. As regards regulation which is enacted by the Swedish Parliament, publication is as a main rule made in the Swedish Code of Statutes (Sw. Svensk författningssamling, “SFS”). Incorporation Acts relating to DT Ts are published in the Swedish Code of Statutes, typically including a Swedish and an English language version of the DTT, but not other language versions. In principle all international agreements entered into by Sweden, including DT Ts, are published in Sweden’s Agreements (Sw. Sveriges överenskommelser, “SÖ”). Incorporation Acts that give domestic law effect to such agreements, on the other hand, are not published in Sweden’s Agreements as Sweden’s Agreements is not one of the Code of Statutes pointed out by the Publication of Statutes Act. Thus, in addition to the publication in the Swedish Code of Statutes, DT Ts (but not the Incorporation Acts) are published in Sweden’s Agreements, often but not always including all authentic language versions of the treaty.

The Swedish version of a DTT will often expressly state in which languages that particular DTT has been done and that all versions are equally authoritative (sometimes giving preference to the English text in event of divergence of interpretation). Similarly, some Incorporation Acts make clear that there are other language versions than those which are published in the Swedish Code of Statutes and that all versions are equally authoritative. In these cases it can be argued that all language versions have been incorporated by

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163 Ch. 8 sec. 19 RF.
164 Sec. 3 item 1 lagen (1976:633) om kungörande av lagar och andra författningar.
165 See for instance the Incorporation Acts relating to the DT Ts with Argentina, Bolivia, Canada (which excludes the French version), China, Egypt, India, Kazakstan, Macedonia, Ukraina, and Vietnam.
167 For instance, the Swedish and English language versions of the DTT with Oman, which is limited to certain categories of income, is published in SÖ 2005:46, but the Arabic language version has been excluded.
168 See for instance sec. 1.2 of the Incorporation Act relating to the Nordic DTT and sec. 1 of the Incorporation Act relating to the DTT with Russia.
reference in the DTT text set out as a schedule to the Incorporation Act or by reference in the Incorporation Act itself, despite the fact that the schedule to the Act does not include all language versions. Furthermore, the Publication of Statutes Act states that where an agreement has been made in more than one language, the authority which publishes the statute giving domestic law effect to the agreement may resolve that only one language version shall be published.\textsuperscript{169} Thus, according to this provision there is no statutory requirement that all authentic language versions must have been published in order to make them applicable as law.

On the other hand, as noted above, the Swedish Instrument of Government requires that laws are published. Thus, it can be argued that at a minimum a language version must have been published in SÖ to be considered incorporated, regardless of whether the published version or versions make clear that there are other authentic language versions and despite the regulation in the Publication of Statutes Act.\textsuperscript{170}

Regardless of the above discussion, there is probably a risk that language versions which have been published in the Swedish Code of Statutes are given preference over versions that have been published in Sweden’s Agreements or that have not been published at all, not because they have a higher statutory value or because they have been incorporated and the other versions have not, but because they are more easily accessible. Since the Swedish Code of Statutes is nowadays available electronically, electronic publication of all language versions in the Swedish Code of Statutes may be a feasible option which should not entail substantial cost and which would make all language versions easily accessible to taxpayers as well as authorities and courts.

\textsuperscript{169} Sec. 14 para. 2 lagen (1976:633) om kungörande av lagar och andra författningar. Cf. SOU 1974:100 Internationella överenskommelser och svensk rätt (Eng. Report by the commission of inquiry on international agreements and Swedish law), pp. 104–107. In the Report, there was a discussion as to whether all authentic language versions should be published. Taking into account that there was no consistent practice in this respect in the other states which had been examined by the commission, the costs associated with a publication of all language versions and the lack of meaning in publishing texts that can only be understood by a handful of readers, the commission did not see any reason for changing the Swedish practice of only publishing certain language versions. However, the commission stressed the importance of clarifying in the Incorporation Act which language versions are authentic, for instance by including in the schedule to the Act the provision of the treaty that sets out the authentic language versions. Further, the commission recommended providing information in a note regarding the omitted language versions and a reference to where the omitted versions are to be found.

Where there is no authentic Swedish version, a translation into Swedish is included in the schedule to the Incorporation Act.\textsuperscript{171} The Swedish translation has been described as “merely an aid for the interpretation of the authentic text”.\textsuperscript{172} In my view, there is reason to completely disregard the Swedish translation. The translation has not been agreed on by the contracting states and therefore clearly has no legal status under international law. Further, provided that the Incorporation Act makes clear that the Swedish text is not authentic, for instance by referring to it as a translation, or where this follows from the authentic text set out as a schedule to the Act, the Swedish text can hardly be considered to have been adopted by the Swedish Parliament.\textsuperscript{173}

As regards the interpretative value in Sweden of different authentic language versions, HFD made the following statement in RÅ 1987 ref. 162.

The Swedish text is the starting point when applying the treaty in Sweden. However, in order to clarify the meaning of the text, the English text may be used for guidance.\textsuperscript{174} As the negotiations can be presumed to have been conducted in English, special weight should be given to that text as a means of establishing the intention of the contracting states.\textsuperscript{175}

Similarly, HFD made the following statement in RÅ 2004 not. 59.

The DTT is done in the Swedish and Spanish languages. This means – where, as in this case, nothing else is stated – that both language versions are of equal value. However, for the purpose of applying the DTT in Sweden, the Swedish

\textsuperscript{171} See for instance the DTTs with Albania, Estonia, the Gambia, Latvia, the Philippines, Malaysia, and Venezuela.
\textsuperscript{172} Fensby, ‘Ingående och införlivande av dubbelbeskattningsavtal’, SvSKT 1995, No. 6-7, p. 417.
\textsuperscript{173} Cf. Winther-Sørensen, Beskatning af international erhvervsindkomst (2000), pp. 64–65.
\textsuperscript{174} It is possible that the source of the statement by HFD is a statement by Sandström in Svenska dubbelbeskattningsavtal i vad de avse skatt å inkomst eller förmögenhet (1949), pp. 41–42. According to Sandström, a contracting state to an international treaty authenticated in the languages of the two contracting states is as a main rule only bound by its own language version and may not refer to the language version of the other contracting state. Only where it is not possible to derive from the Swedish text which foreign concept the Swedish version has in view or where the Swedish text uses a term which has several meanings may guidance be sought in the foreign text. In my opinion, Sandström’s view on interpretation of international treaties is obsolete.
\textsuperscript{175} The author’s translation. In Swedish, the statement reads as follows: “När avtalet skall tillämpas i Sverige är utgångspunkten den svenska texten. För förtydligande av textens innebörd får emellertid ledning sökas i den engelska texten. Eftersom förhandlingarna torde ha fört på engelska, får denna text tillmätas en särskild betydelse som tolkningsdatum för vad parterna avsett med avtalet.”
text shall be of primary use (cf. Art. II.2 of the DTT). In unclear cases, there is reason to also take the Spanish text into account.\textsuperscript{176}

There is no legal basis for attributing a higher value to the Swedish text than other authentic language versions which are equally authoritative and which have been given domestic law effect.\textsuperscript{177} Thus, it is my opinion that HFD’s statements that the Swedish text is the starting point or of primary use should not be interpreted as meaning that the Swedish text shall override other authentic language versions, but merely as a description of the process of DTT interpretation in practice. From a theoretical point of view, all equally authoritative language versions should always be taken into account in the process of interpreting a DTT. However, it would be unrealistic to always require a comparison of all such text versions, since Swedish practitioners typically do not master all languages concerned. The right to rely on a single language version should, however, be exercised in good faith. In the case of an ambiguity or obscurity or upon discovery of a discrepancy between the texts, the DTT should be interpreted by reference to all authentic language versions.\textsuperscript{178}

HFD’s statement in RÅ 1987 ref. 162 regarding the weight that shall be attributed to the text of the language spoken during treaty negotiations is in my view not possible to reconcile with the VCLT view that all authentic language versions are equally authoritative. Since the statement has not been reiterated in later case law, it is unclear whether it has any bearing today.

\textsuperscript{176} The author’s translation. In Swedish, the statement read: “Skatteavtalet är avfattat på svenska och spanska språken. Detta innebär – när som i detta fall inte något annat är angivet – att båda språkversionerna äger lika vitsord. Vid tillämpningen i Sverige skall i första hand den svenska texten användas (jfr artikel II § 2 i avtalet). I oklara fall har man dock anledning att beakta också den spanska texten.”

\textsuperscript{177} Cf. Sundgren, ’Interpretation of Tax Treaties Authenticated in Two or More Languages – A Case Study’, SvSkT, 2006, Issue 5, pp. 383–384, and Wittendorf, "Armslængdeprincipippet i dansk og international skatteret" (2009), p. 149. The interpretational rule of the DTT with Peru (Art. II.2), which HFD referred to in RÅ 2004 not. 59, does not have any bearing on the value attributed to the different language versions of the DTT. Cf. also Zimmer, Internasjonal Inntektsskatterett (2009), p. 76.

\textsuperscript{178} Engelen, Interpretation of Tax Treaties under International Law (2004), pp. 382–391. Cases where HFD has considered the non-Swedish language versions as clearer than the Swedish version include RÅ 1967 ref. 22 and RÅ 2004 not. 59.
3.8.3 The OECD Model

3.8.3.1 The Work of the OECD

As a background to the discussion on the legal status of the Articles of the OECD Model and the Commentaries to the Articles, an outline of the OECD’s work with the OECD Model is first presented.

According to Article 1 of the OECD Convention, the aims of the OECD are “to promote policies designed to achieve the highest sustainable economic growth and employment and a rising standard of living in Member countries, while maintaining financial stability, and thus to contribute to the development of the world economy, to contribute to sound economic expansion in Member as well as non-member countries in the process of economic development and to contribute to the expansion of world trade on a multilateral, non-discriminatory basis in accordance with international obligations”. In order to achieve its aims, the OECD may take decisions which are binding on the member countries or make recommendations to member countries.\(^{179}\) The decisions are taken and recommendations are made by consensus, i.e. each member country may veto a decision or recommendation. However, a member country may abstain from voting on a decision or recommendation without invalidating it, in which case the decision or recommendation is applicable to the other member countries, but not to the abstaining member.\(^{180}\)

Already in the 1920s, the League of Nations began developing a model tax convention that would serve as a model used by countries when negotiating bilateral DTTs. The Organisation for European Economic Co-operation and its successor, the OECD, commenced working on a draft model convention in 1956 and presented its first model convention in 1963. Revised versions were published in 1977 and 1992. Since 1992, the OECD has provided periodic updates without waiting for a complete revision. The involvement of the OECD in the development of a standard for DTTs can be seen as a consequence of the above referred to goals set out in the OECD Convention, since a reduction or removal of barriers in the form of double taxation of cross border transactions can be expected to contribute to the expansion of world trade.

In practice, the Articles of the OECD Model have, to a very large extent, come to serve as a basis for DTT negotiation between both OECD member and non-member countries. As a consequence, most bilateral tax treaties

\(^{179}\) Art. 5 of the OECD Convention.

\(^{180}\) Art. 6 of the OECD Convention.
today largely follow the text of the Articles of the OECD Model. There are close to 350 treaties between OECD Member countries. In addition, there are over 1500 DTTs world-wide which are based on the Model.\footnote{According to the website of the OECD, <http://www.oecd.org> accessed 5 January 2012, under the topic “Tax” and the subtopic “Tax Treaties, About”.} All DTTs concluded by Sweden in recent years are, more or less, based on the OECD Model.\footnote{Some Swedish DTTs are modelled on the UN Model. As such they are indirectly based on the OECD Model, since the UN Model follows the OECD Model to a significant extent.} Furthermore, the OECD Model has had a significant impact on other model conventions such as the UN Model and the US Model. There can be no doubt that the OECD Model has had considerable influence on the DTTs between both OECD member and non-member countries.

The OECD is run by the Council which is made up of one representative per member country, plus a representative of the European Commission.\footnote{Arts. 7 and 13 of the OECD Convention. There are currently 34 member countries according to <http://www.oecd.org> accessed 11 January 2012.} The Council meets once a year at ministerial level to discuss key issues and set priorities for OECD work and on a regular basis in sessions of permanent representatives. The Council has established some 200 committees dealing with specific policy areas. Representatives of the member countries meet in the committees. The Committee on Fiscal Affairs (“CFA”) is responsible for matters relating to taxation. In particular, it reviews the Articles and Commentaries of the OECD Model on a continual basis and makes proposals for periodic updates, which are then approved by the OECD Council.\footnote{Information on the history, organisation, etc. of the OECD can be found at <http://www.oecd.org>.}

The OECD Model is presented in two volumes. Volume I includes the Introduction, the Articles of the OECD Model and the Commentaries. Volume II includes a section on the positions of non-member countries, reprints of 16 previous reports dealing with tax conventions that the CFA has adopted since 1977, the list of DTTs concluded between Member countries, and the text of the Council Recommendation on the Model Tax Convention. The OECD also publishes a condensed version of the model, excluding for instance the reports adopted by the CFA.
3.8.3.2 The Commentaries of the OECD Model

1. Introduction
As described above, the OECD Model includes both the Articles themselves and the Commentaries to the Articles. The purpose of this sub-chapter is to analyse the legal basis for reference to the Commentaries of the OECD Model.

The Commentaries often provide input of relevance for the interpretation of DTT provisions. The question of what weight ought to be attributed to the Commentaries of the OECD Model is therefore an important one. In practice, there is no doubt that the Commentaries have come to play a significant role in the process of interpreting DTTs.\(^{185}\)

As the member states of the OECD (and self-explanatory non-member states) are free to deviate from the Articles of the OECD Model and since the Commentaries refer to these Articles, the Commentaries are of little or no relevance if the DTT provisions in question do not in substance comply with the Articles of the OECD Model.\(^{186}\) A basic presumption for the following discussion on the relevance of the Commentaries as a source of law is therefore that the DTT provisions that are being interpreted have been modelled on the Articles of the OECD Model. Further, one or both contracting states may have filed an observation on the Commentaries regarding a specific point, which may act to qualify, reduce, or eliminate the relevance of the Commentaries (see sub-chapter 3.8.3.3).

The current version of the OECD Model, as well as its earlier versions, is the subject of a recommendation of the Council. The Council recommends the governments of member countries “when concluding new bilateral conventions or revising existing bilateral conventions, to conform to the Model Tax Convention, as interpreted by the Commentaries thereon”. Furthermore, the OECD Council recommends the governments of member countries “that their tax administrations follow the Commentaries on the Articles of the Model Tax Convention, as modified from time to time, when applying and interpreting the provisions of their bilateral tax conventions that are based on these Articles”.\(^{187}\)

When the relevance of the Commentaries of the OECD Model is dis-

\(^{185}\) Cf. the OECD Model, Introduction, paras. 29.1–29.3. The Commentaries themselves point to the fact that there is widespread use of the Commentaries by tax administrations, taxpayers, and courts.

\(^{186}\) Baker, *Double Taxation Conventions* (2005), Introductory Topics, E.16.

discussed, the participants in the discussions in most cases have the relevance of the Commentaries in a domestic law context in view. There is usually no reference in DTTs or in domestic law to the Commentaries. Consequently, insofar as rules and principles for interpretation of international law, for instance the interpretational rules of the VCLT, are referred to as a legal basis for reference to the Commentaries, there is an implicit assumption that international law is allowed to exercise at least some form of influence on domestic law. Thus, the relevance of the discussions as to whether the use of the Commentaries for interpretational purposes can be justified on the basis of international law rules or principles (such as those found in the VCLT) is inextricably linked to the relation between international law and domestic law in the state applying the DTT (cf. sub-chapter 3.6).

For national courts, tax administrations, and taxpayers in Sweden and other states that adhere to the dualistic principle, the discussion as to whether the Commentaries are binding under international law may be important, but it is not as decisive as it is in countries that adhere to the monistic principle. If the Commentaries can be regarded as binding under international law, then in monistic states this would imply an obligation for national courts and tax authorities to follow the Commentaries, whereas the same would not necessarily apply to national courts and tax authorities in states that adhere to the dualistic principle.

There is no fully developed international consensus on the exact relation between the Commentaries and the actual treaties which are negotiated on the basis of the OECD Model. Several possible justifications for considering the Commentaries have been suggested, mainly on the basis of the interpretational rules of the VCLT. The lines of reasoning with regard to the interpretational rules of the VCLT can in short be described as follows.

2. Legal basis for reference to the Commentaries based on the interpretational rules of the VCLT

Based on Article 31.1 VCLT – evidence of the ordinary meaning can be found in the Commentaries

According to Article 31.1 VCLT, “[a] treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty

in their context and in the light of its object and purpose”. According to some authors, evidence of the “ordinary meaning” of a DTT term can be found in the Commentaries, provided that the meaning used in the Commentaries has established itself in the “international tax language”, i.e. in the language used by tax lawyers, tax administrations, treaty negotiators, etc. As a consequence, DTTs shall be interpreted in accordance with that meaning.189

**Based on Article 31.1 and Article 31.2 VCLT – the Commentaries constitute “context” for the purpose of determining the ordinary meaning**

According to Article 31.2 VCLT, “[t]he context for the purpose of the interpretation of a treaty shall comprise, in addition to the text, including its preamble and annexes: (a) any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty; (b) any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty”. Some authors suggest that the Commentaries are an agreement or instrument relating to the DTT and, as such, are a part of the context of the treaty in the sense of Article 31.2 VCLT. As a consequence, the Commentaries would influence the interpretation of DTT terms under Article 31.1 VCLT.190

**Based on Article 31.1 and Article 31.3 VCLT – the Commentaries shall be taken into account in their capacity as “subsequent agreement” or “subsequent practice” for the purpose of establishing the ordinary meaning**

According to Article 31.3 VCLT, “[t]here shall be taken into account, together with the context: (a) any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions; (b) any subsequent practice in the application of the treaty which establishes


the agreement of the parties regarding its interpretation; (c) any relevant rules of international law applicable in the relations between the parties”.

It can be argued that the Commentaries constitute a subsequent agreement regarding the application of the DTT or that the Commentaries may give rise to a subsequent practice in the application of the DTT which establishes the agreement of the contracting states regarding its interpretation, and that the Commentaries shall therefore be taken into account for the purpose of interpreting DTT provisions.\(^\text{191}\)

Based on Article 31.4 VCLT – the Commentaries provide evidence of a special meaning

According to Article 31.4 of the VCLT, “[a] special meaning shall be given to a term if it is established that the parties so intended”.

According to some authors, such special meaning of a DTT term intended by the contracting states can be derived from the Commentaries.\(^\text{192}\)

Based on Article 32 VCLT – the Commentaries shall be taken into account in their capacity as supplementary means of interpretation

According to Article 32 VCLT, “[r]ecourse may be had to supplementary means of interpretation, including the preparatory work of the treaty and the circumstances of its conclusion, in order to confirm the meaning resulting from the application of article 31, or to determine the meaning when the interpretation according to article 31: (a) leaves the meaning ambiguous or obscure; or (b) leads to a result which is manifestly absurd or unreasonable”.

According to some authors, the Commentaries constitute such supplementary means of interpretation.\(^\text{193}\)

\(^{191}\) Cf. the discussion in Avery Jones and others, ‘The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model-II’, \textit{BTR}, 1984, No. 2, p. 96.


\(^{193}\) Avery Jones and others, ‘The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model-II’, \textit{BTR}, 1984, No. 2, pp. 96–101.
3. Counterargument against legal reference to the Commentaries based on the interpretational rules of the VCLT

Counterarguments can be put forward against all of the above approaches. Some of them are presented below.

The Commentaries frequently “enlarge upon, add to and expand the terms of the Model” and can in such cases hardly be said to provide the ordinary meaning of DTT terms in the sense of Article 31.1 VCLT. This does, however, not rule out that the Commentaries may provide evidence of an intention by the contracting states to give a term such special meaning as is referred to in Article 31.4 VCLT.194 Furthermore, it does not rule out that evidence of the ordinary meaning can be found in the Commentaries where the meaning given to a term in the Commentaries stays within a reasonable scope.

However, a problem for all approaches based on Article 31 VCLT is that Article 31.1 VCLT provides that a treaty shall be interpreted in accordance with the ordinary meaning of a term and that, similarly, Article 31.4 VCLT provides that a special meaning shall be given to a treaty term if it is established that the parties so intended. Consequently, where the ordinary or special meaning of a term can be derived from the Commentaries it would seem (at least from the perspective of international law) that there would be no choice but to follow the Commentaries. Although it has been suggested that the Commentaries may be binding under international law through the principles of acquiescence and estoppel, both of which are founded on considerations of good faith and equity,195 the prevailing view is undoubtedly that the Commentaries are non-binding. For instance, the use of the instrument “recommendation” by the OECD Council196, as opposed to a “decision”, is generally perceived as a strong indication of the fact that there is no intention to create a binding obligation under international law on the contracting states. Furthermore, the Commentaries themselves point out that they are not binding under international law, stating that “[a]lthough the Commentaries are not designed to be annexed in any manner to the conventions signed by the

195 See Engelen, Interpretation of Tax Treaties under International Law (2004), in particular pp. 463–472, who argues that OECD member states shall be deemed to have acquiesced in the Commentaries, unless they have entered an observation on the Commentaries regarding the issue in question, and are therefore estopped (i.e. precluded) from denying its validity under international law.
Member Countries, which unlike the Model are legally binding international instruments, they can nevertheless be of great assistance in the application and interpretation of conventions and, in particular, in the settlement of any disputes”.197 If the Commentaries are understood as non-binding, it follows that they are inconsistent with the mandatory nature of Article 31 VCLT and it can therefore be argued that they must fall outside the scope of that article.198

As regards the view that the Commentaries constitute an agreement or instrument which was made in connection with the conclusion of the treaty and therefore fall under Article 31.2 VCLT, there are additional reasons for scepticism. According to Article 31.2 VCLT, the context comprises “any agreement relating to the treaty which was made between all the parties in connection with the conclusion of the treaty” and to “any instrument which was made by one or more parties in connection with the conclusion of the treaty and accepted by the other parties as an instrument related to the treaty”. It may be possible to claim that the Commentaries constitute an instrument which was accepted by the other contracting state as related to the treaty, but the Commentaries were not made “by one or more parties” to the DTT, but rather by a collective of states represented by their government officials. Thus, there is no identity between the contributors to the Commentaries and the parties to the DTT. Furthermore, the Commentaries were not made in connection with the conclusion of the particular treaty in question.199 The VCLT itself is a treaty under international law and shall therefore be interpreted on the basis of the interpretational rules of the VCLT. The ordinary meaning of the word “made” can hardly be taken to include the mere recognition by the other state of the Commentaries. Consequently, in my opinion the arguments for subsuming the Commentaries under Article 31.2 VCLT are not convincing. Moreover, international agreements often

197 The OECD Model, Introduction, para. 29.
require approval by the national legislator to become binding. The Commentaries have not been subject to such approval.\textsuperscript{200}

For the same reasons it is doubtful whether post-treaty changes to the Commentaries can be taken as constituting a subsequent agreement between the parties regarding the interpretation of a treaty or the application of its provisions in the sense of Article 31.3(a) VCLT, i.e. the Commentaries are not agreed on by the contracting states in question, but by a collective of states represented by their government officials, they do not address any particular DTT, and they are typically not subject to approval by the legislative bodies of the contracting states.

The Commentaries cannot in themselves constitute a subsequent practice in the application of a DTT in the sense of Article 31.3(b) VCLT, but it is possible that they, in time, can contribute to the establishment of such a practice, provided that the DTT is applied in accordance with the Commentaries during a number of years.\textsuperscript{201} However, it can be questioned whether a consistent application of a DTT by national courts and tax administrations can be said to establish the interpretation of the DTT in a way that is binding on the contracting states in accordance with Article 31 VCLT.\textsuperscript{202}

Even if the Commentaries are considered as non-binding and therefore inconsistent with the mandatory nature of Article 31 VCLT, they may still be covered by the interpretational rules of the VCLT, provided that they can be regarded as a supplementary means of interpretation under Article 32 VCLT. Article 32 VCLT states that supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion. The Commentaries are not preparatory work in respect of any particular treaty and can therefore not be regarded as "the preparatory work of the treaty".\textsuperscript{203} Arguably, they can be regarded as "circumstances of its conclusion", insofar as they were present at the time of the conclusion of the treaty. Furthermore, as the word "include" in Article 32 VCLT indicates that the provision does not provide an exhaustive definition of the supplementary means of interpretation, but allows other material to be taken into account, it is possible that they can be considered as supplementary means of inter-

\textsuperscript{200} Wattel & Marres, 'The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties', \textit{ET}, 2003, p. 226.
\textsuperscript{201} Ibid, pp. 227–228.
\textsuperscript{203} Vogel and others, \textit{Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen} (2008), Einleitung, para. 125.
pretation regardless of whether they are also considered as “circumstances” of the conclusion of the treaty. However, if the Commentaries are considered to fall within Article 32 VCLT, recourse may normally only be had to the Commentaries to confirm the meaning resulting from the application of the general rules in Article 31 VCLT. Only if the interpretation according to Article 31 VCLT leaves the meaning ambiguous or obscure or leads to a result which is manifestly absurd or unreasonable can the Commentaries be used to determine the meaning of a DTT term. Such legal basis for reference to the Commentaries would therefore provide for a much more limited role for the Commentaries in the interpretational process than what is often the case in practice.

To sum up, there is no developed consensus on how (and even if at all) the Commentaries can be fitted into the framework of the interpretational rules of the VCLT. This is probably due to the fact that the VCLT was not drafted with the intention of comprising such materials as a commentary to a model treaty. It may be even more difficult to fit the Commentaries into the VCLT provisions in cases where one or both contracting states are not members of the OECD and have not taken part in the drafting of the Commentaries.

In spite of the difficulties of subsuming the Commentaries under the provisions of the VCLT and in spite of the fact that there is usually no constitutional basis for reference to the Commentaries, courts in many states do refer to them regularly, in most cases without discussing the basis for so doing.204

4. Other legal basis for reference to the Commentaries
Some authors argue that the intention of the contracting states provides a basis for reference to the Commentaries. Where the contracting states have been involved in the development of the OECD Model and have adopted a certain provision of the OECD Model, it can presumed that the contracting states intended that the provisions in the DTT negotiated by them should be interpreted on the same basis as set out in the relevant Commentaries that were current and available to them at the time that they were negotiating the particular treaty. This presumption is rebutted if there is evidence to the contrary, for instance in the form of observations or recorded positions of disagreement by a contracting state.205 However, it would seem that a reference to the Commentaries on the basis of the intention of the contracting states

204 Baker, Double Taxation Conventions (2005), Introductory Topics, E.12.
presupposes that the intention of the contracting states exists as an element distinct from the treaty text (unless the text of the DTT in question refers to the Commentaries) and that it would therefore be contrary to the objective, textual approach of the VCLT. On the other hand it can be argued that the starting point of the search for the intention of the parties is in fact the DTT text (i.e. its conformity with the OECD Model) and that this basis for reference to the Commentaries can therefore be reconciled with the textual approach of the VCLT.

Another way of justifying the Commentaries without the need to refer to the interpretational rules of the VCLT would be to consider the Commentaries current when the DTT was concluded as “context” in the sense of the interpretational rule of the DTT (cf. Article 3.2 of the OECD Model, which states that undefined DTT terms shall have the meaning that they have under internal law, “unless the context otherwise requires”, and which is discussed further in sub-chapter 3.8.6). If so, most DTTs would be regarded as including an implicit reference to the Commentaries.206 According to the Commentaries themselves, “context” in Article 3.2 of the OECD Model is determined in particular by the intention of the contracting states when signing the DTT as well as the meaning given to the term in question in the legislation of the other contracting state.207 Insofar as there is evidence that the contracting states intended terms not defined in the DTT to have the meaning that they have been given in the Commentaries, it can thus be argued that the solution proposed by the Commentaries constitute context for the purpose of the interpretational rule of the DTT. However, in the interpretational rule of a DTT, the context typically prevails over the meaning given to the term in the internal law of the state applying the DTT only if the context so requires. It is not at all evident that the context in the form of the Commentaries shall be attributed such weight. Furthermore, it can be argued that the term “context” in the interpretational rule of the DTT comprises the treaty in a wide sense, taking into account its object and purpose as well as systematic considerations, but not external elements such as the Commentaries.208 Consequently, the Commentaries would be excluded from “context” in the interpretational rule of the DTT and the interpreta-

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207 The OECD Model, Commentary to Art. 3, para. 12.
tional rule would in such case not be regarded as including an implicit reference to the Commentaries.

Even if there would be no legal basis for considering the Commentaries as such, it can be argued that the frequent application of the Commentaries may lead to the development of an international custom. Thus, it can be argued that the Commentaries may provide evidence of an established international custom. International custom is an accepted source of international law, as shown by Article 38.1 of the Statute of the International Court of Justice,\(^{209}\) which states that the court shall apply international conventions as well as international custom.\(^{210}\) However, it can be questioned whether the application of DTTs by national courts and tax administrations can constitute such state practice as is required in order for an international custom to develop. Furthermore, in order for a customary rule to develop, it is not sufficient that states act in a certain manner. They must act in that manner due to a belief that there is a legal obligation to do so.\(^{211}\) The relative importance of, on the one hand, the existence of state practice, and, on the other hand, the belief by a state that it is bound by a legal obligation to act accordingly is disputed.\(^{212}\) As the Commentaries are generally perceived as non-binding, states are not likely to believe themselves to be bound by the Commentaries.\(^{213}\) However, it is submitted that states may believe that the interpretation advocated by the Commentaries is in fact the correct one and that, consequently, they are obliged to apply DTTs in accordance with that interpretation, resulting in the existence of international custom. A customary rule developed on the basis of the interpretation favoured by the Com-

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\(^{209}\) The Statute of the International Court of Justice is annexed to the Charter of the United Nations, of which it forms an integral part.

\(^{210}\) Vogel and others, on the other hand, argues in *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Einleitung, para. 125, that there can be no legal basis for the Commentaries outside the scope of the VCLT, and Ellis also questions in ‘The Role of the Commentaries on the OECD Model in the Tax Treaty Interpretation Process – Response to David Ward’, *BIFD*, 2006, p. 103, whether the VCLT would allow that.

\(^{211}\) In the words of Art. 38.1 of the Statute of the International Court of Justice, the Court shall apply “international custom, as evidence of a general practice accepted as law”. The Latin term for this subjective element of customary rules is *opinio juris sive necessitatis*.


mentaries would normally not contradict the written rules of the DTT. The
customary rule and the written rules can therefore exist alongside without
the need of giving priority to any of them over the other.

Yet another way of justifying the use of the Commentaries outside the
framework of the interpretational rules of the VCLT is to refer to “principles
of logic and good sense”. The fact that certain interpretational principles
have been codified by the VCLT does not rule out the use of general prin-
ciples of law. The application of such principles may therefore allow refer-
ence to the Commentaries. However, unlike under the interpretational rules
of the VCLT, such reference would be discretionary and would be appropri-
ate if it assists in resolving issues of interpretation of tax treaty articles based
on the Articles of the OECD Model.

From a teleological standpoint (cf. the reference to the object and purpose
of the treaty in Article 31.1. VCLT) it can be argued that, irrespective of
the basis for referring to the Commentaries, the taking into account of the
Commentaries for the purpose of DTT interpretation increases the chance of
common interpretation by the contracting states and, consequently, reduces
the risk of remaining double taxation or double non-taxation. In my view,
the goal of common interpretation by the contracting states is an argument for
reference to the Commentaries on the same level as general principles of law,
i.e. it is a reasonable argument for taking into account the Commentaries, but
the Commentaries would always have to come second to materials that have a
more solid legal basis, such as the materials referred to in the interpretational
rules of the VCLT. The use of the Commentaries would therefore always be
discretionary. Nonetheless, where other sources do not suffice to establish the
meaning of a term and the solution proposed by the Commentaries leads to
an appropriate result, the Commentaries may have an important role to play.

214 Cf. Art. 38.1.c of the Statute of the International Court of Justice, which refers to “the
general principles of law recognized by civilized nations”. See also ‘Draft Articles on the Law
of Treaties with commentaries’, *Yearbook of the International Law Commission*, 1966, vol. II,

215 Ward and others, *The Interpretation of Income Tax Treaties with Particular Reference to the
*Internasjonal Inntektsskatterett* (2009), p. 79. Ward and others also state that reference
to the Commentaries would be appropriate if it “throws a useful light on the intentions of
the negotiators”. In my view, the intentions of the treaty negotiators (who are government
officials of the contracting states) are irrelevant to the interpretation of a DTT, as it is not the
treaty negotiators who are parties to the DTT.

216 Vogel and others, *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf
Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), paras. 114 and 124. See also
In my view, it is important when taking the Commentaries into account to keep in mind that they are negotiated and adopted by governmental representatives (i.e. by representatives of the tax creditor) without approval by the legislature. Thus, insofar as the interpretation advocated by the Commentaries is to the detriment of the taxpayer, it may be inappropriate and possibly contrary to constitutional or other legal principles to rely on them.217

There is also reason for caution where one or both contracting states is not a member of the OECD and may have had limited or no influence on the drafting of the Commentaries and may not have been given a chance to express dissent against the interpretations suggested by the Commentaries. In this respect it should be noted that in recent years many non-member states have been given the opportunity to participate in the development of the OECD Model and to express their positions with regard to the Commentaries. The Commentaries may therefore be relevant to DTTs concluded with or between non-member states as well, although there may be reason for caution where a non-member state which has not been given the opportunity to express disagreement with the Commentaries is involved.218

In the discussions concerning the legal basis for the Commentaries, the authors usually try to find a basis that would be accepted in an international law context, for instance by subsuming the Commentaries under the interpretational rules of the VCLT. As such authors will typically be concerned with the relevance of the Commentaries in the relation between a state and its taxpayers (not in the relation between the contracting states), there is in doing so an implicit assumption that international law is allowed to exercise at least some form of influence on domestic law. However, it would also be possible to search for a legal basis in legal sources of relevance for the application of domestic law. Again, the relevance of such legal basis would depend on the relation between international law and domestic law in the state applying the DTT. For instance, it can be argued that the international law dimension of a DTT would preclude a state from applying domestic legal sources. If so, a domestic legal basis for the Commentaries would be of no interest. However, insofar as domestic legal sources can be applied for interpreting DTTs in their capacity as domestic legislation, it may be relevant to

218 Baker, Double Taxation Conventions (2005), Introductory Topics, E.17.
look for a legal basis for reference to the Commentaries in such sources. For instance, legislation giving domestic law effect to a DTT or materials relating to such legislation may refer to the OECD Model in general or to the Commentaries in particular. The use of domestic legal sources is discussed further in the sub-chapter on unilateral materials (see sub-chapter 3.8.7).

With regard to Sweden, the Commentaries are not annexed to the DTTs, nor are they referred to in the Incorporation Acts or in the DTTs. It is thus clear that the Commentaries are not legally binding statutes under Swedish law and do not in themselves give rise to any rights or obligations for Swedish taxpayers. This means that there is no obligation under Swedish domestic law to apply the Commentaries when interpreting the articles of a DTT entered into by Sweden. However, preparatory works relating to Incorporation Acts frequently refer to the Articles of the OECD Model and usually comment in particular on any deviations. This may be taken as evidence of the legislator’s intent that the DTT articles in question shall be interpreted in accordance with the Commentaries, insofar as the DTT complies with the Articles of the OECD Model.219

5. General conclusions
My conclusions on the subject of the legal relevance of the Commentaries of the OECD Model can be summarised as follows. The Commentaries are not legally binding instruments. Therefore they cannot in themselves provide conclusive evidence of the ordinary or special meaning of a term in a DTT. Additional evidence is required. The question as to whether the meaning given to a DTT term in the Commentaries corresponds to the ordinary or special meaning of that term must therefore be answered on a case by case basis taking into account other sources than the Commentaries. In some cases the Commentaries can provide partial but not conclusive evidence of the ordinary or special meaning of a term.220 Furthermore, they can occasionally also provide evidence of a subsequent practice or international custom. In such cases, it follows from the VCLT that there is a binding obligation under international law to follow the interpretation advocated by the Commentaries, which may or may not lead to a corresponding obligation at

220 Cf. Wattel & Marres, ‘The Legal Status of the OECD Commentary and Static or Ambulatory Interpretation of Tax Treaties’, ET, 2003, p. 226, who state that the meaning of a term according to the Commentaries may be an indication of its ordinary meaning and that the Commentaries can shed light on the ordinary meaning of treaty terms, but do not seem to believe that the Commentaries can provide conclusive evidence of the ordinary meaning.
the national level, depending on the relationship between international law and domestic law in the state in which the DTT is being applied.

Where there is insufficient evidence in addition to the Commentaries to establish the ordinary or special meaning of a term or a subsequent practice or international custom, the interpretation favoured by the Commentaries will not be binding under international law. Furthermore, the interpretation advocated by the Commentaries will typically not be binding under domestic law. Even so, it is permissible to refer to the Commentaries under general principles of law and it may often be appropriate to do so if the Commentaries are helpful in establishing the meaning of a particular tax treaty provision, provided that the DTT text in substance complies with the Articles of the OECD Model and that the Commentaries are not contradicted by the DTT text or by other material that has a more solid legal basis. However, such reference is discretionary and may be unconstitutional or otherwise inappropriate where it works to the detriment of a taxpayer.

6. Swedish case law

In the jurisprudence of HFD, reference has been made to the Commentaries in a number of cases, mostly without any elaboration as to the legal basis for so doing. Only in a few cases has HFD discussed the legal basis for referring to the Commentaries.

In the court case RÅ 1996 ref. 84, the question was whether a Luxembourg fund company was to be treated as transparent for tax purposes under Swedish law. The answer depended on whether the company was deemed not liable to tax and hence not resident in Luxembourg for the purpose of the DTT between Sweden and Luxembourg. In its ruling, HFD held that that DTT interpretation shall be aimed at establishing the common intention of the parties by use of the methods and means provided in Articles 31–33 VCLT. Furthermore, HFD made the following statement:

In addition to these general guidelines [i.e. the interpretational principles provided by the VCLT], within the field of international taxation special weight should often be attributed to the model convention of the OECD and the commentaries to the convention that have been developed by the organisation. Where a DTT or a provision in such a treaty conforms to the model convention,

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221 See for instance RÅ 1987 ref. 158, RÅ 1991 ref. 107 (as regards the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, which form an integral part of the Commentary to Art. 9 of the OECD Model, cf. the OECD Model, Commentary to Art. 9, para. 1), RÅ 1991 not. 228, RÅ 1993 not. 677, RÅ 2001 ref. 38, and RÅ 2001 ref. 50.
there is normally reason to assume that contracting parties intended to achieve a result in accordance with the result recommended by the OECD … 222

Thus, HFD did not subsume the Commentaries under any particular VCLT provision, but recognised that the Commentaries can play an important role in DTT interpretation on the basis that they provide evidence of the intention of the contracting states. The same reasoning can be found other HFD cases as well.223

In my view, HFD’s reference to the intention of the contracting states, without any evidence of the intention of the parties other than the conformity of the DTT text with that of the OECD Model, can be described as a subjective approach and is hard to reconcile with the textual approach of the VCLT.224 However, the fact that HFD refers to the Commentaries as an element that should be taken into account in addition to the interpretational rules of the VCLT and that HFD does not give the impression that it believes itself to be bound by the Commentaries is consistent with the difficulty of subsuming the Commentaries under any particular VCLT provision. Consequently, a reference to the Commentaries on the basis referred to by HFD is permissible under general principles of law but is discretionary and must be used with caution.

3.8.3.3 Reservations to the Articles, Observations to the Commentaries, and Positions Expressed by Non-Member States

As noted above, the governments of the member countries of the OECD are recommended to enter into DTTs conforming to the Articles of the OECD Model.225 Since it is merely a recommendation, a member country is not bound by the Articles unless they are included in a treaty with another state. In such case the Articles become binding under international law and may also become binding under domestic law on the basis of the monistic or dualistic approaches described above.

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222 The author’s translation. In Swedish, the statement reads as follows: “Utöver dessa allmänna riktlinjer bör inom området för internationell beskattning särskild betydelse ofta tillmätas OECD:s modellavtal och de kommentarer till avtalet som utarbetats inom organisationen. Har ett dubbelskattningsavtal eller en bestämmelse i ett sådant avtal utformats i överensstämmelse med modellavtalet, bör det normalt finnas fog för antagande av att avtalsparterna avsett att uppnå ett resultat som överensstämmer med vad OECD rekommenderat …”

223 See RÅ 1987 ref. 162 and RÅ 1995 not. 68.


Even though member states are free to depart from the Articles of the OECD Model, they may enter reservations in the OECD Model on the Articles. According to the VCLT, the purpose of entering a reservation to a provision of an international treaty is to “exclude or to vary the legal effect of certain provisions of the treaty in their application to that State”. However, as the OECD Model is not a binding treaty there is no need for excluding or varying the legal effect of its provisions. Instead, the effect of a reservation is merely to declare that the state in question does not intend to enter into DTTs on the basis of the OECD Model in that particular respect.

Furthermore, observations on the Commentaries may be inserted at the request of member countries that are unable to concur in the interpretation of an Article made in the Commentaries. Such observations do not express disagreement with the wording of the Article, but indicate that the member country in question favours a different interpretation of the Article.

Moreover, since the influence of the OECD Model has extended beyond the OECD member countries, the process for updating the Articles and Commentaries has been opened up to input from non-member countries and 31 non-member countries have been given the opportunity to express their positions on the Articles and Commentaries.

According to the Commentaries, member countries should conform to the Articles as interpreted by the Commentaries and having regard to the reservations contained therein and their tax authorities should follow these Commentaries “subject to their observations thereon”. Furthermore, the Commentaries point out that observations do not express disagreement with the Articles, but “usefully indicate the way in which those countries will apply the provisions of the Article in question”. Thus, the Commentaries recognise that states which have requested an observation to be inserted in the Commentaries do not have to follow the Commentaries in that particular respect.

It can be argued that an observation inserted at the request of a state provides evidence of that state’s intention when concluding DTTs in the particular mat-

226 Cf. the OECD Model, Introduction, paras. 31–32.
227 Art 2.1(d) VCLT.
228 The OECD Model, Introduction, para. 30.
229 See “Non-OECD Economies’ Positions on the OECD Model Tax Convention” at pp. 425–463 of the Condensed version of the OECD Model. Estonia and Israel have expressed their positions in their capacity as non-members, but have become members in 2010.
230 The OECD Model, Introduction, para. 3.
231 The OECD Model, Introduction, para. 30.
ter which is covered by the observation. However, since the intention expressed in the observation is not expressed in the text of the treaty, the extent to which it shall be taken into account will depend on the value attributed to the Commentaries. So far, there seems to be no consensus among the member countries regarding the consequences for DTT interpretation of having observations on the Commentaries inserted. Another interesting question is whether a contracting state which has entered into a DTT with another state which has requested an observation to be inserted into the Commentaries shall be considered to have agreed on the interpretation made by that state in the absence of an objection, if it shall be considered to have accepted a non-symmetrical interpretation, or if it shall be considered to insist on a different interpretation.

Sweden has entered reservations on Articles 8, 13, 15, 21, and 22. Four out of six reservations made relate to taxation of the air transport consortium Scandinavian Airlines System (SAS). Only one observation, on Article 7, has been inserted at the request of Sweden. It concerns the attribution of “free” capital for the purpose of attributing profits to a PE. Sweden does not agree with the approaches included in the OECD Report Attribution of Profits to Permanent Establishments.

3.8.3.4 Ambulatory or Static Reference to the Commentaries

Since the Commentaries are of less or no relevance as a source of law where the DTT article in question does not in substance comply with the corresponding Article of the OECD Model, post-treaty amendments to the Commentaries that are a direct result of changes to the Articles are generally of little or no value for interpreting DTTs. However, amendments to the

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233 The OECD Model, Commentary to Art. 8, para. 33, Commentary to Art. 13, paras. 39 and 44, Commentary to Art. 15, para. 15, Commentary to Art. 21, para. 14, and Commentary to Art. 22, para. 12.
234 The OECD Model, Commentary to Art. 7, para. 82.
235 Cf. the OECD Model, Introduction, para. 35. Such amendments may, however, provide grounds for an *argumentum e contrario*. The OECD Model, on the other hand, states in the Introduction, para. 36, that the CFA “disagrees with any form of *a contrario* interpretation that would necessarily infer from a change to an Article of the Model Convention or to the Commentaries that the previous wording resulted in consequences different from those of the modified wording”. Further, it says that “[m]any amendments are intended to simply clarify, not change, the meaning of the Articles or the Commentaries, and such *a contrario* interpretations would clearly be wrong in those cases”. Naturally, *e contrario* arguments cannot be applied where it can be established that a change is indeed a clarification. However, the fact that the Commentaries claim that a change is meant as a clarification is in my view not
Commentaries are often made without any changes to the corresponding Article being implemented. In such cases, the question arises as to which version of the Commentaries is relevant – the Commentaries current at the time of conclusion of the DTT or a later version. According to the Commentaries themselves, existing DTTs should, as far as possible, be interpreted “in the spirit of the revised Commentaries”.\footnote{The OECD Model, Introduction, paras. 33–34.}

Whether it is the version of the Commentaries present at the time of the conclusion of the DTT or a later version that shall be considered as relevant depends on the legal basis for reference to the Commentaries (see sub-chapter 3.8.3.2). First, it can be established that later amendments to the Commentaries are not relevant for determining what the intentions of the contracting states were at the time when the DTT was concluded. Thus, insofar as the intention of the contracting states is considered as the relevant basis for reference to the Commentaries, it would be inconsistent to refer to Commentaries that postdate that time.\footnote{Cf. Barenfeld, Taxation of Cross-Border Partnerships (2005), pp. 45–47.} Second, it can be established that later amendments are not part of the context as defined in Article 31.2 VCLT, since they were not made in connection with the conclusion of the treaty. Third, it may at first glance seem reasonable to subsume later Commentaries under Article 31.3 VCLT, which refers to “any subsequent agreement between the parties regarding the interpretation of the treaty or the application of its provisions” and “any subsequent practice in the application of the treaty which established the agreement of the parties regarding its interpretation”. However, as pointed out above in sub-chapter 3.8.3.2, the Commentaries were not made by the parties to the DTT, but rather by a collective of states represented by their government officials, they do not relate to any particular treaty, and they have not gained approval by the national legislators. Consequently, they can hardly be deemed to constitute a subsequent agreement in the sense of Article 31.3(a) VCLT. It may be possible for the Commentaries to give rise to a subsequent practice in the sense of Article 31.3(b) VCLT, provided that the DTT is applied in accordance with the Commentaries during a number of years, although that would rule out the use of recent Commentaries. However, it can be questioned whether a consistent application of a DTT by national courts and tax authorities can be said to establish the interpretation of the DTT in a way that is binding on the contracting states in accordance with Article 31.

sufficient to conclude that there has been no change of meaning and that there are no grounds for \emph{e contrario} arguments.
VCLT. Thus, Article 31.3(b) VCLT does not seem to provide a solid basis for reference to later Commentaries.

It can be argued that later Commentaries, just as the Commentaries current at the time of conclusion of the DTT, may provide evidence of the ordinary or special meaning of a DTT term (cf. Articles 31.1 and 31.4 VCLT). However, since the fact that a treaty term is attributed a certain meaning in the Commentaries does not automatically cause that meaning to become the ordinary meaning in the sense of Article 31.1 VCLT or a special meaning under Article 31.4 VCLT, some authors argue that the Commentaries can only provide evidence of the ordinary or special meaning of a term if they have been present for a certain period of time.\(^{238}\)

As regards the ordinary meaning of a term referred to in Article 31.1, there is no indication in the VCLT that only the ordinary meaning at the time of conclusion of the treaty shall be taken into account.\(^{239}\) It is therefore in my view possible that later Commentaries may provide evidence of the ordinary meaning of a DTT term. As pointed out above, the evidence will generally be stronger the longer the commentary in question has been present in the Commentaries. However, as the binding nature of an ordinary meaning according to the VCLT – Article 31.1 VCLT uses the word *shall* – is inconsistent with the prevailing opinion that the Commentaries are not legally binding instruments it seems reasonable to require that evidence of the ordinary meaning can also be found elsewhere for an ordinary meaning to be considered established (see sub-chapter 3.8.3.2).

Article 31.4 VCLT on the other hand provides that a special meaning shall be given to a term if it is established that the parties so intended, i.e. it refers to the intention of the contracting states when concluding the treaty and thus does not permit the taking into account of a special meaning derived from later Commentaries.\(^{240}\)

\(^{238}\) Vogel and others, *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Einleitung, para. 128. See also Dahlberg, ‘Vilket rättskällevärde har kommentaren till OECD:s modellavtal?’ in Arvidsson, Melz & Silfverberg (eds.), *Festskrift till Lindencrona* (2003), pp. 151–154. According to Dahlberg, Commentaries that have not yet led to the establishment of an ordinary or special meaning can normally be regarded as such “supplementary means of interpretation” as are referred to in Art. 32 VCLT.


\(^{240}\) Cf. Ault, ‘The Role of the OECD commentaries in the interpretation of tax treaties’
Although later Commentaries are neither “the preparatory work of the treaty”, nor “circumstances of its conclusion”, it is possible that they can be regarded as supplementary means of interpretation in accordance with Article 32 VCLT as that provision does not provide an exhaustive definition of supplementary means of interpretation. If so, there would be a legal basis for referring to them, but only in those limited situations which are referred to in Article 32 VCLT.241

Finally, as concluded above, it is permissible to refer to the Commentaries under general principles of law if (i) the DTT text complies in substance with the Articles of the OECD Model and (ii) the Commentaries are not contradicted by the DTT text or by other material that has a more solid legal basis. The same reasoning applies to later Commentaries. However, such reference to the Commentaries is discretionary and should be used with caution as it may be unconstitutional or otherwise inappropriate where it works to the detriment of a taxpayer.242 In particular, the use of later Commentaries is likely to raise constitutional concerns where it changes the meaning of a DTT provision. It may be possible to interpret the legislators approval of a DTT conforming to the Articles of the OECD Model as an indirect approval of the Commentaries that were current at the time when the DTT was concluded, but the same reasoning can hardly be applied in respect of later Commentaries that were unknown to the legislator at the time when the DTT was approved.243

HPD has not expressed any clear position as to whether a static or ambulatory approach is to be adopted. However, in RÅ 1996 ref. 84, the court stated that, at the time of conclusion of the DTT, the Commentary to Article 4 of the OECD Model did not include any statements that could provide guidance for the interpretation in question. Further, it pointed out that some amendments had been made in later Commentaries, but disregarding that these amendments were made several years after the conclusion

242 Baker, Double Taxation Conventions (2005), Introductory topics, E.15.
of the DTT, they seemed to lack relevance for the type of companies in question. Although HFD did not expressly say whether a static or ambulatory approach shall be adopted, the statements made by HFD appear to indicate a reluctance to take later Commentaries into account.\textsuperscript{244} This reluctance seems consistent with the court’s emphasis on the intention of the contracting states at the time of conclusion of the DTT.

3.8.4 The UN Model

The League of Nations began working with the first model bilateral convention in 1921, and the first model convention was presented in 1928. Revised models were presented in 1943 (The Model Convention of Mexico) and 1946 (The Model Convention of London). The Fiscal Commission of the United Nations ceased in 1954 and the baton was picked up by the OECD (at that time named “OEEC”). In the mid-1960s, the United Nations began to take a renewed interest in the problem of double taxation, as a result of the continued increase in the number of developing Member States and as part of its action aimed at promoting the flow of foreign investment to developing countries. That renewed interest led to the setting up of a working group of tax experts, which formulated guidelines that resulted in a model convention together with commentaries, adopted in 1979 and published in 1980. The 1977 OECD Model was used as the working group’s main reference text in order to take advantage of the accumulated technical expertise embodied in that convention and the commentaries thereon and also for reasons of practical convenience stemming from the fact that the convention was being used by OECD member countries in the negotiation of tax treaties not only with each other but also with developing countries. The commentaries of the UN model convention incorporated the views of the members of the group and also reproduced, where appropriate, the Commentaries on the Articles of the 1977 OECD Model. In 1999, a revised version was adopted, with the objective of taking account of developments since 1980 in the globalisation of trade and investment and in the international tax policies of industrialised and developing countries, for instance the advent of new financial instruments, new transfer pricing mechanisms, the growth of tax havens and subsequent OECD Model updates.\textsuperscript{245}

\textsuperscript{245} The historic background description is based on the UN Model, Introduction, Ch. A. Origin of the United Nations Model Convention and Ch. B. Historical setting of the United Nations Model Convention.
In most respects, the UN Model is based on the OECD pattern. However, the OECD Model emphasises the residence principle, i.e. the taxing right of the residence state is given precedence over the taxing right of the source state. The UN Model recognises that such a pattern may not be equally appropriate in treaties between developing and industrialised countries because capital investment is largely made from industrialised countries to developing countries and funds consequently largely flow from developing to industrialised countries. The revenue sacrifice of the source state would therefore be one-sided. Consequently, the UN Model does not recommend the relatively low tax rate limitations for the source state provided for by the OECD Model in respect of dividends and interest, but leaves it to the contracting states to establish maximum tax rates in bilateral negotiations.\footnote{Arts. 10 and 11 of the UN Model.}

Furthermore, the UN Model provides for the imposition of tax at source in respect of royalties arising in the source state, whereas the OECD Model reserves an exclusive right for the residence state to tax such royalties.\footnote{Art. 12 of the UN Model.} Consequently, the double tax relief article of the UN Model provides for the application of the principle of credit in respect of royalties. In all other respects, the double tax relief article of the UN Model corresponds to that of the OECD Model.\footnote{Arts. 23 A and 23 B of the UN Model.}

The conclusions drawn above in sub-chapter 3.8.3.2 concerning the legal basis for reference to the Commentaries of the OECD Model apply, \textit{mutatis mutandis}, to the commentaries of the UN Model.

### 3.8.5 Mutual Agreements

Most DTTs include a clause that provides for a mutual agreement procedure whereby the competent authorities of the contracting states are obliged to endeavour to resolve cases of double taxation not in accordance with the DTT, to resolve problems relating to the interpretation or application of the DTT, and to consult together for the elimination of double taxation in cases not provided for in the DTT.\footnote{Cf. Art. 25.2-3 of the OECD Model.} Mutual agreements can be used both for solving individual cases and general issues of DTT interpretation and application.

The mutual agreement procedure clause of the OECD Model authorises the competent authorities of the contracting states to communicate directly without going through the regular diplomatic channels.\footnote{Art. 25.4 of the OECD Model.} The term com-
petent authority is usually defined in the DTT as the tax authority (or the highest tax authority if there is more than one) of each contracting state. Swedish DTTs typically define competent authority as the Minister of Finance, his authorised representative or the authority which is designated as a competent authority for the purposes of the DTT. According to Swedish internal law, the function of competent authority is normally exercised by the Swedish Tax Agency.

There seems to be widespread agreement that mutual agreements aimed at resolving problems relating to the interpretation or application of a DTT can be regarded as subsequent agreements under Article 31.3(a) VCLT, at least insofar as they do not go further than a fair and reasonable interpretation of the DTT would. According to Article 31.3 VCLT, such subsequent agreements shall, for the purpose of interpreting a DTT, be taken into account together with the context. According to the International Law Commission, an agreement as to the interpretation of a provision which is reached after the conclusion of the treaty represents an authentic interpretation by the parties which must be read into the treaty for purposes of its interpretation. This implies that subsequent agreements and, hence, mutual agreements can be

251 Cf. Art. 3.1 f) of the OECD Model and the OECD Model, Commentary to Art. 3, para. 7.
253 Cf. the first sentence of Art. 25.3 of the OECD Model.
considered binding under international law. In other words, the competent authorities act as representatives of the contracting states and are authorised by delegation to conclude an agreement regarding the interpretation of the DTT or the application of its provisions.

The question whether the contracting states will in fact consider themselves bound by the mutual agreement under international law is another matter. On the one hand, it can be argued that the inclusion of a clause on a mutual agreement procedure in a DTT in effect delegates competence to the competent authority to conclude agreements regarding the interpretation of the DTT (but not the power to enter into agreements that constitute treaty amendments). On the other hand, domestic constitutional law may require approval by the legislator in order for an international agreement to become effective. Furthermore, it is another matter whether it would be possible to interpret the clause on the mutual agreement procedure as a delegation of power for domestic law purposes and whether such a delegation would be permissible.\textsuperscript{256} This issue has to be determined on the basis of the domestic law of the state applying the treaty.

As far as Swedish law is concerned, it is clear that from a constitutional point of view implementation into Swedish law by means of enactment of new legislation by the Swedish Parliament would be required in order for a mutual agreement to be attributed domestic law effect.\textsuperscript{257} Thus, Swedish courts are not bound by a mutual agreement entered into by the Swedish competent authority with the competent authority of another state.\textsuperscript{258}

Even though mutual agreements are not binding under Swedish domestic

\begin{footnotesize}
\textsuperscript{256} In some states courts have an exclusive right to interpret treaties, which may preclude the competent authority from concluding a mutual agreement concerning the interpretation of a DTT, cf. the OECD Model, Commentary to Art. 25, para. 53.

\textsuperscript{257} Ch. 8 sec. 2 RF. See also Mattsson, ‘Ömsesidig överenskommelse’, \textit{SvSkT}, 1990, No. 3, p. 161, and Boström & Tyllström, ‘Sweden’ in Vogel & Prokisch (general reporters), \textit{Interpretation of double taxation conventions} (1993), p. 566. In a few cases, Swedish mutual agreements have been given domestic law effect by means of approval by the Swedish Parliament, see Lindencrona, \textit{Dubbelbeskattningsavtalsrätt} (1994), p. 82. In recent years, the Swedish competent authority has only seemed to conclude mutual agreements relating to individual cases.

\textsuperscript{258} HFD has made it clear in its rulings RÅ 1983 Aa 185–188 that it does not consider itself to be bound by mutual agreements relating to individual taxpayers. Contrary to agreements by the Swedish Ministry of Finance and its counterpart in France under which the taxpayers in question were to be deemed non-resident in France for the purpose of the DTT between Sweden and France, HFD held that the taxpayers were resident in France. HFD expressly stated that negotiations and measures of the Swedish and French Ministries of Finance were not binding on the tax courts. It is submitted that the outcome would be the same as regards mutual agreements relating to general issues of interpretation and application.
\end{footnotesize}
law, it is permissible for a court to refer to a mutual agreement under general principles of law if it is helpful in establishing the meaning of a particular tax treaty provision, provided that it represents a reasonable interpretation of the DTT text and is not contradicted by other material with a more solid legal basis. However, such reference is discretionary and may be unconstitutional or otherwise inappropriate where it works to the detriment of a taxpayer.259 There is also an additional reason for caution insofar as mutual agreements that work to the detriment of a taxpayer are concerned, as mutual agreements are typically not published and can therefore not be assumed to be known to the taxpayer. Furthermore, where a mutual agreement is the result of a negotiation involving trade-offs, it may be inappropriate as a basis for interpretation.260

According to the Commentaries, mutual agreements resolving general difficulties of interpretation or application are binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.261 As follows from the above there may be reasons from the point of view of domestic law for considering such mutual agreements as non-binding. However, even where a mutual agreement has not been given domestic law effect, there are good reasons for a taxpayer to expect the tax authorities to follow it where it works in favour of the taxpayer, especially where the tax authorities have concluded the mutual agreement in their capacity as competent authority.262

3.8.6  Internal Law – In Particular by Reference in the Interpretational Rule of the Treaty

1. Introduction
This section deals with the use of internal law for the purpose of interpreting DTT provisions. This is to be distinguished from the use of internal law as a complement to DTT provisions where a subject matter is dealt with by

259 Cf. the reasoning concerning the legal basis for reference to the Commentaries in sub-ch. 3.8.3.2.
261 The OECD Model, Commentary to Art. 25, para. 54.
262 According to sec. 16 lag (2009:1289) om prissättningsbesked (Eng. Advance Pricing Agreement Act), an advance pricing agreement between the Swedish Tax Agency and a taxpayer is binding on the Swedish Tax Agency, which for the taxpayer has the same effect as if the Swedish Tax Agency would have been bound by the underlying mutual agreement itself.
internal law but not or only to a limited extent by the DTT in question (cf. sub-chapter 3.1).

Ideally, all terms used in a DTT would be defined in the DTT, so that it would be possible to apply the DTT autonomously, without reference to the internal laws of the contracting states. This would, at least in theory, lead to a complete harmonisation of the application of the DTT by the contracting states, thereby avoiding remaining double taxation and unintentional double non-taxation resulting from differences in the interpretation of DTT terms. However, in practice it is not possible to provide all-embracing definitions within the framework of a bilateral treaty. Sometimes terms are expressly defined in the DTT while on other occasions the meaning of a term must be sought by interpretation of the DTT. However, in many instances the DTT in question may be silent or unclear, which means that little or no evidence of the meaning of a term can be found in the DTT. In such cases, the meaning of the term may be sought in the internal law of one of the contracting states. Most DTTs therefore contain a rule of interpretation which refers to internal law as regards the meaning of terms not defined in the DTT. The interpretational rule of the OECD Model is worded as follows.

ARTiCLE 3
GENERAL DEFiNiTiONS

2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

2. The meaning of “not defined therein”
As the interpretational rule only applies to terms that are not defined in the DTT, an important question is whether a term can be said to be defined only where an express definition has been included in the DTT or if it is sufficient that the meaning of a term can be derived through interpretation of the DTT. In my view the term “defined” indicates that there must be an express definition of the term. However, if the meaning of a term can be derived through interpretation of the DTT, that may be of relevance for determining whether the context requires that another meaning than the meaning under internal law shall be applied.

The Articles of the OECD Model contain express definitions of terms such
as person, company, enterprise, international traffic, competent authority, national, business, taxes on income and on capital, resident of a contracting state, permanent establishment, immovable property, dividends, interest, and royalties, which may preclude a contracting state from referring to internal law on the basis of the interpretational rule. An interesting question as regards these terms is whether the reference to internal law in the interpretational rule of the DTT is also applicable where a definition of a term has been included in the DTT but does not provide sufficient clarity as to the meaning of the term in a specific case. It can be argued that although the term should in such case primarily be interpreted on the basis of the treaty text, internal law may be applied by reference in the interpretational rule of the DTT to define an expression used in the course of a definition in the treaty or to complete a definition when a DTT partially defines a term by saying that it includes certain things. If so, recourse to internal law on the basis of the interpretational rule may in practice be of relevance not only to undefined terms, but also to terms that have been defined in the DTT, where a sufficiently clear meaning cannot be derived through interpretation of the DTT. Even if the interpretational rule would not be considered applicable, it may be necessary to fall back on internal law where the meaning of a term according to the definition of a DTT is not sufficiently clear.

3. Other DTT references to internal law
Some definitions in the OECD Model include references to the internal laws of the contracting states. This is the case as regards the terms resident of a contracting state, immovable property, and dividends. As regards the term resident of a contracting state, reference is made to the state or states in which the person is liable to tax by reason of domicile, residence, etc. As regards immovable property, it is the law of the state in which the property is situated that shall be applied. The reference to internal law in the definition of dividends is made to the laws of the state of which the company making the distribution is a resident. Where the DTT defines a term by making reference to the internal law of a contracting state, internal law is applied on the basis of that reference and the interpretational rule is not applicable.

263 Arts. 2.2, 3, 4.1, 5, 6.2, 10.3, 11.3, and 12.2 of the OECD Model.
265 Arts. 4, 6.1, and 10.3 of the OECD Model.
266 Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Commentary to Art. 3, para. 107.
4. R’s or N’s internal law?

As follows from the above, the interpretational rule of the OECD Model concerns the “application of the Convention … by a Contracting State” and refers to the meaning that the undefined term has under the law “of that State”. In other words, the interpretational rule of a DTT typically refers to the internal law of the state that applies the DTT. Consequently, the general view is that it is the internal law of the contracting state in which the DTT is applied that is relevant, regardless of whether that state acts in its capacity as R or N. Where the meaning of an undefined DTT term under the internal laws of R and N differs, R and N are therefore likely to interpret the term differently on the basis of their respective internal laws. A suggestion aimed at avoiding such differences in interpretation where recourse is had to internal law has been put forward by Déry & Ward and by Avery Jones.267 According to this suggestion it is always the internal law of N which shall be applied. The reasoning behind this suggestion is as follows. Article 3.2 of the OECD Model concerns the “application of the Convention”. It is N which applies the DTT to determine whether it may tax an item of income or whether its taxing right is limited in some way. There is no need for the interpretational rule in R. All R does is to check whether N has correctly applied the DTT and, if so, grant double tax relief. If there is no definition of a term in the DTT and the context does not require that a term is given a different meaning than it has under the law of N, then an application of the DTT in N on the basis of the meaning of the term under N’s law is in accordance with the DTT, meaning that R shall provide double tax relief regardless of the meaning given to the term under R’s internal law.

However, this suggestion has not gained general acceptance. As pointed out above, Article 3.2 of the OECD Model refers to the application of the DTT by “a Contracting State” (i.e. by either contracting state applying the DTT) and in no way indicates that only N applies the DTT.268 Furthermore, although an interpretation based on the meaning given to a term in N would decrease the risk of diverging interpretation in the contracting states and, as a consequence, would better serve the purpose of relieving double taxation while avoiding double non-taxation, it can be argued that an equally important objective is to achieve a balanced allocation of taxing rights.


R would be bound by the meaning given to a term under the internal law of N and, as a result might be obligated to provide double tax relief on the basis of the classification of an item of income made under N’s law, that balance might be disrupted.\textsuperscript{269} In other words, a reference to the internal law of N would in effect constitute a delegation of legislative power to N. In practice it is therefore unlikely that R would accept such a solution.

Interestingly, HFD has made reference to the internal law of Sweden’s treaty partner, in spite of the prevailing view that it is the internal law of the state applying the DTT which is relevant, unless the context requires otherwise. In RÅ78 1:22, HFD held that the term “fiscal year” was to be interpreted on the basis of the internal law of the state in which the taxpayer had temporarily stayed, which in that case meant that the meaning under the internal law of South Africa was applied.\textsuperscript{270}

5. The meaning of “unless the context otherwise requires”
Where a term is not defined in the DTT in question, the meaning found in the internal law of the state in which the DTT is applied for the purposes of the taxes to which the DTT applies shall as a main rule be applied. Where a term is defined differently for the purposes of different laws of that contracting state, the meaning given to the term under the tax laws of that state shall prevail over the meaning given to it under other laws.\textsuperscript{271} However, if the context requires that a different meaning is applied, that meaning shall be applied instead. Thus, the questions are how far one should go in endeavouring to find the meaning of a term in the context and to what extent the context shall be considered to require the non-application of an internal law meaning.\textsuperscript{272}

The first question depends partly on the scope given to the term “context”. If “context” is understood in a wide sense it is more likely that the meaning of a term can be found in the context, potentially leading to the non-application of internal law.\textsuperscript{273} According to the Commentaries of the

\textsuperscript{269} Michelsen, \textit{International Skatteret} (2003), p. 79.
\textsuperscript{270} Mattsson, ‘Tolkning av dubbelbeskatteringsavtal’ in Mattsson, \textit{Skrifter i internationell skatterätt} (2002), pp. 217–218, who notes that the ruling can be reconciled with the interpretational rule if the context is deemed to require that the term is interpreted in accordance with the meaning under South African internal law.
\textsuperscript{271} The OECD Model, Commentary to Art. 3, para. 13.1.
\textsuperscript{273} For instance, referring to the origin of the term “context” and the unsatisfactory result of interpretation on the basis of internal law, Vogel and others argue that “context” shall be understood in a wide sense, see \textit{Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen} (2008), Art. 3, para. 121.
OECD Model, the context is determined in particular by the intention of the contracting states when signing the DTT as well as by the meaning given to the term in question in the legislation of the other contracting state. According to the Commentaries, the wording is intended to provide a balance between the need to ensure the permanency of commitments entered into by states when signing a DTT (a state should not be allowed to make a DTT partially inoperative by subsequent amendment in internal law of the scope of a term not defined in the DTT) and the need to be able to apply the DTT in a convenient and practical way over time.274 The reference in the Commentaries to the intention of the contracting states when signing the DTT and the meaning given to the term in question in the legislation of the other contracting state implies that the context referred to in Article 3.2 of the OECD Model would not have the limited scope that it has under Article 31.2 VCLT, in which the primacy of the treaty text is underlined.

The expression “unless the context otherwise requires” in the interpretational rule is in itself subject to the interpretational rules of the VCLT, i.e. it shall be interpreted in accordance with the ordinary meaning to be given to the terms in their context and in the light of the object and purpose of the treaty. It can be argued that since DTT terms are used in a DTT context, the term “context” shall comprise the DTT as a whole as well as its object and purpose, but not elements outside the DTT.275 This seems to be the position of HFD, which in RÅ 2009 ref. 91 stated that the expression “unless the context otherwise requires” seemingly means what can be derived through regular interpretation of the DTT. On the other hand, it can be argued that it does not make sense to give the expression “unless the context otherwise requires” such a narrow meaning because the VCLT context was not intended to be used in isolation from other factors, such as the object and purpose of the treaty, subsequent agreements and practice, and supplementary means of interpretation. The use of the word “context” in a limited sense, for instance on the basis of the meaning of context according to the VCLT, would have the effect of excluding such interpretational sources which the VCLT itself indicates are to be used.276 Consequently, it can be argued that all of the items which may be taken into account in interpreting treaties should be considered as “context” in the expression “unless the context otherwise requires”.

274 The OECD Model, Commentary to Art. 3, paras. 12–13.
Where a DTT term is interpreted on the basis of the internal laws of the contracting states, the risk of different interpretation in the contracting states increases and consequently, the risk of unresolved double taxation or double non-taxation also increases, for instance due to the application of different distributive rules on the same income. Thus, it can be argued that an interpretation derived from the context which avoids double taxation and double non-taxation is more consistent with the object and purpose of the DTT and therefore forbids a reference to internal law. However, in practice more than one interpretation can often be derived from the context, especially since there are different views as to what constitutes “context”. This means that the risk of double taxation or double non-taxation remains even if the context is taken to require that the term shall have a different meaning than under the internal laws of the contracting states. In my view, the context requires that a term is given a particular meaning where an interpretation on the basis of the context leads to an unambiguous result. Where more than one plausible meaning can be derived from the context, the internal law meaning shall normally prevail. Furthermore, the statement in the Commentaries referred to above implies that if a contracting state amends its internal law so as to change the balance of the DTT, that may constitute grounds for not applying the definition of a term under the internal law of that state. For instance, if a term was given a similar meaning in the internal laws of the contracting states at the time the DTT was entered into and the DTT was negotiated on the basis of that mutual understanding of the term, there may be reasons for not letting amendments of the internal law of one of the contracting states influence the meaning of the term. In my view, this is consistent with the general requirement in Article 31.1 VCLT of interpreting treaties in good faith.

6. Static or ambulatory reference to internal law
Since the 1995 version of the OECD Model, it is made clear that it is the legislation in force when the tax is imposed and not that in force when the DTT was signed which is relevant, by referring to the meaning that the term has “at that time”, i.e. when the DTT is applied. According to the Commentaries, the amendment was intended as a clarification. However, according to the Commentaries, the legislation in force when the DTT was concluded shall be taken into account in its capacity as context. If substantial changes

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279 The OECD Model, Commentary to Art. 3, para. 11.
have been made to the legislation, it may be inappropriate to refer to the legislation in force when the tax is imposed. In other words, the context may require that the meaning given to a term in the legislation applicable when the DTT was concluded shall prevail.280

Previous to the 1995 amendment, the interpretational rule did not include the phrase “at that time”. Even though the amendment to the interpretational rule of the OECD Model according to the Commentaries is meant as a clarification, it can be argued that it was in fact a change of meaning, since the previous wording could be interpreted as a reference to the legislation in force when the DTT was concluded and since legal certainty and the general principle of *pacta sunt servanda* speaks in favour of such an interpretation. Taxpayers should be able to obtain certainty about their future tax obligations and it should not be possible to extend the obligations to their disadvantage unless that change is accorded the same democratic legitimacy as the DTT itself. On the other hand, changes to the tax law would typically require involvement of the national legislator to at least the same extent as changes to the DTT would, so the principle of legal certainty may not constitute strong support for a reference to the legislation in force when the DTT was concluded. However, insofar as a DTT is interpreted on the basis of the perceived intention of the parties, it is the intention of the parties at the time the DTT was concluded which is relevant. Later developments were not known to the parties and were therefore not embraced by the agreement.281

An interesting case in this regard is RÅ 1987 ref. 162. In this ruling, the question was whether the remittance base clause of the DTT, which required income to have been remitted to the UK in order for Sweden to exempt it from taxation, covered capital gains. In spite of the fact that the interpretational rule referred to the applicable tax law (*Sw. gällande lagstiftning*), i.e. the tax law applicable when the DTT was applied, and that the term income according to Swedish law covered capital gains, HFD concluded that the term “income from a source” in the remittance rule did not cover capital gains since the intention of the parties at the time the treaty was concluded was to exclude capital gains. Presumably, HFD meant that the intention of the parties was relevant as “context” and required a different meaning to apply than the meaning under Swedish law when the DTT was applied.282

280 The OECD Model, Commentary to Art. 3, para. 12.
282 An issue which is discussed in sub-ch. 4.4.3 is whether it would have been possible to conclude on the basis of the DTT text that capital gains were covered by the term “income”,...
3.8.7 Unilateral Materials

Frequently, there are materials available concerning the interpretation of a DTT which have been made by one contracting state and which have not been approved or otherwise expressly recognised by the other contracting state. For instance, the government or tax authority of a contracting state may have issued guidelines on the interpretation of a specific DTT or on the interpretation of DTTs in general. Furthermore, many states have their own adaptation of the OECD Model as a basis for DTT negotiation and may have published their national model treaty together with some form of commentary. Moreover, the government of a contracting state may have presented its views on the interpretation of a DTT to the legislator in connection with the proposal to approve the DTT or in a government bill aimed at giving domestic law effect to the DTT.

As the contracting states to a DTT have not agreed on such unilateral materials, they clearly cannot in themselves be considered binding under international law. It is therefore relevant to ask whether the interpretational rules of the VCLT provide any legal basis for reference to unilateral materials.

Unilateral materials cannot be regarded as any such materials as are referred to in Article 31 VCLT as they do not constitute “context” in the sense of the VCLT (cf. Article 31.1-2 VCLT) and do not constitute a subsequent agreement or subsequent practice or relevant rules of international law (cf. Article 31.3 VCLT). Moreover, as unilateral materials only provide evidence of the intention of one of the contracting states, they cannot provide evidence of an intention of the contracting states to give a term a special meaning (cf. Article 31.4 VCLT). Furthermore, as the examples given in Article 32 VCLT refer to the treaty and the conclusion of the treaty and since the conclusion of the treaty requires the involvement of all parties to the treaty, it seems that Article 32 VCLT excludes unilateral materials. For instance, supplementary means of interpretation include the preparatory work of the treaty and the circumstances of its conclusion, but preparatory work of domestic legislation does not constitute preparatory work of the treaty. Only if it can be shown that a specific unilateral material reflects the view of both parties, can it be

in which case the substantial (and possibly excessive) efforts of HFD to establish the intention of the parties could have been avoided.


argued that it falls within the scope of Article 32 VCLT.\textsuperscript{285} However, in order to come to that conclusion other materials would be required, in which case these should be referred to rather than the unilateral material itself.\textsuperscript{286} Thus, the VCLT does not normally seem to provide any legal basis for reference to unilateral materials. In fact, it would be surprising if such a basis could be found as it would be inconsistent to take national materials into account for international law purposes.

Although unilateral materials may not be relevant for interpreting agreements under international law, it can be argued that such materials are relevant for interpreting DTTs in their capacity as domestic law on the basis of the rules and principles of legal interpretation applicable in the state in which the DTT is applied. This seems to be the position of the Swedish Government. For instance, in the Government Bill for the Incorporation Act relating to the DTT between Sweden and Estonia, the Government states that DTTs shall in principle be interpreted in the same way as other Swedish tax laws on the basis of the text and with the assistance of public preparatory works.\textsuperscript{287} The statement has been reiterated in other government bills.\textsuperscript{288} Furthermore, the fact that national courts are usually more familiar with domestic as opposed to international legal sources, may in practice give domestic legal sources the upper hand.

On the other hand, interpretation of a DTT on the basis of unilateral materials increases the risk of application of the DTT contrary to the interpretation that would follow from international law. In other words, the use of unilateral materials may result in a contracting state acting in breach of its treaty obligations.

HFD has on a number of occasions interpreted DTTs with reference to statements made in preparatory works relating to the Incorporation Act or with reference to guidelines on the interpretation of the DTT issued by the Swedish Government, i.e. on the basis of unilateral materials.\textsuperscript{289} It is likely


\textsuperscript{286} Avery Jones and others, ‘The Interpretation of Tax Treaties with Particular Reference to Article 3(2) of the OECD Model-II’, \textit{BTR}, 1984, Issue No. 2, pp. 97–98.


\textsuperscript{288} See Dahlberg, \textit{Svensk skatteavtalspolitik och utländska basbolag} (2000), p. 76, with further references.

\textsuperscript{289} See for instance RÅ 1987 ref. 162, RÅ 1989 ref. 37, RÅ 1995 not. 68, and RÅ 2004 ref. 20.
that the Swedish tradition of customarily using preparatory works for interpreting internal law has influenced HFD to interpret DTTs in a similar way. There are examples of references to unilateral materials in the case law of other countries as well. In the cases referred to, HFD has used statements in the preparatory works for the purpose of determining the intention of the contracting states. Thus, HFD’s use of unilateral material does not indicate that HFD interprets DTTs in the same way as domestic law, although under an international law approach it could be argued that reference to unilateral material is not permissible according to the VCLT.

3.9 Summary and Conclusions

DTTs function by limiting the taxing rights of the contracting states provided for under their internal laws. In other words, DTT provisions which limit a contracting state’s right to tax as provided for under internal law must generally prevail over internal law if the DTT is to have any effect. DTT provisions are typically given priority over internal law on the basis of express conflict rules or implied principles of statutory interpretation. In practice, the legal basis for giving priority to DTT provisions over internal law may be more or less clear.

Although DTTs function by limiting the taxing rights of the contracting states under their internal laws, the possibility of enacting national legislation which is contrary to a state’s obligations under international law seems to be a logical consequence of the dualistic approach. The political and judicial consequences of such a treaty override may, however, be severe. Courts in many states are therefore reluctant to give internal law priority over DTT provisions, unless it is clear that this was the intention of the legislator. HFD’s judgment in RÅ 2010 ref. 112 is in line with this approach, although some aspects of HFD’s position remain to be crystallised.

Countries that follow the dualistic approach distinguish, more or less consistently, between DTTs in their capacity as international and domestic law. Sweden is a country that seems to make a very clear distinction between the two, as is illustrated by the fact that domestic legislation which incorporates a DTT is applied with disregard to the DTTs effect (or lack of effect) in international law.

In spite of the distinction between DTTs in their capacity as international treaties and domestic law which is made by states that follow a dualistic

approach, DTTs in their capacity as domestic law are typically not interpret-
ed on the basis of the same principles and legal sources as other domestic law. Instead, the principles for interpreting international law play a significantly greater role. Furthermore, other legal sources than are otherwise relevant for interpreting domestic law, in particular the Commentaries of the OECD Model, are taken into account. Sweden is no exception in this regard.

Consequently, HFD has adopted a broader approach as regards interpre-
tation of DTTs than is customary for its interpretation of internal law, for instance by referring to the interpretational principles of the VCLT and by referring to the Commentaries of the OECD Model. On the other hand, there are several cases where HFD has referred to unilateral materials, without any detailed discussion as to the legal basis for doing so and despite the fact that the VCLT rejects the use of such materials. It is difficult to find consistency in Swedish case law in the area of interpretation of DTTs. As a result, it is difficult to draw any unambiguous conclusions on the relative weight of different legal sources in Sweden.

HFD case law is also contradictory in another way. In spite of the fact that HFD clearly considers the interpretational principles laid down in the VCLT to be relevant, HFD has on several occasions emphasised the importance of the common intention of the parties in connection with DTT interpretation without sticking to the objective approach of the VCLT. For instance, HFD has found evidence of the intention of the parties in unilateral materials without support for that evidence in the DTT text.

In my view there are strong arguments in support of the objective approach advocated by the VCLT, in particular when it comes to DTTs as the power to tax is a central part of the sovereignty of each state. There is therefore reason to presume that a contracting state has only given up its taxing right to the extent that this can be derived from the text of the DTT, even if this means in a given situation that double taxation cannot be eliminated. However, that is not the way that HFD has applied the interpretational rules of the VCLT. Thus, the subjective approach favoured by HFD and the application of certain unilateral materials for the purpose of DTT interpretation that according to the VCLT are not permissible must, at least for the present, be regarded as current practice. Even so, there is reason to stress that unilateral materials should be used with caution. Normally, the legislator can be presumed to intend to fulfil Sweden's international obligations and DTTs should therefore be applied with this intention in mind, i.e. by taking into account international law principles for the purpose of interpreting DTTs also in their capacity as domestic legislation, so as to avoid a conflict between the interpretation of the DTT
for domestic law purposes and the interpretation under international law.²⁹¹ However, as long as an interpretation on the basis of unilateral materials is not contrary to the DTT text or an unambiguous interpretation that follows from the materials referred to by the VCLT, it would not be contrary to Sweden’s international obligations or the principle of legality. In such cases, it may be reasonable to refer to unilateral materials. In other cases, reference to unilateral materials would be inappropriate.

As regards the legal sources available beside the DTT text, one stands out as particularly important and frequently applied in practice, namely the Commentaries of the OECD Model. This is in spite of the fact that there is no consensus regarding the legal basis for reference to the Commentaries. However, unreflected use of the Commentaries may prove problematic. Although it is permissible to refer to the Commentaries under general principles of law, and may often be appropriate to do so if the Commentaries are helpful in establishing the meaning of a particular tax treaty provision, the preconditions for reference to the Commentaries are that the DTT text in substance complies with the Articles of the OECD Model and that the Commentaries are not contradicted by the DTT text or by any other material that has a more solid legal basis. Furthermore, as the Commentaries are (at least normally) not binding under international law and not a part of the domestic law (at least not in Sweden), reference to the Commentaries is discretionary and may be unconstitutional or otherwise inappropriate where it works to the detriment of a taxpayer.

4 Elimination of Double Taxation under the Distributive Rules and the Double Tax Relief Article

4.1 Introduction

This chapter seeks to deal with some general issues that apply in regard to the elimination of double taxation under DT Ts, irrespective of the method for elimination of double taxation that applies. Rules providing for elimination of double taxation can be found in the distributive rules and in the double tax relief article. Issues that relate specifically to either of the distributive rules or the double tax relief article, but not to any specific principle or method for elimination of double tax relief, are also dealt with in this chapter. The systematisation of the methods and the analysis of issues that relate specifically to the principles or methods per se, on the other hand, are presented in chapter 5. Both this chapter and chapter 5 relate to the first aim of the study, namely to systematise and analyse the methods for elimination of double taxation under DT Ts in order to gain a better understanding of how they work.

With the exception of the distributive rule on so-called corresponding adjustment, DT Ts are as a main rule only effective in situations where the internal laws of the contracting states provide for imposition of tax on the same taxpayer. This is sometimes referred to as a requirement for subject identity. The requirement for subject identity is dealt with in sub-chapter 4.2.

Sub-chapter 4.3 deals with issues that are connected with the elimination of double taxation under the distributive rules. Sub-chapter 4.3.2 analyses the distributive rules of the OECD Model and identifies the situations where double taxation is eliminated completely by the distributive rules. Distributive rules limit the taxing rights of a contracting state on the basis of the presence or absence of certain connecting factors. Sub-chapter 4.3.3 analyses the consequences of temporal limitations in respect of such factors, i.e. situations where the connecting factors are present for a limited period of time. The application of the distributive rules requires that income is attributed and expense is allocated to either R or N. This matter is dealt with in sub-chapter 4.3.4. The attribution of income and allocation of expense also has implications for the elimination of double taxation under the double tax relief article, for instance
in regard to the computation of the foreign tax credit limitation. However, as attribution of income and allocation of expense is determined on the basis of the provisions of the distributive rules, I have considered it relevant to deal with this issue in sub-chapter 4.3. Furthermore, although DTTs generally do not contain rules for the quantification of income, the article on business profits provides principles for the quantification of income which in effect puts a ceiling on the income that N may subject to tax and a minimum level in respect of which R is obliged to provide double tax relief. The quantification of income under the article on business profits is dealt with in sub-chapter 4.3.5.

Sub-chapter 4.4 seeks to analyse issues that are connected with the elimination of double taxation under the double tax relief article. Sub-chapter 4.4.2 analyses the double tax relief article of the OECD Model. The terms “income” and “source” are often applied in the double tax relief article and the meaning of these terms is discussed in sub-chapters 4.4.3 and 4.4.4. The double tax relief article normally requires that the taxation in N is in accordance with the DTT in order for R’s obligation to provide double tax relief to apply. In other words, there is no obligation under the double tax relief article to provide relief in respect of N tax in excess of the taxing right which is reserved to N under the DTT. Sub-chapter 4.4.5 seeks to analyse the requirement for taxation in accordance with the DTT.

Finally, sub-chapter 4.5 summarises the discussions and the conclusions which have been drawn.

4.2 Attribution of Income to a Person – the Requirement for Subject Identity

It is conceptually not possible for a taxpayer to claim treaty benefits in relation to a contracting state where no tax is being imposed on the taxpayer by that state. Thus, where two states impose tax in respect of the same subject matter but on two different persons, each of these persons can invoke the DTT against the respective state which imposes tax on that person, but not against the other state. It is perfectly possible that each of the contracting states is unhindered by the DTT from imposing tax on the person on which it imposes tax. If so, the double taxation cannot be resolved under the DTT. However, where tax is imposed by the contracting states under their internal laws in respect of an item of income on the same taxpayer, the DTT typically precludes one of the contracting states from exercising its taxing right, so that elimination of double taxation can be achieved by invoking the DTT against that state. In other words, DTTs deal mainly with juridical double
taxation (double taxation of the same taxpayer in respect of the same subject matter) as opposed to economic double taxation (taxation of different taxpayers in respect of the same subject matter). The fact that in principle tax must be imposed on the same taxpayer in order for the DTT to provide a solution to the double taxation is sometimes referred to as a requirement for “subject identity”.

As it is necessary to attribute income to a taxpayer in order to determine the tax liability, the internal laws of the contracting states include rules and principles for attributing income to a person. DTTs, on the other hand, typically do not contain rules for attributing income to a person. Therefore, internal law must be relied upon to determine whether there is subject identity. Normally, it is the internal law of the state that applies the DTT which is relevant for determining whether there is subject identity, although it would be conceivable for that state to take into account the attribution made by the other contracting state.

The subject identity requirement gives rise to particular difficulties insofar as there is a conflict in the attribution of income to a person, i.e. where the contracting states due to differences in their internal laws or in the interpretation of the facts of a case attribute income to different persons. One example of a conflict in the attribution of income to a person is the treatment of so-called hybrid entities. A hybrid entity as an entity which is considered transparent for tax purposes by one contracting state, meaning that income flows through the entity and is taxed in that state at the level of the partners, but is taxed as a company in the other contracting state.

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292 The DTT article on so-called corresponding adjustment (cf. Art. 9 of the OECD Model) deals, however, with taxation of two taxpayers in respect of the same subject matter, i.e. no subject identity is required. For a critical analysis of the subject identity requirement, see Flick, ‘Das Erfordernis der Subjektidentität bei Doppelbesteuerungsnormen’, Steuer und Wirtschaft, 1960, pp. 329–350.

293 In practice, states may accept treaty entitlement in certain situations despite the absence of formal subject identity, see Wheeler (general reporter), Conflicts in the attribution of income to a person (2007), p. 56.

294 As regards the attribution of income to a person under Swedish internal law, see Gustafsson Myslinski, ‘Sweden’ in Wheeler (general reporter), Conflicts in the attribution of income to a person (2007), pp. 603–622.


296 For an in-depth study of this topic, see Barenfeld, Taxation of Cross-Border Partnerships (2005).
rise to attribution of income by the contracting states to different persons will not be dealt with in this study.297

As it is conceptually not possible for a taxpayer to claim treaty benefits in relation to a contracting state where no tax is being imposed on the taxpayer in question by that state, a taxpayer cannot claim an exemption of income where that income is considered attributable to another taxpayer. Thus, subject identity is required in order to exempt income under a DTT.298 For instance, a shareholder of a company in N cannot invoke the DTT between R and N to exempt the income of the company from taxation in N, regardless of the fact that the taxation of the company affects the shareholder by reducing the value of the shareholding. Similarly, under the principle of credit, a taxpayer is normally not entitled to credit tax paid by another taxpayer. For instance, a shareholder of a company in N cannot, unless expressly provided for,299 credit tax paid by that company, regardless of the fact that the taxation of the company reduces the value of the shareholding. Correspondingly, tax rate limitations under the distributive rules in respect of payments made by a resident of N to a resident of R in the form of dividends, interest, or royalty only apply where the resident of R is regarded as the taxpayer and do not limit N’s right to tax its residents.300

297 For an extensive survey, see Wheeler (general reporter), Conflicts in the attribution of income to a person (2007).
299 Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Einleitung, para. 134, regarding so-called indirect credit. Cf. also the OECD Model, Commentary to Art. 23, para. 52. Indirect credit was considered in connection with the introduction of Swedish legislation on unilateral credit, but was rejected since the legislation was intended to complement the system of bilateral DTTs but not to replace the DTTs by providing benefits in excess of the DTT benefits and since the introduction of indirect credit could have consequences that were difficult to foresee, see prop. 1966:127, p. 58.
300 Cf. Art. 10.2 sub-para. 2 of the OECD Model in respect of dividends. Thus, the tax rate limitation in respect of dividends does not apply, nor is R obliged to provide double tax relief, in respect of tax on the income of the payer, regardless of whether that tax is imposed at distribution, as is for instance the case concerning Estonian corporate tax, cf. the Swedish Tax Agency, Ställningstagande (Eng. Published Position), 13 November 2009, dnr 131 818415-09/111. Furthermore, even if tax is imposed on the gross amount of the payment, it falls outside the scope of the tax rate limitations and R’s obligation to provide double tax relief if the payer is regarded as the taxpayer, as is for instance the case concerning the Contribution for Intervention in the Economic Domain (CIIDE) imposed by Brazil on remittances abroad of royalties etc. (see for instance Hammarstedt, ‘Svenska företags skatteproblem i Brasilien’, SvSkT, 2009, No. 5, p. 532). With regard to dividends, interest, and royalty there is also a
If a taxpayer derives income through a partnership or another entity that is treated by both contracting states as transparent for tax purposes, meaning that income flows through the entity and is taxed at the level of the partners, it would make sense to argue that there is subject identity with regard to income derived through the entity as it is the partners and no one else that is liable to tax in both states. However, it is also possible to regard the transparent entity as the beneficiary of the income it derives, so that the taxpayer is not entitled to double tax relief in respect of income derived through the transparent entity.

The last-mentioned position was taken by HFD in the case RÅ 2001 ref. 46. According to the circumstances presented relating to question number five of this advance ruling, a Swedish insurance company owned a Swedish limited partnership, which was transparent for both US and Swedish tax purposes. The Swedish limited partnership in its turn owned a number of US entities (either in the form of limited partnerships or single member limited liability companies) holding immovable property, all of them transparent for tax purposes in the US. The Council for Advance Tax Rulings held, with reference to the double tax relief article of the DTT with USA and Swedish internal law, that a taxpayer is only entitled to a tax credit where the same person derives the same income in both contracting states. The Council for Advance Tax Rulings regarded the income from the immovable property as income derived by the US entities despite the fact that the insurance company was, at least with respect to the immovable property owned through the US limited partnerships, liable to tax on income from the immovable property in both Sweden and the US. Thus, according to the Council for Advance Tax Rulings, subject identity for tax purposes was not sufficient; subject identity with regard to legal entitlement to the income was also deemed to be required. As a result, the US tax was held not to be creditable by the insurance company. HFD did not change the judgment of the Council for Advance Tax Rulings. The Swedish Foreign Tax Credit Act was later amended to allow owners in

question whether there is a beneficial owner of the dividend, interest, or royalty, other than the legal owner (cf. Arts. 10.2, 11.2, and 12.1 of the OECD Model). Furthermore, the limitations to the taxing right of N do not apply if the holding in respect of which dividends are paid, the debt-claim in respect of which interest is paid, or the right or property in respect of which royalty is paid is considered effectively connected with a PE in N of the beneficial owner (cf. Arts. 10.4, 11.4, and 12.3 of the OECD Model).

301 Vogel and others, *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Einleitung, para. 134.

a tax transparent partnership a unilateral credit in such situations regardless of HFD’s interpretation of the requirement with respect to subject identity.

Where the state of residence of the owner of an entity regards the entity as transparent for tax purposes and the state of residence of the entity taxes the entity as a company, it is the view of the OECD Model that the principle of credit obliges the first-mentioned state to allow a credit for tax paid by the entity in the other state. As the state of residence of the owners flows through to the owners the income of the entity it would, according to the OECD Model, be coherent to also flow through to the partners tax paid by the entity for the purpose of providing double tax relief. Distributions made by the entity, on the other hand, would not be regarded as income in the state of residence of the owners and, hence, there would be no obligation to provide a credit in respect of withholding tax levied by the other state on such distributions.303

As regards Sweden, it can be noted that the Swedish Foreign Tax Credit Act states that the taxpayer (with some exceptions introduced as a consequence of the above-mentioned judgment) must have been subject to tax in the foreign state.304 In other words, the Swedish Foreign Tax Credit Act requires subject identity for tax purposes as a principal rule. It does not expressly require subject identity with regard to legal entitlement to the income, but it can be argued that such an additional requirement applies in accordance with the above-mentioned judgment, unless otherwise is expressly provided for.

4.3 Elimination of Double Taxation under the Distributive Rules

4.3.1 Introduction

The distributive rules limit, with regard to different classes of income, the respective taxing rights of R and N. In certain cases, one of the contracting states may be precluded from taxing an item of income, so that the taxing right is in effect allocated exclusively to the other contracting state. In such cases, double taxation is eliminated under the distributive rules, so that the double tax relief article is not required to achieve elimination of double taxation. In other cases, the taxing rights of both contracting states are reserved

303 The OECD Model, Commentary to Art. 23, paras. 69.1–69.3.
304 Ch. 2 sec. 1 para. 1 item 2 AvrL.
under the distributive rule in question. If so, the remaining double taxation is normally eliminated under the double tax relief article.\textsuperscript{305}

Where the distributive rules allow taxation in both contracting states, the taxing right in N may be limited to a specific rate on the gross income. Where the taxation in N under N’s internal law exceeds the limit provided under the DTT, such limitation results in a partial double tax relief, but not a complete elimination of the double taxation. According to the OECD Model, limitation of the tax rate in N is applied in respect of dividends paid by a company which is a resident of N to a resident of R if the beneficial owner is a resident of R\textsuperscript{306} and in respect of interest arising in N and paid to a resident of R if the beneficial owner is a resident of R\textsuperscript{307}. Application of the double tax relief article may eliminate double taxation that remains after application of the tax rate limitation. Elimination of double taxation under DTTs by means of limitation of the tax rate in N is dealt with in sub-chapter 5.3.

Where the tax authorities of one contracting state have made an adjustment to the taxable income of a company in that state on the basis that transactions have been entered into with an associated company in the other contracting state on other than arm’s length terms, the distributive rules provide an obligation for the other contracting state to eliminate double taxation by making an appropriate adjustment of the tax charged on the profits of the company in that state, provided that it considers the adjustment made by the first-mentioned state to be justified.\textsuperscript{308} As stated in sub-chapter 1.3.3, this particular type of double tax relief is not dealt with in this study.

### 4.3.2 Exemption of Income under the Distributive Rules

According to the OECD Model

Where the parties to a DTT intend to allocate the taxing right in respect of a certain class of income to either R or N exclusively, they may do so by using a wording in the distributive rule applicable to that class of income that precludes the other state from taxing the income in question, for instance by inserting the phrase “shall be taxable only in that State [i.e. in R]” or “shall be taxable only in the other Contracting State [i.e. in N]”. In such cases, it

\textsuperscript{305} Vogel and others refer to this as “complete” distributive rules as opposed to “open” ones, Vogel and others, Doppelbesteuerungsaufkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), vor Art. 6-22, para. 7.

\textsuperscript{306} Art. 10.2 of the OECD Model.

\textsuperscript{307} Art. 11.2 of the OECD Model.

\textsuperscript{308} Cf. Art. 9 of the OECD Model.
follows from the DTT that the state in relation to which the taxing right is not reserved is under an obligation to exempt the income from taxation irrespective of its internal tax laws. In other words, the principle of exemption is applied under the distributive rules.

For other items of income, the right to tax is not attributed exclusively to R or N. In the OECD Model, the phrase “may be taxed in the other State [i.e. in N]” is used in such cases. Double taxation that remains after application of the relevant distributive rule may in such cases be eliminated by R under the double tax relief article.

According to the OECD Model, the principle of exemption is applied under the distributive rules in respect of the following items of income:309

Items of income in respect of which R is given exclusive right to tax

A. Income from immovable property situated in R or in a third state.310
B. Business profits of an enterprise insofar as they are not attributable to a PE in N.311
C. Profits from the operation of ships or aircraft in international traffic and from the operation of boats engaged in inland waterways transport if the place of effective management of the enterprise is situated in R or, where the place of effective management is aboard a ship or boat, if the home harbour is situated in R, or, where no home harbour exist, if the operator is resident in R.312

309 Cf. the OECD Model, Commentary to Art. 23, para. 6. Note that Arts. 8 and 19 of the OECD Model are not primarily based on the residence criteria and are thus not specifically aimed at giving R or N the taxing right. However, these articles have been included in the list as either R or N is given exclusive taxing right if the relevant criterion (place of effective management and paying state in respect of which services are or have been rendered, respectively) is fulfilled.
310 Art. 6.1 of the OECD Model e contrario.
311 Art. 7.1 of the OECD Model.
312 Art. 8.1-3 of the OECD Model. As Art. 8 of the OECD Model states that the income shall be taxable only in the contracting state of which the place of effective management of the enterprise is situated (or, if the place of effective management is aboard a ship or boat, in the contracting state in which the home harbour is situated or, if there is no such home harbour, in the contracting state of which the operator is a resident), it might be argued that neither contracting state is entitled to tax the income if the place of effective management (or home harbour or residence of the operator) is situated in a third state (cf. also Arts. 13.3 and 15.3 of the OECD Model which give rise to the same interpretational issue). However, in my view it would not make sense to interpret a DTT as precluding both contracting states from exercising their taxing rights. It would therefore be possible to argue that such income falls outside the scope of the provisions referred to and instead shall be subsumed under the other
D. Royalties arising in N and beneficially owned by a resident of R provided that the right or property in respect of which the royalties are paid is not effectively connected with a PE of the taxpayer in N.\textsuperscript{313}

E. Gains derived from the alienation of any property other than (i) immovable property situated in N, (ii) movable property forming part of the business property of a PE of the taxpayer in N, (iii) ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats if the place of effective management of the enterprise is situated in N and (iv) gains from the alienation of shares deriving more than 50 per cent of their value from immovable property situated in N.\textsuperscript{314}

F. Salaries, wages and other similar remuneration in respect of an employment if the employment is exercised outside N or if certain conditions concerning time spent in N etc. are fulfilled, with the exception of directors’ fees, pensions, income derived by entertainers and sportsmen and income from government service, unless the remuneration is derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic or aboard a boat engaged in inland waterways transport and the place of effective management of the enterprise is situated in N.\textsuperscript{315}

G. Pensions and other similar remuneration paid in consideration of past employment with the exception of remuneration paid in respect of government service.\textsuperscript{316}

H. Salaries, wages and other similar remuneration paid by R or a political subdivision or a local authority thereof to an individual in respect of services rendered to that state or subdivision or authority and such remuneration paid by N or a political subdivision or a local authority thereof in respect of services rendered to N or a subdivision or authority of N if services are rendered in R and the taxpayer is (i) a national of R or (ii) did not become a resident of R solely for the purpose of rendering the services. Furthermore, pensions and other similar remuneration paid by, or out of funds created by, R or a politi-

\textsuperscript{313} Art. 12.1 and 12.3 of the OECD Model.

\textsuperscript{314} Art. 13 of the OECD Model.

\textsuperscript{315} Art. 15 of the OECD Model. See the comment in footnote 312 above.

\textsuperscript{316} Art. 18 of the OECD Model.
cal subdivision or a local authority thereof to an individual in respect of services rendered to that state or subdivision or authority and such remuneration paid by, or out of funds created by N or a political subdivision or a local authority thereof in respect of services rendered to N or a subdivision or a local authority of N if the taxpayer is a national of R.\textsuperscript{317}

I. Payments which a student or business apprentice who is present in N solely for the purpose of his education or training receives for the purpose of his maintenance, education or training provided that the payment arises from sources outside N.\textsuperscript{318}

J. Items of income not dealt with in Articles 6–20 of the OECD Model insofar as the right or property in respect of which the income is paid is not effectively connected with a PE of the taxpayer in N, but including income from immovable property situated in R or in a third state even in cases where the immovable property is effectively connected with such PE in N.\textsuperscript{319}

\textit{Items of income in respect of which N is given exclusive right to tax}

A. Profits from the operation of ships or aircraft in international traffic and from the operation of boats engaged in inland waterways transport if the place of effective management of the enterprise is situated in N or, where the place of effective management is aboard a ship or boat, if the home harbour is situated in N or, where no home harbour exists, if the operator is a resident of N.\textsuperscript{320}

B. Gains derived from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats if the place of effective management of the enterprise is situated in N.\textsuperscript{321}

C. Salaries, wages and other similar remuneration paid by N or a political subdivision or a local authority thereof to an individual in respect of services rendered to N or a subdivision or an authority thereof, unless the services are rendered in R and the individual is (i) a national of R

\textsuperscript{317} Art. 19.1-2 of the OECD Model.
\textsuperscript{318} Art. 20 of the OECD Model.
\textsuperscript{319} Art. 21 of the OECD Model.
\textsuperscript{320} Art. 8.1-3 of the OECD Model.
\textsuperscript{321} Art. 13.3 of the OECD Model.
or (ii) did not become a resident in R solely for the purpose of rendering the services. Moreover, pensions and other similar remuneration paid by, or out of funds created by, N or a political subdivision or a local authority thereof to an individual in respect of services rendered to N or subdivision or authority, unless the individual is a national of R. 322

D. Payments which a student or business apprentice who immediately before visiting R was a resident of N and who is present in R solely for the purpose of his education or training receives for the purpose of his maintenance, education or training provided that the payment arise from sources outside R. 323

As follows from the above, complete elimination of double taxation under the distributive rules typically takes place where the distributive rules provide that N shall exempt an item of income from tax. Only in a few specific situations do the distributive rules provide that R shall exempt an item of income from tax.

4.3.3 Timing Issues

4.3.3.1 Introduction

As income tax is charged on the basis of the taxable income of a taxpayer which arises in a specific period (typically one year in the case of taxation by assessment) a necessary step in determining the tax liability of a taxpayer is to determine when income arises, i.e. when the taxable event which triggers tax liability occurs. The internal laws of the contracting states therefore always include rules or principles for determining when income arises, either in the tax laws or on the basis of accounting principles.

In contrast, DTT provisions do not determine tax liability and therefore do not contain provisions for determining when income arises. However, DTTs provide restrictions to the taxing rights of contracting states on the basis of certain criteria and the factual circumstances for determining whether these criteria are fulfilled may be present in a certain period but absent in another period. This raises the question whether the time at which taxation shall take place according to the internal law of a contracting state is relevant for determining whether the DTT precludes it from exercising its taxing right.

322 Art. 19.1-2 of the OECD Model.
323 Art. 20 of the OECD Model.
Furthermore, the application by the contracting states of different principles for determining when income arises may lead to the attribution of income to different periods by the contracting states, often referred to as a timing mismatch. For instance, one contracting state may tax an item of income on a cash basis whereas the other state taxes the item of income on an accrual basis or a state may tax appreciation of an asset whereas most states would require that some form of alienation has taken place. Such timing mismatches may cause problems with regard to the elimination of double taxation. Moreover, a timing mismatch may coincide with a change of residence, complicating double tax relief even further.

4.3.3.2 Temporal Limitations to the Allocation of Taxing Rights

As tax liability is determined under internal law, DTTs do not contain rules on when the taxable event occurs. Instead it is left up to the internal laws of the contracting states to determine when income arises. However, the distributive rules of a DTT allocate taxing rights on the basis of the existence of a connection either between a contracting state and a taxpayer (residency) or between a contracting state and an activity or property that generates income. In cases where that connection is not permanent, this leads to a temporal limitation to the exercise of a taxing right, meaning that the taxing right may be exercised in the period in which the connection exists but not otherwise. For instance, where a distributive rule reserves N’s right to tax income attributable to a PE and that PE exists for a limited period, N may be precluded from taxing income because the income is attributable to a period when the PE has not yet been established or has ceased. The main question in this regard is whether the DTT provides principles for referring income to a period in which the connection does or does not exist or if this is to be determined on the basis of internal law.

In the literature, the opinion has been expressed that income which is earned in a period in which a required connection between a contracting state and an activity or property that generates income exists may be taxed in that state regardless of when the taxable event according to the internal law of that state occurs. For instance, according to the distributive rule on employment income, income from employment may be taxed in N if the

324 Cf. OECD Model, Commentary to Art. 13, paras. 6–10.
325 For a detailed analysis of the links required under the distributive rules, see Schuch, Die Zeit im Recht der Doppelbesteuerungsabkommen (2002), pp. 151–233.
employment is exercised in N.\footnote{Cf. Art. 15.1 of the OECD Model.} As a consequence, it has been argued that income from the exercise of an employment in N may be taxed in N regardless of whether the income according to the internal law of N arises before or after the period in which the employment was exercised. On the other hand, N may not tax income which is earned outside that period, regardless of whether the taxable event according to the internal law of N occurs during a period in which employment is exercised in N.\footnote{Vogel and others, \textit{Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen} (2008), vor Art. 6-22, paras. 8–9, with further references. Vogel and others also state that N may tax if such link existed when whatever decisively caused the income to accrue actually occurred. As it is often not possible to pinpoint a particular moment in time when something decisively caused an item of income to accrue, the statement provides limited guidance, cf. Schuch, \textit{Die Zeit im Recht der Doppelbesteuerungsabkommen} (2002), pp. 150–151.}

R is generally entitled to tax an item of income without a connection between R and the activity or property that gives rise to the income in question. Provided that the taxpayer in question remains a resident in R for the purpose of the DTT, R may therefore exercise freely its taxing right provided for under R’s internal law.\footnote{Only in very few cases do the distributive rules of a DTT preclude R from taxing an item of income, cf. sub-ch. 4.3.2.} However, since the provisions of the distributive rules do not provide any restrictions as to when tax is to be levied and since the double tax relief article require that relief be granted where an item of income or capital may be taxed by N in accordance with the provisions of the DTT, it can be argued that such relief must be provided regardless of when the tax is levied by N.\footnote{The OECD Model, Commentary to Art. 23, para. 32.8.}

The following example illustrates the issue.

\begin{quote}

\textit{X, who is an individual resident in R, performs work for an employer in N during a three months period. As he receives his monthly wages in arrears, the salary relating to the last month of work in N is received after the employment in N has ended. Income from employment is taxed on a cash basis according to the internal law of N. According to the DTT between R and N, salaries, wages and other similar remuneration derived by a resident of R in respect of employment exercised in N may be taxed in N.\footnote{Cf. Art. 15.1 of the OECD Model.} As the employment has ended when the last salary payment is received by X, the requirements of the DTT for taxation in N are no longer valid.}
\end{quote}
satisfied at the time when X receives the salary payment and the taxable income arises according to the internal law of N. Is N entitled to tax the last salary payment? Is R obliged to provide double tax relief?

According to the view expressed in the literature, the distributive rules do not provide for any restrictions as to when tax is to be levied by N, but only require that the connection stated in the distributive rule in question is present when the income is earned. N would therefore be entitled to tax the salary relating to the last month of work in N, regardless of the fact that the connection required under the distributive rules is no longer present when the income arises according to the internal law of N. Correspondingly, as R’s obligation under the DTT to provide double tax relief reflects N’s right under the DTT to tax income, a consequence of the view that the taxation in N of the salary is in accordance with the DTT is that R is obliged to provide double tax relief.

Thus, as long as salaries, wages and other similar remuneration are received on the basis of exercise of employment in N, N would be entitled to tax the employee, regardless of when the income is paid to the employee or is otherwise considered to have arisen. Consequently, if an employee who is a resident of one contracting state, R, receives a sign-on fee to perform work in the other contracting state, N, the sign-on fee would for the purpose of the DTT be deemed to be derived from employment exercised in N regardless of the fact that it was paid prior to the commencement of the exercise of the employment in N and irrespective of whether N would tax the sign-on fee on a cash basis under its internal law. R on the other hand is entitled to tax the employee on the basis of the fact that the employee is a resident of R, but would be obliged to provide double tax relief in respect of the income, regardless of when the income arises under internal law.

As regards business profits, N is usually entitled under the DTT to tax the profits of an enterprise resident in R insofar as they are attributable to a PE in N. In line with the above, it can be argued that there is no requirement under the DTT that there is a PE in N when business profits arise under N’s internal law in order for N to be entitled to tax the income. Instead, it is decisive whether the income was earned in a period in which a PE existed.

331 OECD Model, Commentary to Art. 15, para. 2.2. It is another matter that the internal law of N may not provide for taxation of the sign-on fee.
332 Cf. Art. 7.1 of the OECD Model.
and that the income in question can be attributed to that PE. \textsuperscript{333} As regards Sweden, this view was confirmed by HFD in the court case RÅ 1993 ref. 29. A Swedish resident taxpayer owned a share in a racehorse in the US. The income from the racehorse was considered as business profits attributable to a PE in the US. When the horse died (and, hence, the PE ceased), insurance compensation was paid to the owners. The question was whether the insurance compensation could be regarded under the DTT between Sweden and the US as income attributable to a PE in the US, which would render it exempt from tax in Sweden, in spite of the fact that there was no PE when the compensation was paid. HFD held that the compensation was attributable to the PE, since the payment was made as a result of events that took place when the PE existed.

The focus on the earning period, which in principle is independent of the internal laws of the contracting states, eliminates some of the problems caused by different rules in the contracting states on when the income arises. However, in my view the use of the earning period as an instrument to allocate taxing rights is not without problem, as no objective criteria exist for determining in what period an item of income is earned independently of the internal laws of the contracting states.

Where income is earned continually and on a regular basis, for instance where an employee works full time and receives monthly wages, it may not be too difficult to attribute a part of that income to a specific period. However, if the same line of reasoning is applied to other items of income, the situation may be more complicated.

As far as business income is concerned, it is normally not a matter of simply distributing income evenly over the period in which it was earned. Business income and expenses usually fluctuate. Some basis for determining the income relating to a specific period will have to be applied. Although in principle the allocation of taxing rights under the DTT may be independent of the internal laws of the contracting states, it may be difficult to find any other principles for considering income taxed on an accrual basis to have been earned by a PE in a specific period than the principles found in the internal law of the state applying the DTT.

As the determination of the taxable event under the internal laws of the contracting states is in principle irrelevant for the allocation of taxing rights under the DTT and the obligation to eliminate double taxation, at least according to the view expressed in the OECD Model and in the literature,

\textsuperscript{333} Winther-Sørensen, \textit{Beskatning af international erhvervsindkomst} (2000), pp. 150–151.
it might be expected that a timing mismatch, i.e. taxation by the contracting states in different periods, would not have an impact on the elimination of double taxation under the double tax relief article. However, in practice, timing mismatches may create significant obstacles. For instance, if R taxes a transaction in year 1 and N taxes the same transaction in year 2, R is in principle obliged under the DTT to eliminate double taxation, but may deny a credit in year 1 due to the fact that no N tax has been paid in that year. Furthermore, R may deny a credit in year 2 due to the fact that there is no R tax attributable to income from N in that year, meaning that the foreign tax credit limitation is zero. Conversely, if N taxes a transaction in year 1 and R taxes the same transaction in year 2, R may deny a credit in year 1 since there is no R tax attributable to the income in question in that year. Furthermore, R may or may not allow a credit in year 2 for N tax paid in a previous year. For an analysis of this issue, see sub-chapter 5.4.11. Moreover, for an evaluation of exemption with progression and ordinary credit in connection with such timing mismatches, see sub-chapter 6.4.

4.3.3.3 Timing Mismatch in Combination with a Change of Residence
The DTT residence article deals with cases of concurrent unlimited tax liability by providing principles for determining at a specific time which of the contracting states is to be considered the state of residence for the purpose of the DTT. The distributive rules and the double tax relief article then eliminate double taxation by limiting the taxing rights of R and N respectively.

If a change of residence takes place, a taxpayer may be a resident of one contracting state for the purpose of the DTT and taxed in that state on an item of income and then a resident of the other contracting state and taxed in that other state on the same item of income. In that case there is no concurrent residence in the two states, as the taxpayer is a resident of each state at different times. It can therefore be argued that both states are entitled to tax the item of income in question and that the DTT cannot solve double taxation occurring in such situations.

However, insofar as the distributive rule in question allocates taxing rights on the basis of a connection between a contracting state and an activity or property that generates the income, the distributive rules provide the tools for solving double taxation. For instance, where income from employment is

335 Cf. Art. 4 of the OECD Model.
earned in a period in which employment is exercised in a contracting state, it can be argued that that state is entitled to tax the income in its capacity as N, regardless of whether the income according to the other state arises in a later period in which the taxpayer has become a resident of that other state.

That is the position of the OECD Model. The solution is illustrated by an example: a taxpayer receives employee stock-options and is taxed in the state of residence when the options are granted. After changing residence, the taxpayer is taxed once again in the new state of residence on the basis of his exercise of the options. According to the OECD Model, either contracting state shall be regarded as N to the extent that the employment services to which the options relate have been rendered in that state. As a consequence, the other state shall be regarded as R in that period and shall eliminate double taxation in accordance with the double tax relief article. The income is allocated on the basis of the time period when it was earned regardless of when it was received by the taxpayer.

According to the view of the OECD, it does not make any difference if the contracting states under their internal laws tax the income at different times, since the taxable events under internal law are irrelevant for the application of the distributive rule in question. Also, it does not matter if the state which under the DTT is deemed as N levies tax under its internal law on the basis of residence (the taxpayer is a resident of that state when the taxable event under its internal law occurs).

As pointed out above, this solution to the problem requires that the income can be allocated between the contracting states independently of the rules of the internal laws of the contracting states for referring income to a specific period. That may be possible where the distributive rule in question provides for the allocation of the primary taxing right to N on the basis of the existence of a connection between N and an activity or property that generates the income in question. However, where a distributive rule allocates the taxing right to R only, there is no requirement for such a connection. As a consequence, there is no basis for referring income to a specific period independently of the rules of the internal laws of the contracting states and, hence, no basis for allocating income between the state of residence prior to the change of residence and the state of residence after the change of residence. Where an item of income according to the distributive rule in question is taxable only in R, the DTT therefore does not preclude the contracting states from

336 The OECD Model, Commentary to Art. 23, para. 4.1-2.
337 The OECD Model, Commentary to Art. 23, para. 4.2.
taxing an item of income at two different times in their capacity as R at the respective times.

For instance, income from employment services rendered in a third state is usually only taxable in R.\footnote{Art. 15.1 of the OECD Model.} If the contracting states tax income from employment in a third state at different times and each of the states is deemed to be the state of residence under the DTT when it exercises its taxing right, there will be no obligation under the DTT to eliminate double taxation.\footnote{The OECD Model, Commentary to Art. 23, para. 4.3, and Tenore, 'Timing Issues Related to Changes in Treaty Residence or Source', Intertax, 2006, Issue 3, p. 134.} Similarly, income from the alienation of movable property is, subject to certain exceptions, taxable only in the state of which the alienator is a resident.\footnote{Art. 13.5 of the OECD Model.} N is normally precluded from taxing the gain regardless of any connection between N and an activity (e.g. the disposal) or property (e.g. a company that has issued shares which are being sold) that has generated the gain. This is illustrated by the following example.

\textit{X is a resident of state A and owns shares in a company in A. After moving to state B he disposes of his shares and makes a capital gain. As a result of the relocation, X becomes resident in B for the purpose of the DTT between A and B. According to State A, the relocation to state B triggers tax on the appreciation that has taken place until the relocation, whereas state B regards the disposal of shares as a taxable event. According to the DTT, which conforms to the OECD Model, gains from the alienation of the shares shall be taxable only in the contracting state of which X is a resident.}\footnote{Art. 13.5 of the OECD Model.}

In this case, the taxable event under A’s internal law is the relocation. At that time, X is a resident of state A for the purpose of the DTT.\footnote{Although it is, as regards taxation which is triggered by a change of residence, generally assumed that the taxable event occurs prior to the change of residence, this standpoint can be criticised as being a fiction since there are no objective criteria for determining whether...} The taxable

\[338\] Art. 15.1 of the OECD Model.


\[340\] Art. 13.5 of the OECD Model. According to the OECD Model, taxation only in R applies to gains from the alienation of property other than (i) immovable property in the other contracting state, (ii) movable property forming part of the business property of a PE which an enterprise of a contracting state has in the other contracting state, (iii) ships, aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of suchs ships and (iv) gains derived by a resident of a contracting state from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other contracting state, see Arts. 13 and 21 of the OECD Model.

\[341\] Art. 13.5 of the OECD Model.
event under state B’s internal law on the other hand is the disposal. At that time, X is a resident of state B. As the capital gains article allocates the taxing right in respect of the item of income in question to R, no connection between the taxing state and an activity or property that has generated the income is required. The distributive rule therefore does not provide any principles for referring income to the period prior to or after the change of residence that can override the time of the taxable events under the internal laws of the contracting states. Consequently, under the DTT both states are entitled to tax the capital gain in their capacity as R and there is no obligation to eliminate double taxation.

It can be argued that it would be reasonable for state B not to tax appreciation that has taken place before the relocation to state B, as prior to the relocation there was neither a connection between state B and an activity or property that has generated the income nor a connection between state B and the taxpayer. Non-taxation by state B of appreciation that has occurred before the relocation can be achieved by allowing a step up of the acquisition value relating to the shares. However, as the quantification of the taxable income is a matter which is determined under internal law (see sub-chapter 4.3.5), state B is free to compute the capital gain on the basis of the historical acquisition value, thereby effectively taxing value appreciation that has taken place before the change of residence. It would be possible to deal with this situation in the DTT, for instance by providing that B shall credit tax paid in A in connection with the change of residence from the tax in B on the gain derived as a result of the disposal or that A shall, retroactively, credit

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343 Cf. the OECD Model, Commentary to Art. 13, paras. 5–9. It can be questioned whether the term "alienation" in the capital gains article covers taxation of a value appreciation, where no transfer of the ownership has taken place, such as the exit tax in state A referred to in the above example. If the taxation of the value appreciation would not come within the scope of the capital gains article, the item of income may instead fall under the DTT article on other income. However, as the other income article typically also allocates the taxing right to R, a subsumption of the income under the other income article instead of the capital gains article is normally of little relevance for the outcome. For a detailed analysis of this issue, see Cejie, Utflyttningsbeskattning och kapitalökningar (2010), pp. 139–151 and 177–184, with further references.

344 Similarly, Cejie concludes that the reasoning in the Commentaries concerning the employment income article cannot be applied by analogy to the capital gains article, see Cejie, Utflyttningsbeskattning och kapitalökningar (2010), p. 155.

345 This solution has been adopted in Sweden’s DTT with Germany, see Art. 23.2 b).
the tax imposed by B as a result of the disposal against the tax imposed by A in connection with the change of residence. However, most DTTs do not provide a solution to the double taxation which occurs in such cases.

The other side of the coin is that a DTT may preclude a contracting state from taxing an item of income where the distributive rule allocates the taxing right to R and the state in question is no longer the state of residence under the DTT when the taxable event occurs according to that state’s internal law, regardless of the existence of a connection between that state and an activity or property that has generated the income. This is illustrated by the following example.

X is a taxpayer who moves from one contracting state, A, and takes up residence in the other contracting state, B. After his arrival in state B, X disposes of shares in a company in A and realises a capital gain. The sale is taxable in state B under state B’s internal law, since X is liable to tax on his worldwide income in B after taking up residence there. At the same time, the sale is taxable in state A under state A’s internal law, since state A taxes former residents who dispose of shares within ten years after becoming non-resident. State A and state B have entered into a DTT which is identical to the OECD Model. Is state A entitled to tax the capital gain?

It would be possible to argue that appreciation which has occurred up until X’s relocation to B was earned in A and that A, as a result, would be entitled to tax a part of the capital gain corresponding to that increase in value. B would therefore be required to provide double tax relief in respect of that capital gain. Further, it would be possible to argue that there is a link between the capital gain and state A, which would justify taxation in A, as the shares are shares in a company in A. However, as the capital gains article does not allocate any taxing right to N on the basis of the existence of a connection between N and an activity or property that has generated the income in question, the article does not provide any principles for referring income to the period prior

346 The application of such a “trailing tax” levied in spite of the non-resident status of the taxpayer is applied under Swedish law according to ch. 3 sec. 19 IL.

347 As a component of a proposed model treaty for the EC, Pistone has proposed such a solution whereby a capital gain which has accrued when the taxpayer was a resident of a Member State may be taxed in that state regardless of whether alienation takes place when the taxpayer has become a resident of another Member State and whereby, consequently, the other Member State is obliged to provide double tax relief, see Pistone, The Impact of Community Law on Tax Treaties: Issues and Solutions (2002), pp. 295–296.
to the change of residence. Neither the connection between state A and the
taxpayer when the value increase took place nor the connection between state
A and the property that has given rise to the gain due to the residence of the
company in A is normally taken into consideration by the DTT. As a con-
sequence, each state is entitled to tax the income insofar as the taxable event
under internal law occurs when the taxpayer is a resident of that state. In this
case the taxable event under A’s internal law is the disposal. At that time, state
B is the state of residence, which means that state A is precluded from taxing
the capital gain.

4.3.4 Attribution of Income and Allocation of Expense to R or N

In order to determine the tax liability of a taxpayer, it is often necessary to
determine to what extent income derived by the taxpayer can be regarded
as “foreign income”, i.e. income which under internal law is exempted from
tax or entitles the taxpayer to a credit of foreign tax. The internal laws of the
contracting states therefore provide principles for determining whether an
item of income or expense shall be considered as domestic or foreign.348

The distributive rules of a DTT also provide principles for attributing
income and allocating expense to R or N. If an item of income in accordance
with these principles is attributed to R, it follows from the distributive rules
that it shall be taxable in R only. Similarly, if an expense is allocated to R, it
would normally be deductible in R only. If, on the other hand, an item of
income is attributed or an expense is allocated to N, it may also be taxable/
deductible in N or, alternatively, taxable/deductible in N only.

In addition to being a necessary step in applying the distributive rules, the
attribution of income and allocation of expense are central to the applica-
tion of the double tax relief article by R. Double tax relief is only provided
by R in respect of income which is attributable to N under the distribu-
tive rules and, correspondingly, expense allocated to N reduces the amount
of income in respect of which double tax relief is given.349 Furthermore,
where the principle of credit is applied, R must attribute income and allocate
expense to N for the purpose of computing the foreign tax credit limitation.

348 Furthermore, if foreign tax credit limitations are computed separately for different catego-
ries of income, each item of foreign income must be attributed to its limitation category and
the expense allocated to foreign income must be allocated among the separate limitation
categories.

349 This follows from the wording of the double tax relief article which states that double tax
relief shall be provided in respect of income which under the distributive rules may be taxed
in N, cf. Arts. 23 A and 23 B of the OECD Model.
Any allocation of expense to the gross income derived from N reduces the income for which credit is to be given and correspondingly the foreign tax credit limitation.\textsuperscript{350} Thus, if gross income is overattributed or expenses are underallocated to N, the foreign tax credit limitation will increase, and more foreign taxes will be allowed to offset tax in R. If, instead, gross income is underattributed or expenses are overallocated to N, the foreign tax credit limitation will be decreased, and fewer foreign taxes will be allowed to offset tax in R.

For instance, under the distributive rules of a DTT, income derived from immovable property (and costs relating to such income) is attributed on the basis of the place of the property.\textsuperscript{351} Furthermore, if an enterprise carried on by a resident of a contracting state has a PE in N, business profits (and corresponding costs) connected with the PE are attributed to N. In other cases, the business profits are attributed to R. Dividends and interest are attributed to R, unless they are paid by a company in N or, as regards interest, have arisen in N.\textsuperscript{352} Since the attribution of income and allocation of expense under the distributive rules of a DTT may limit the taxing right of a contracting state that would otherwise apply under internal law, DTT interpretation often plays an important role for the attribution of income and allocation of expense.\textsuperscript{353}

Just as the application of different distributive rules by the contracting states may lead to double taxation or double non-taxation, differences in the attribution of income or allocation of expense to R or N may have similar effects.\textsuperscript{354} For instance, the contracting states may agree that an item of income shall be subsumed under the DTT article on business profits but may disagree as to

\begin{itemize}
\item\textsuperscript{350} An illustration of this is given by RÅ 1976 ref. 64. The taxpayer in question received dividends on shares in a foreign company. Furthermore, the taxpayer paid interest on a promissory note which was issued in connection with an acquisition of shares. These shares had been sold and the consideration had been used for the acquisition of shares in the foreign company. For the purpose of computing the foreign tax credit limitation, interest on the promissory note was considered connected with the dividends on the shares in the foreign company and therefore deductible from the foreign income, resulting in a reduction of the foreign tax credit limitation. In my view this is a rather far-reaching conclusion as in practice money is often difficult to trace unless it has been kept separate. Therefore in most cases a pro rata allocation of interest costs would be the appropriate solution (cf. Vogel and others, Doppeleuuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 149).
\item\textsuperscript{351} Cf. Arts. 6.1 and 21.1 of the OECD Model.
\item\textsuperscript{352} Cf. Arts. 10.1, 11.1, 11.5, and 21.1.
\item\textsuperscript{353} Winther-Sørensen, Beskatning af international erhvervsindkomst (2000), p. 140.
\item\textsuperscript{354} As regards the effects of differences in the attribution of income or allocation of expense where exemption with progression or ordinary credit is applied, see sub-ch. 6.5.
\end{itemize}
whether the profits are attributable to a PE in N. If R attributes the item of income in question to R and N attributes the same item of income to the PE that the taxpayer has in N, it is unlikely that either R or N will be willing to give up its taxing right. Conversely, an item of income may be exempt from tax in N since N deems it to be attributable to R and, at the same time, R may regard it as foreign income and therefore subject to double tax relief in R (though in this case only the principle of exemption will decrease the tax liability in R as there will be no N tax to credit).

Particular difficulties arise as regards the allocation of deductions that are allowed without any actual expenses and hence cannot be linked to any specific income, such as personal or family allowances, insurance premiums, etc. Generally, DTT provisions will not give any guidance as to the allocation of such deductions. In my view, a pro rata allocation would normally be the most reasonable solution. Under a pro rata allocation, costs that cannot be linked to any specific items of income would be allocated to foreign income on the basis of the relation between, on the one hand, the foreign gross income less costs which are directly connected with the foreign income and, on the other hand, the worldwide gross income less any costs which are directly connected with domestic or foreign income.

The OECD Model mentions the issue of allocating costs which are not connected with any specific items of income and recognises that contracting states which prefer to have special problems solved in their DTTs are free to do so in bilateral negotiations.

Under Swedish law, certain costs that cannot be linked to any specific income, such as group contribution payments, are for the purpose of computing the foreign tax credit limitation excluded from the foreign income. As a consequence, the taxpayer may in practice be allowed a credit of foreign

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355 Cf. the OECD Model, Commentary to Art. 23, paras. 42 and 62. It can be noted that in RÅ 2001 ref. 43, HFD stated by way of obiter dictum that not only costs directly connected with the foreign income shall be deducted, but costs which are common to the operations in different countries as well. However, HFD did not address the question as to whether such common costs shall be allocated to the foreign income on a pro rata basis. See also Berglund & Bexelius, ‘Sweden’ in Blanluet & Durand (general reporters), Key Practical Issues to Eliminate Double Taxation of Business Income (2011), pp. 631–633.


357 The OECD Model, Commentary to Art. 23, paras. 41–43 and 62.

358 According to Swedish law, income can be shifted within a company group by means of group contribution payment, i.e. a payment which is deductible for the payer and regarded as taxable income for the recipient, see ch. 35 IL.

tax in excess of the Swedish tax attributable to the income from the other state. The reason stated in the preparatory works for not allocating a pro rata portion of the group contribution payment to the foreign income is that a group contribution payment is not regarded as foreign income for the recipient. Presumably, the fact that such payments are not costs in a strict sense, but a mechanism for shifting income within a group, led to this conclusion, although in my view it would have been appropriate to explain the reasoning in more detail. For certain other costs, administrability is stated as the reason for not deducting them from the foreign income.

4.3.5 Quantification of Income

In order for a contracting state to exercise its taxing right, it is necessary to quantify the amount of income by quantifying gross income and expenses. Rules and principles on quantification of income are therefore included in the internal laws of all states. Where a contracting state exempts income from taxation, it is in principle not necessary to quantify the exempted income. However, insofar as the exempted income is taken into account for the purpose of determining the tax on the remaining income, as is the case under exemption with progression, it is necessary to quantify the exempted income even though it is not taxable as such.

DTTs function by limiting the taxing right of a contracting state which is provided for under its internal law in respect of certain items of income. As pointed out above, the application of the DTT comprises the subsumption of an item of income under a specific distributive rule and the characterisation of gross income and costs as either domestic or foreign. However, although DTTs deal with the attribution of income and allocation of expense, DTTs do not generally concern themselves with quantification of taxable income on the basis of the items of income and costs so allocated. Since DTTs are silent in these respects, in principle these remain matters determined under the internal laws of the contracting states without limitation of DTT provisions. DTTs do however provide some principles for the quantification of income insofar as business profits are concerned. To the extent that

\[\text{References:}\]

360 Cf. HFD’s reasoning in RÅ 2004 ref. 132 I.
362 Cf. OECD Model, Commentary to Art. 7, paras. 30–32, Commentary to Art. 13, para. 12, and Commentary to Art. 23, para. 39.
363 Cf. Art. 7.2 of the OECD Model and the OECD Model, Commentary to Art. 7, paras. 15–43.
a quantification of the income, taking into account these principles, falls below a quantification of the taxable income under internal law, the DTT limits the amount of income that may be subjected to tax. Similarly, where there is an obligation under the DTT to eliminate double taxation and the quantification of foreign income, taking into account the principles provided by the DTT article on business profits, exceeds the amount of foreign income computed under internal law, double tax relief shall be provided in respect of the higher amount.

4.4 Elimination of Double Taxation under the Double Tax Relief Article

4.4.1 Introduction

The distributive rules frequently reserve (either in full or to a limited degree) N’s taxing right without precluding R from taxing the income in question, usually by stating that the item of income “may be taxed” in N. In such cases, the double tax relief article usually places an obligation on R to eliminate remaining double taxation by stating that R shall provide double tax relief in respect of income which in accordance with the DTT “may be taxed” in N. Thus, in order to determine whether there is an obligation to eliminate double taxation under the double tax relief article, the double tax relief article must be read in combination with the relevant distributive rule. Furthermore, where the double tax relief article provides for different methods of elimination of double taxation in respect of different classes of income, which is often the case, the classification of an item of income in accordance with the distributive rules is of relevance for determining which one of these methods is to be applied. This means that it is also necessary to read the double tax relief article in combination with the distributive rules in order to find out in what way double taxation shall be relieved.

A taxpayer’s ability to pay tax is usually determined by reference to the taxpayer’s aggregate income and individual factors such as personal and family circumstances. Such factors are generally easier to assess at the place where the taxpayer’s personal and financial interests are centred, which normally coincides with the residence of the taxpayer under the DTT. Thus, it has been considered appropriate to place the obligation to provide double tax relief on R, facilitating double tax relief to be provided taking into account the taxpayer’s overall ability to pay, as is for example the case where exemption with progression or the principle of credit is applied.
Double tax relief articles usually provide that R shall provide double tax relief where

(i) a resident of a contracting state
(ii) derives income
(iii) which in accordance with the provisions of the DTT
(iv) may be taxed in the other state.

As regards prerequisite (i), it can be noted that the DTT as a whole applies to persons who are residents of one or both of the contracting states. The term “resident of a contracting state” is defined in the DTT. There is no indication that the term should have any other meaning for the purpose of the double tax relief article than under the DTT as a whole.

The term “income” and the meaning of the phrase taxed “in accordance with the provisions of the DTT” are discussed below. Furthermore, some DTTs, albeit not the OECD Model, provide for double tax relief only in respect of income from “sources” in N. The term “source” is therefore also discussed below.

Normally, the obligation to provide double tax relief under the double tax relief article lies with R. As a main rule, this obligation is independent of whether N actually exercises the taxing right reserved to it under the distributive rules. The application of the principle of exemption by R may therefore result in double non-taxation. In contrast, where the principle of credit is applied, non-taxation of the income in N will merely mean that there will be no N tax to credit against the R tax.

However, in addition to the methods for elimination of double taxation per se, the double tax relief article may contain provisions that limit R’s obligation to eliminate double taxation, inter alia for the purpose of avoiding

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364 Cf. Art. 1 of the OECD Model. Some treaty benefits may be provided to non-residents as well, cf. Art. 24 of the OECD Model.
365 Cf. Art. 4 of the OECD Model.
367 As regards the question whether income which is exempted from taxation under the internal law of N shall be taken into account for the purpose of computing the foreign tax credit limitation, see sub-chapter 5.4.13.4.
double non-taxation. For instance, R’s obligation to eliminate double taxation may be subject to N actually exercising its taxing right.\footnote{See sub-ch. 5.2.3 as regards subject-to-tax clauses.}

Finally, the above-mentioned expression of the double tax relief article, “may be taxed”, refers to the expression which is normally applied in the distributive rules where the taxing right is not exclusively allocated to either of the contracting states, as opposed to situations where income according to the distributive rules “shall be taxable only in” R or N. Thus, the double tax relief article clearly does not apply where the relevant distributive rule provides that the income shall be taxable only in R. However, in the few cases where the distributive rules state that income shall be taxable only in N, it can be argued that the income “may be taxed” in N as N is not precluded from taxing it and that, as a consequence, the double tax relief article is applicable. This would normally be of no consequence as an obligation for R to provide double tax relief by exempting the income already follows from the distributive rules. However, the applicability of the double tax relief article may be of relevance where the double tax relief article contains provisions in addition to the provision that sets out the obligation to provide double tax relief.

\section*{4.4.2 The Double Tax Relief Article of the OECD Model}

\subsection*{4.4.2.1 General on the Double Tax Relief Article of the OECD Model}

The OECD member states have not been able to agree on one single method for elimination of double taxation under the double tax relief article. Instead, the OECD Model offers a choice between two methods: \textit{exemption with progression} (Article 23 A) and \textit{ordinary credit} (Article 23 B).

The Commentaries of the OECD Model acknowledge that the contracting states may use a combination of the methods, for instance by applying either method to different classes of income, or by excluding specific items, such as income that benefit from preferential tax treatment in N, from exemption and to apply to such items the principle of credit.\footnote{The OECD Model, Commentary to Art. 23, paras. 31–31.1.}
4.4.2.2 Article 23 A of the OECD Model

Article 23 A of the OECD Model reads as follows:

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23 A

EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

4. The provisions 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 the Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

Although the member states of the OECD have not been able to agree on one method for elimination of double taxation it has, according to the Commentaries, been found important to limit the number of methods based on each leading principle to be employed.\textsuperscript{370} As regards the principle of exemption, exemption with progression is recommended.

For items of income in respect of which the contracting states have agreed on a limitation of the tax rate to be applied by N, as is normally the case concerning dividends and interest, the principle of exemption is generally

\textsuperscript{370} The OECD Model, Commentary to Art. 23, paras. 28–29.
not an appropriate means of eliminating double taxation. The tax rate limitations provided by the DTT often result in taxation that is lower than the tax which is normally applied by R and N under their internal laws. If the income in question would be exempted from tax in R, it would therefore be subjected to taxation that is lower than if taxation would only have taken place in N or R. In the second paragraph of Article 23 A, the OECD Model therefore proposes that the principle of credit shall be applied in respect of such items of income.

According to the OECD Model, the R tax on dividends paid by a company which is a resident of N and interest arising in N will very often be higher than the tax rate limitation provided by the OECD Model, meaning that the N tax will be creditable in its entirety and that the aggregate tax will correspond to the R tax. The OECD Model therefore states that the contracting states may delete the second sentence of paragraph 2 so that full credit is applied instead of ordinary credit.\(^{371}\) In my opinion it is not that uncommon that the R tax falls below the tax imposed by N, as the R tax is normally based on net income whereas the tax rate limitations are applied to gross income (see sub-chapter 5.3.1). A deletion of the second paragraph would therefore be of greater significance than indicated by the statement in the Commentaries.

Since the 1963 Draft Convention, the OECD Model reserves expressly a right to take into account income which has been exempted under the double tax relief article from taxation in R for the purpose of calculating the tax rate to be applied to the remaining income (sometimes referred to as a “proviso safeguarding progression”). It can be argued that DTTs based on this wording do not reserve a right to take into consideration income which has been exempted under the distributive rules. In the 1977 OECD Model, the wording was therefore changed so that the article clearly applies to income exempted under any provision of the DTT. The proviso safeguarding progression is analysed in sub-chapter 5.2.6.

The purpose of paragraph 4, which was added in 2000, is to prevent double non-taxation due to conflicts of qualification in cases where N, as a result of disagreements between R and N on the facts of a case or the interpretation of DTT provisions, considers a DTT provision to be applicable which precludes it from taxing the income in question or sets a limit to the tax rate that may be applied by N while R, at the same time, considers another DTT provision to be applicable which reserves in full N’s right to tax the income in question.

\(^{371}\) The OECD Model, Commentary to Art. 23, paras. 47–48.
under its internal law. In such case, paragraph 4 relieves R of the obligation to eliminate double taxation that would otherwise have applied. In other words, R is not obliged under the DTT to exempt an item of income where N applies the provisions of the DTT to exempt that item of income. However, the obligation to eliminate double taxation remains unaffected where N considers that it may tax an item under the DTT but where no tax is actually payable under the internal law of N. Thus, paragraph 4 is not to be taken as a generally applicable subject-to-tax provision.\textsuperscript{372}

The situation is more complicated where N applies the DTT to exempt an item of income and the classification under the DTT is based on the interaction between the internal law of N and the DTT. For instance, the DTT may refer to internal law so that the interpretation of a term of relevance for the classification of an item of income follows from the internal laws of the contracting states. Thus, N may apply a distributive rule which precludes it from taxing an item of income and R may apply a different distributive rule without there being any disagreement on the interpretation of the DTT \textit{per se} or on the facts of the case. In such cases the OECD view is that R should, for the purpose of applying paragraph 1, consider that the item of income may not be taxed in N under the DTT. As the double tax relief article only applies where income “may be taxed” in N, R would therefore not be obliged to eliminate double taxation. If the OECD view were correct, paragraph 4 would be redundant in such a case.\textsuperscript{373}

That conclusion can only be reached if R accedes to the classification made by N. If so, R can consider that it is not a question of income that “may be taxed” in N and that, consequently, the obligation under the double tax relief article does not apply. However, where a DTT is interpreted with reference to internal law, the prevailing view is that it is the internal law of the state applying the DTT which is relevant (see sub-chapter 3.8.6). Acceding to the classification made by N would be contrary to that principle. Even though a classification in R in accordance with the classification in N would stand a better chance of avoiding double non-taxation, there is in my

\textsuperscript{372} The OECD Model, Commentary to Art. 23, paras. 56.1.–56.2.

\textsuperscript{373} The OECD Model, Commentary to Art. 23, para. 56.3. See also Ratka, ‘Die Besteuerung im Quellenstaat als Voraussetzung der Anwendung des Methodenartikels’ in Sutter & Wimpissinger, \textit{Freistellungs- und Anrechnungsmethode in den Doppelbesteuerungsabkommen} (2002), pp. 90–102, who points out that, where a DTT term is interpreted on the basis of the meaning of that term under internal law, it may not always be easy to determine whether a conflict of qualification occurs as a result of different DTT interpretation or as a result of the interaction between internal law and DTT provisions.
view insufficient support in the DTT text for deviating from the principles of DTT application that would apply in other cases. In other words, I do not agree with the OECD view. This brings us back to paragraph 4 and the question as to whether N can be considered to have applied the provisions of the DTT to exempt income where N applies a distributive rule which precludes it from taxing an item of income and the subsumption of that item of income under that specific distributive rule follows from an interpretation of a DTT term on the basis of internal law. In my view, N could still be regarded as applying the provisions of the DTT to exempt the income, provided that there is no express definition of the term in the DTT and that the context does not require that the term is given a different meaning. Thus, paragraph 4 would be applicable and R would not be obliged to exempt the item of income that N has exempted from tax.

4.4.2.3 Article 23 B of the OECD Model

Article 23 B of the OECD Model reads as follows:

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23 B

CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:
   a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
   b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

The second, alternative, method recommended by the OECD Model is the ordinary credit method. According to the ordinary credit method, R taxes
income which under the DTT may be taxed in N, but shall allow a credit from the R tax equal to the tax paid in N, albeit restricted to the R tax which is proportionate to the income that may be taxed in N. In practice, the foreign tax credit limitation can be computed in many different ways, for instance on basis of the entire foreign income of the taxpayer, on the basis of the entire income derived by the taxpayer from N, separately for each item of income, etc. (see sub-chapter 5.4.13).

The second paragraph of Article 23 B acknowledges that the principle of exemption is applied by R under the distributive rules in certain cases and therefore reserves a right to take into account the exempted income for the purpose of computing the tax on the remaining income, meaning that exemption with progression is applied in these cases.

4.4.3 The Term Income

A prerequisite for the application of the double tax relief article is that a resident of a contracting state derives income which in accordance with the DTT may be taxed in the other contracting state. No express definition of “income” is given. This means that the interpretational rule of the DTT requires that the term shall have the meaning that it has under the internal law of that state for the purposes of the taxes to which the DTT applies, unless the context otherwise requires (see sub-chapter 3.8.6).

Even though there is no express definition of the term “income” in the DTT, it is clear that the double tax relief article applies in respect of any items of income which under the DTT may be taxed in N. Thus, it follows that the term “income” under the double tax relief article means any form of income, profits, payments, gains, etc. as are covered by the distributive rules of the DTT in question. To give the term “income” a more narrow meaning than under the distributive rules, on the basis of the meaning of the term under internal law, would be contrary to the object and purpose of the DTT as it would render the DTT ineffective in areas that were clearly intended to be covered by the DTT. It is another matter that the forms of income referred to in the distributive rules may in some cases in their turn be given the meaning that they have under the internal law of a contracting state and that the internal law of a contracting state may thus indirectly influence the meaning of the term income. Moreover, the conclusion that the meaning of the term “income” can be derived from the DTT is supported by the fact

374 Cf. Arts. 23 A.1 and 23 B.1 of the OECD Model.
that the DTT usually includes a catch-up distributive rule, which applies to items of income not dealt with in the other distributive rules. This wording suggests that all profits, gains, etc. dealt with by the distributive rules constitute “income” in the sense of the DTT.

As the DTT as a whole can be regarded as “context” in the sense of the interpretational rule of the DTT, and since the meaning of the term can be derived from the DTT, there is in my view reason to consider the context referred to in the interpretational rule of the DTT as requiring that the meaning that can be derived from the DTT shall prevail over the meaning of the term under internal law (cf. sub-chapter 3.8.6). However, HFD has on two occasions interpreted the DTT term “income” with reference to internal law.

In RÅ 1987 ref. 162, one question was whether the “subject-to-remittance” rule in Sweden’s former DTT with the United Kingdom applied to capital gains. At the time of the conclusion of the DTT, Sweden did not tax capital gains derived by former residents. However, a considerable time after the conclusion of the DTT, legislation was introduced to that effect, which made capital gains derived by a former resident of Sweden taxable in Sweden during a ten year period after moving from Sweden. Under the distributive rules, capital gains were taxable only in R, which in principle meant that Sweden in its capacity as N was precluded from exercising its taxing right with respect to capital gains derived by a resident of the United Kingdom who had previously been a resident of Sweden. However, it followed from the “subject-to-remittance rule” of the DTT that if taxation in the United Kingdom of income from sources in Sweden was determined by reference to the amount which was remitted to the United Kingdom, then Sweden’s obligation as source state to exempt income under the distributive rules would only apply to the part of the income which was remitted to the United Kingdom. The question was whether capital gains derived by a former Swedish resident could be regarded as income in the sense of the “subject-to-remittance rule”.

375 Cf. Art. 21.1 of the OECD Model.
HFD stated that the interpretation of the DTT was to be based mainly on the intention of the parties at the time of the conclusion of the DTT. According to HFD, the meaning of the term “income” in other provisions of the DTT did not give conclusive evidence of the meaning under the subject to remittance rule. Further, it held that the term “income” for the purpose of other provisions of the DTT seemed to include capital gains only to the extent that this was made clear by express reference or from the context. It then went on to analyse the circumstances in connection with the conclusion of the DTT on the basis of the preparatory works of the Incorporation Act relating to the amendment of the DTT, which according to HFD made clear that the amendment of the subject-to-remittance rule was of a formal nature and that there was no intention to widen the scope to include capital gains. This conclusion was further supported by the fact that the expression “income from sources”, which was not applied under Swedish internal law, in the internal law of the United Kingdom excluded capital gains. This meant that the term “income” in the subject to remittance rule of the DTT was deemed not to include capital gains and that Sweden was precluded from taxing the capital gain in question irrespective of whether the gain had been remitted to the United Kingdom.

Similarly, in RÅ 2004 not. 59, the question was whether a specific provision in the former DTT with Peru of 1968 applied in respect of capital gains. Under the distributive rules of the DTT, Sweden was precluded from taxing capital gains on shares in a Peruvian company derived by a company resident in Sweden, i.e. the right to tax such capital gains was reserved to N. However, another provision of the DTT stated that “income from sources in Peru, which under Peruvian internal law and in accordance with this DTT is taxed in Peru, be it directly or by way of deduction on remittance, shall be exempt from tax in Sweden”. HFD held that this provision could be perceived (based on an *e contrario* interpretation) as meaning that income which was not taxed in Peru was taxable in Sweden, i.e. as a generally applicable subject-to-tax rule. According to HFD, it was not possible solely on the basis of the Swedish DTT text to determine whether the phrase “income from sources” in this provision included capital gains. However, the Spanish version used the phrase “el rédito de fuente”, literally meaning “yield from a source”, which

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378 The author’s translation. In Swedish, the whole paragraph of the provision read as follows: “Där icke bestämmelserna i artikel VIII annat föranleda skall inkomst från inkomstkällor i Peru, vilken inkomst enligt peruansk lag och i överensstämmelse med avtalet är underkastad beskattning i Peru vare sig direkt eller genom skatteavdrag, vara undantagen från svensk skatt.”
according to HFD made it very unlikely that capital gains were covered by the
term “income from sources”. As a consequence, the allocation of taxing rights
was determined on the basis of the distributive rule, disregarding the potential
subject-to-tax rule, with the consequence that Sweden was precluded from
taxing capital gains on shares in a Peruvian company derived by a company
resident in Sweden.

In neither of these cases did HFD try to establish the ordinary meaning
of the term “income” in a DTT context, which as explained above clearly
includes capital gains. Instead, HFD tried to establish the meaning of the term
under the subject-to-remittance rule and the subject-to-tax rule by analysing
the meaning given to the different language versions under the internal laws of
the contracting states. In both cases, the meaning given to the language version
of the other state under the internal laws of that state was given precedence.

Judging from the statements made by HFD, it seems that HFD was of the
opinion that the meaning given to the term under the other provisions of
the DTT did not apply for the purpose of the subject-to-remittance rule and
the subject-to-tax rule respectively. However, in order to reach that conclu-
sion it would have been logical to first analyse whether there was convincing
evidence that the meaning of the term under the specific provisions was an
exception to the meaning under the DTT as a whole, as it would have been
reasonable to assume that the contracting states did not intend to give the
term a special meaning for the purpose of these provisions unless there was
evidence to the contrary. The fact that HFD did not refer to the ordinary
DTT meaning of the term indicates that it was not considered.

4.4.4 The Term Source

According to the internal law of many countries of British legal tradition,
unilateral double tax relief is only provided in respect of income from sources
in another state. The purpose of such source rules is to make sure that double
tax relief is provided in respect of an appropriate amount of income. In-
appropriate source rules that treat too much or too little income as foreign

379 Cf. Art. 31.1 VCLT.
380 Furthermore, as has been pointed out by Sundgren, the draft version of the DTT with
Peru, which was made in English, used the phrase “income from sources”. Thus, it seems that
the Spanish expression “el rédito de fuente” was simply a translation of “income from sources”
and does not indicate any intention to give the term “income” under the provision of the
DTT that might be perceived as a subject-to-tax rule any other meaning than under the other
provisions of the DTT, see Sundgren, ‘Interpretation of Tax Treaties Authenticated in Two or
source income may cause erosion of the tax base or international double taxation. The source of an income may be determined either on the basis of express internal law provisions or on case law, for instance according to the situs of a property from which income is derived.

The double tax relief article of the OECD Model as well as DTTs entered into by most states do not apply the term “source”. Instead, double tax relief under the double tax relief article is generally provided in respect of income which in accordance with the DTT may be taxed in N, i.e. if the distributive rules do not preclude N from taxing an item of income which is covered by the DTT, R is obligated to provide double tax relief. Thus, the distributive rules of the DTT are themselves designed to ensure that double tax relief is provided in respect of an appropriate amount of income.

However, in many DTTs entered into by countries that adhere to British legal tradition, including the United States, the internal law source prerequisite has been transplanted into the DTTs so that double tax relief shall only be provided in respect of income which is sourced in N. If the term is not defined in the DTT in question, “source” will normally have the meaning that it has under the tax laws of that state for the purposes of the taxes to which the DTT applies. As the definition of source under the internal law of R may not cover all items of income which under the distributive rules of the applicable DTT may be taxed in N, there may be situations where the distributive rules of a DTT reserves N’s right to tax an item of income, while under the double tax relief article R is not obligated to provide double tax relief as the item of income is deemed not to have its source in N. Although less likely, there may also be situations where an item of income will be regarded as having its source in N and where R, as a consequence, is obligated under the double tax relief article to provide double tax relief in spite

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381 Shay and others, ‘Report of the Task Force on International Tax Reform’, Tax Lawyer, 2006, No. 3, p. 762. According to ch. 2. sec. 1 para. 1 AvrL, foreign tax is creditable under the Swedish unilateral credit if (i) the item of income in question is taxable according to the Income Tax Act, (ii) the taxpayer has been taxed on the income in a foreign state, and (iii) the income is deemed to have arisen in the other state according to its tax law. The third condition means that the income must not be taxable in the other state merely on the basis of residence or nationality, as there would in such case be a risk of reciprocal double tax relief, i.e. double tax relief being provided by both Sweden and the other state.


383 Cf. Arts. 23 A and 23 B of the OECD Model.

384 Cf. Art. 3.2 of the OECD Model.
of the fact that N according to the distributive rules is precluded from taxing the income in question.385

The same problem can arise even if the term “source” is not used expressly, if the DTT refers to the internal law of a contracting state and that state applies source rules. For instance, according to the US Model, double tax relief is provided “in accordance with the provisions and subject to the limitations of the law of the United States”, i.e. subject to the United States source rules.386

Thus, if the United States is the state of residence for the purpose of the DTT and, in accordance with United States internal law, an item of income is considered to not have its source in N, double tax relief may be denied in the United States.387

It can be argued that insofar as elimination of double taxation under DTTs is concerned, the provisions of the DTT provide for double tax relief in respect of an appropriate amount of income, thereby rendering additional internal law provisions that serve the same purpose unnecessary. In order to avoid situations where R refuses to provide double tax relief in respect of income which under the DTT may be taxed in N due to the fact that the income in question in accordance with R’s internal law is deemed not to have its source in N, a definition of “source” is therefore often made in the DTT. The definition typically states that income which under the DTT may be taxed in N shall be deemed to have its source in N for the purpose of the double tax relief article, thereby aligning the obligation to provide double tax relief with the distributive rules.388 Such a definition of the term “source” is often referred to as a “deemed source rule”.389

In some DTTs between a country that adheres to the British legal tradition and another country which does not, the source provision of the double tax relief article applies to both states, stating that double tax relief shall be provided in respect of income from sources in the other state, even though only one of the contracting states applies source rules in its internal law.


386 Art. 23.2 of the U.S. Model.


388 See for instance Art. 23.3 of the US Model. As regards the United Kingdom, see Davies, Principles of International Double Taxation Relief (1985), p. 197.

This is for instance the case in Sweden’s DTTs with Greece, Israel, Kenya, New Zealand, Singapore, and Taiwan, where it follows from the double tax relief article that Sweden shall provide double tax relief in respect of income from sources in the other contracting state. The question is then whether the expression “income from sources” shall be interpreted on the basis of the internal law of R, i.e. on the basis of the internal law of the state that applies the double tax relief article, regardless of whether that is Sweden or the other state, on the basis of the internal law of the state which has source rules, or on the basis of the general structure of the DTT.

Where double tax relief shall be provided by the state which has source rules in its internal law, it will normally follow from the interpretational rule of the DTT that the meaning of the term “source” shall be determined on the basis of its meaning under the internal law of that state. However, where it is the other state which shall provide double tax relief, an interpretation on the basis of the internal law of that state would hardly be conclusive for determining its meaning. Further, it can normally be assumed that the state in question has not intended the obligation to provide double tax relief to be modified in some way by the use of the term (unless there is indication to the contrary). Therefore, interpreting the term on the basis of the internal law of the state that has source rules in its internal law where it is the other state which applies the DTT would give an unsatisfactory result. Rather, it is submitted that an interpretation consistent with the DTT structure is preferable, i.e. “income from sources” should be given no other meaning than “income which in accordance with the DTT may be taxed in the other state”, unless there is evidence in the DTT text of an intention to give the expression a specific meaning. In other words, the “context”, i.e. the DTT as a whole, “requires” that “income from sources” is given no other meaning than “income which in accordance with the DTT may be taxed in the other state” (cf. sub-chapter 3.8.6). A counter-argument against the proposed solution is that the term “source” would be given a different meaning depending on whether or not it is the state that has source rules in its internal law that applies the DTT. In other words, the DTT would be interpreted asymmetrically.

From a Swedish point of view, the solution presented is supported by HFD case RÅ 1995 not. 68. The facts of the case were as follows. A Swedish resident had been working as a tour leader in Greece. According to Article XIII.1 of the DTT with Greece, salaries and similar remuneration derived

390 Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 72.
by a resident of a contracting state in respect of an employment shall be taxable only in that state unless the employment is exercised in the other contracting state, meaning that Article XIII.1 reserved Greece’s right to tax the taxpayer on the basis of the fact that the employment had been exercised in Greece. According to the double tax relief article of the DTT, Article XXIII.2, income from sources in Greece, which in accordance with the DTT may be taxed in Greece, shall be exempt from tax in Sweden (with the exception of dividends, interest, and royalty). The court noted that there was no express definition in the DTT of the phrase “income from sources” for the purpose of Article XXIII. Further, the court took notice of the fact that the DTT had been based on the recommendations and reports made by the Fiscal Committee of the OECD, which were later adapted into the 1963 OECD Model. Consequently, the court concluded that there was reason to believe that the contracting states had not intended to give the term “source” any other meaning than the place in which the employment was exercised, i.e. in accordance with the OECD Model. As a result, the taxpayer’s income from work performed in Greece was considered exempt from tax in Sweden.

Some Swedish DTTs contain deemed source rules that seem to apply to both contracting states, but which only make sense where Sweden’s treaty partner is the state of residence, as the provision that sets out an obligation for Sweden to provide double tax relief where Sweden is the state of residence makes no reference to the term “source” and as Sweden does not use source rules in its internal laws. Thus, it is submitted that such deemed source rules should have no effect on the application of the DTT in Sweden.

As regards deemed source rules, it can be noted that Germany, which does not apply source rules under its internal laws, has inserted a DTT provision in several of its DTTs, including in the DTT with Sweden, which at least is very similar to a deemed source rule. The provision states that the income in question shall be deemed to be derived from sources in the other contracting state, if it \( \text{is taxed} \) in the other state in accordance with the DTT. This deviates from the standard wording of a deemed source rule which typically state that the income in questions shall be deemed to have its source in the other contracting state if it \( \text{may be taxed} \) in the other state in accordance with the DTT. Such provisions have been interpreted as subject-to-tax clauses, i.e. is as a requirement that tax is actually imposed by N in order for the obligation to provide double tax relief to apply.

391 See for instance Art. 24.6 of the DTT with Ireland.
392 Vogel, “The Definition of “Source” in Sweden’s Tax Treaty with Germany’ in Lindencrona,
4.4.5 Taxation in Accordance with the Provisions of the DTT

By entering into a DTT, the contracting states agree to limit their respective taxing rights so that an allocation of the tax revenue relating to the transactions covered by the DTT is achieved. The DTT therefore provides for an obligation to provide double tax relief only to the extent that it allocates taxing rights to the other state, normally by stating that the double tax relief article shall apply only in respect of income which “in accordance with the provisions of the DTT may be taxed in the other state”. This means *inter alia* that R is not obligated to eliminate double taxation under the double tax relief article where according to the relevant distributive rule N is precluded from taxing the item of income in question, as the obligation to provide relief lies instead with N. Similarly, where taxation according to the relevant distributive rule may take place in N but is limited to a certain rate, there is no obligation to eliminate double taxation in excess of that rate, irrespective of the amount of tax that has actually been imposed in N. Taxation in N in excess of the DTT tax rate limit may for instance take place where the taxpayer has not claimed a reduction of the N tax rate or has been denied a reduced rate on the basis of failure to fulfil procedural requirements under N’s law, such as the filing of an application for a refund of withholding tax within a set time limit.  

The extent of R’s obligation to provide double tax relief is illustrated by the HFD case RÅ79 1:47. In 1974, a Swedish company had received royalties from Brazil and Spain and therefore claimed a credit against Swedish tax for tax paid in these states on the royalty payments. The tax levied in Brazil and Spain corresponded to approximately 25 % and 8 % respectively of the royalty payments. The DTT with Brazil stated that, where taxation of Brazilian source income may take place under Brazilian law and in accordance with the DTT, Sweden shall allow a credit for Brazilian tax on such income. The DTT with Spain contained a similar provision. In the DTT between Sweden and Brazil the tax rate in the source state in respect of royalties was limited to 15 % and in the DTT between Sweden and Spain it was limited to 5 %. As a consequence, the Swedish company was denied a credit in excess of the taxing rights reserved to the source state under the DTTs.

The above court case predates the Swedish Foreign Tax Credit Act (“AvrL”). According to ch. 2 sec. 8 AvrL, the taxpayer is entitled to credit

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foreign tax in an amount corresponding to the sum of (i) tax which is credit-
itable under chapter 2 section 1 AvrL (ii) tax which is creditable under a
DTT, and (iii) excess credits which have been carried forward. According
to chapter 2 section 2 AvrL, no credit is given under chapter 2 section 1
AvrL if the Swedish tax, the foreign tax and the foreign income is covered
by a DTT. Thus, if an item of income and tax relating to it is covered by a
DTT, no unilateral credit is given under chapter 2 section 1 AvrL. It can be
argued that N tax in excess of a DTT tax rate limitation is not covered by a
DTT and that unilateral credit should therefore be allowed. Thus, unilateral
credit would be denied only where the entire amount of foreign tax imposed
is covered by a DTT. Another interpretation would be that the term “the
foreign tax” is taken as meaning the type of tax levied by N, not the amount
of tax as such. For instance, if an item of income which is covered by a DTT
is subject to income tax in N and if income tax is covered by the DTT, the
foreign tax referred to in the provision would be considered covered by a
DTT, regardless of the amount of tax imposed. According to this interpreta-
tion, tax levied by N in excess of a tax rate limitation provided for in a DTT
would not qualify for unilateral credit. A refusal to provide a credit in these
situations would be in line with the allocation of taxing rights agreed on by
the contracting states. It would in my opinion not normally make sense for
Sweden to unilaterally give up taxing rights to the other contracting state
where these taxing rights have been allocated to Sweden under a DTT.

The question whether tax has been levied by N in accordance with the DTT
often arises where the contracting states classify an item of income differently
for the purpose of the DTT and, as a result, apply different DTT provisions
on the same item of income. The application of different DTT provisions
by the contracting states, potentially leading to taxation in N that from R’s
point of view is not in accordance with the DTT, may be due to differences in
(i) interpretation of the provisions of the DTT, (ii) interpretation of facts, or
(iii) the internal laws of the contracting states.\(^{394}\) It normally makes no differ-
ence under what provision an item of income is subsumed by N, as long as N
does not impose tax in excess of the level stipulated in distributive rule that R
considers to be applicable. Even though N from R’s point of view applies an
incorrect DTT provision to the item of income in question, N cannot be said
to act in breach of the DTT if it does not levy tax in excess of the taxing right
reserved to it. However, if it is precluded from taxing the income in question

\(^{394}\) The OECD Model, Commentary to Art. 23, paras. 32.1–32.7 and 59.
under the distributive rule that R considers to be applicable, the question arises whether imposition of tax on the income by N is in accordance with the DTT. Similarly, if a limitation applies to the N tax rate under the distributive rule that R considers to be applicable, the question arises whether imposition of tax in excess of that limitation is in accordance with the DTT where N considers that a different distributive rule which provides for a higher tax rate limitation or no limitation is applicable.

If N has imposed tax by applying to an item of income a distributive rule that is different from that which R considers to be applicable and if this is due to differences in interpretation of the DTT provisions or facts, then from R's point of view such taxation is clearly not in accordance with the DTT and, as a consequence, there is no obligation for R to eliminate double taxation.395 Similarly, if either of the contracting states, due to differences in interpretation of the residence article or the facts of a case, consider a taxpayer to be a resident of the respective state for the purpose of the DTT, taxation by the other state in excess of the taxing rights reserved to N under the DTT will from R's point of view be considered not in accordance with the DTT. However, insofar as the DTT in substance complies with the OECD Model and N has made an observation in the Commentaries, which R has not objected to, and interprets the DTT accordingly, it can be argued that N taxes the income in accordance with the DTT despite the different interpretation.396 This argument presupposes that R has either accepted and become bound by the interpretation that follows from the observation made by N or that R has accepted asymmetrical treatment by not objecting to the observation made by N (see sub-chapter 3.8.3.3). Otherwise, the interpretation made by N would, from R's point of view, not be in accordance with the DTT.

The situation is different insofar as the taxation in N in excess of the right reserved to N under R's interpretation of the DTT depends on the internal law of N. Although DTTs provide for a systematic approach to dealing with situations where two states assert taxing jurisdiction over the same transaction or person they do not generally concern themselves with aspects of taxation that require detailed regulation such as the characterisation of income or the classification of entities. The subsumption of an item of income under a DTT provision is therefore often made on the basis of the internal laws and practice

395 The OECD Model, Commentary to Art. 23, para. 32.5.
396 See Ward and others, The Interpretation of Income Tax Treaties with Particular Reference to the Commentaries of the OECD Model (2005), pp. 74–75.
of the state in which the DTT is applied. Where the classification of an item of income depends on the internal laws of a contracting state (by explicit reference in the DTT or by application of the interpretational rule of the DTT) it can be argued that the contracting states are given some leeway to classify the income differently without breaching the DTT. Thus, it may be argued, as the OECD Model does, that R is under an obligation to eliminate double taxation even though N imposes tax in excess of the right reserved to N under the distributive rule that R considers to be applicable, provided that the application of different distributive rules is due to differences in the internal laws of the contracting states.

The OECD view is not undisputed. For instance, the Netherlands does not agree that the qualification given by N shall prevail for the purposes of the application of the double tax relief article by R and has submitted an observation to Article 23 of the OECD Model to that end.

In my view it is reasonable to consider N as taxing an item of income in accordance with the DTT if it, on the basis of internal law, considers a different distributive rule than R to be applicable, insofar as the DTT allows classification on the basis of internal law. In such cases, N does not act in breach of its treaty obligations by applying a different distributive rule than R. This conclusion does not presuppose that R accedes to the classification made by N for the purpose of the double tax relief article. It merely means that R accepts the N taxation as being within the interpretative frames set by the DTT provisions.

4.5 Summary

This chapter deals with issues that apply to the elimination of double taxation under DTTs in general. Furthermore, it deals with some issues that relate to the elimination of double taxation under either of the distributive rules or the double tax relief article. However, it does not deal with issues that relate to any specific principle or method for elimination of double taxation.

397 Cf. Art 3.2 of the OECD Model and the discussion in sub-chapter 3.8.6 on the arguments in favour of finding a common interpretation based on the DTT itself or the internal law of N.
398 The OECD Model, Commentary to Art. 23, paras. 32.3-4, and Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), para. 37.
399 The OECD Model, Commentary to Art. 23, para. 80.
In general, DTTs are only effective where tax is imposed under the internal laws of the contracting states on the same taxpayer. This can be referred to as a requirement for “subject identity”. DTTs do not normally contain any rules for attributing income to a person, meaning that the attribution normally is made solely on the basis of internal law. Where income is attributed by the contracting states to different persons, the DTT may be unable to resolve the double taxation. For the purpose of determining whether there is subject identity, it would make sense to look at the attribution of income for tax purposes. For instance, if income is derived through a partnership which is considered by both contracting states as transparent for tax purposes, it would make sense to regard the income as attributable to the owners of the partnership. In Swedish case law, however, subject identity has been determined with reference to legal entitlement to the income. Although, the Swedish Foreign Tax Credit Act has later been amended in order to entitle the owners of a partnership to unilateral credit in respect of foreign tax on income derived through the partnership, the requirement for legal entitlement to the income may still be of relevance in other situations.

Double taxation can be eliminated either under the distributive rules or under the double tax relief article. To the extent that a distributive rule precludes one of the contracting states from taxing an item of income, double taxation is eliminated under the distributive rules without the need for application of the double tax relief article. The situations in which the distributive rules of the OECD Model preclude one of the contracting states from exercising its taxing right are set out in sub-chapter 4.3.2. It follows from that account that there are several situations where the distributive rules allocate the taxing right exclusively to R, but only a few situations where the taxing right is allocated exclusively to N.

The distributive rules of a DTT allocate taxing rights on the basis of the existence of a connection either between a contracting state and a taxpayer or between a contracting state and an activity or property that generates income. In cases where the connection is present only for a limited period, it is necessary to determine whether income is attributable to the period in which the connection existed. As DTTs do not determine tax liability, DTTs do not contain rules for determining when income arises. However, in spite of this, it may sometimes be possible to refer income to a specific period in which there is or is not a connection between N and an activity or property that generates income, independently of the internal laws of the contracting states, at least in uncomplicated cases where income is earned continually and on a regular basis. In complicated cases, it may be necessary to fall back
on internal law in order to refer income to a specific period. Furthermore, where the relevant distributive rule does not allocate a taxing right to N on the basis of the existence of a connection between N and an activity or property that generates income, but instead allocates the taxing right to R on the basis of a connection between the taxpayer and that state, it may be even more difficult to refer income to a specific period, independently of the rules and principles under internal law for determining when income arises. As a consequence, income may have to be referred to the period in which the connection existed on the basis of internal law. In other words, the taxable event under internal law becomes decisive for referring income to a specific period. Where a taxpayer changes his residence and the contracting states refer the income to different periods, double taxation which cannot be solved under the DTT or double non-taxation may therefore occur.

The application of the distributive rules requires that income is attributed and expense is allocated to either R or N. Consequently, the distributive rules provide general principles for attributing income and allocating expense. However, to some extent, the attribution of income and allocation of expense is governed by internal law. Differences in the attribution of income and allocation of expense may result in double taxation that cannot be solved under the DTT or double non-taxation, as shown by the evaluation in sub-chapter 6.5.

The quantification of income is largely dealt with by internal law without interference from DTT provisions. Only to a very limited extent, in relation to business profits, do DTTs provide principles for the quantification of income. To the extent that a quantification of the income, taking into account these principles, falls below a quantification of the taxable income under N’s internal law, the DTT limits the amount of income that N may subject to tax. Similarly, where there is an obligation under the DTT for a state to eliminate double taxation and the quantification of foreign income, taking into account the principles provided by the DTT in regard to business profits, exceeds the amount of foreign income computed under the internal law of that state, double tax relief shall be provided in respect of the higher amount.

In many cases, the distributive rules do not preclude either of the states from taxing an item of income. In such cases, remaining double taxation may be eliminated under the double tax relief article. As regards the term “income”, which is typically applied in the double tax relief article, it is submitted that, in spite of the fact that there are cases from HFD that point in the opposite direction, a meaning of the term can be derived from the
DTT and that no narrower meaning shall be given to the term on the basis of internal law. As regards the requirement of the double tax relief article of some DTTs that double tax relief shall only be provided in respect of income from “sources” in N, which is inserted in many DTTs entered into by states that adhere to the British legal tradition, the situation is different. Generally, no definition of the term “source” is made in DTTs and it is therefore necessary to fall back on internal law to determine the meaning of the term. Thus, the term “source” shall not be given an autonomous meaning. If R does not have source rules in its internal law, it is submitted that the inclusion of the term “source” shall normally be disregarded, i.e. it shall be interpreted as not implying a change of meaning, unless there is evidence in the DTT text of an intention to give the term a specific meaning. Thus, where R does not have source rules in its internal law, double tax relief shall be provided by R in respect of income which in accordance with the DTT may be taxed in N, regardless of whether N considers the income to be sourced in N.

Finally, an important limitation to the obligation to provide double tax relief under the double tax relief article is that double tax relief shall be provided only to the extent that the foreign income is taxed by N in accordance with the DTT. Thus, R is not obliged to provide double tax relief where N imposes tax in excess of the taxing right that is reserved to N under the DTT. Where the contracting states classify an item of income differently for the purpose of the DTT and, as a result, apply different DTT provisions on the same item of income, N may consider that it imposes tax in accordance with the DTT, while R considers that N imposes tax in excess of the taxing right reserved to it under the distributive rule which R considers to be applicable. In such a situation, it is likely that R will deny double tax relief to the extent that the N tax exceeds the taxing right which R considers to have been reserved to N. However, if the DTT allows the classification to be made on the basis of internal law and the classification of income by N has been made with reference to N’s internal law, it seems reasonable to argue that the taxation in N is in accordance with the DTT regardless of whether R considers another distributive rule to be applicable. Consequently, it can be argued that R would be obliged to provide double tax relief.
5 The Methods For Elimination of Double Taxation

5.1 Introduction

This chapter seeks to systematise the various methods applied in DTTs for eliminating double taxation. Furthermore, a number of problems relating to the application of these methods are analysed, in particular from a Swedish perspective. Thus, this chapter relates to the first aim of the study as set out in sub-chapter 1.2.1, namely to systematise and analyse the various forms of the methods for elimination of double taxation under DTTs in order to gain a better understanding of how the methods work.

The techniques for relieving double taxation can be said to fall under two main principles. Under the principle of exemption, one of the contracting states is precluded from taxing an item of income. Under the principle of credit, income derived from the other contracting state is taxed, but a credit is allowed for tax paid in the other contracting state on income derived from that state. The principles of exemption and credit can be broken down into a number of different methods that are used to eliminate or reduce double taxation.

In virtually all DTTs currently in force, both the principle of exemption and the principle of credit are used, although the emphasis may vary considerably. For instance, where exemption is applied by R as the main principle for elimination of double taxation, the principle of credit is normally applied by R in respect of dividends and interest and occasionally also in respect of royalty. Furthermore, the principle of credit may be applied on the basis of special provisions aimed at preventing double non-taxation. Correspondingly, where credit is used by R as the main principle for providing double tax relief, the principle of exemption is normally applied by R under the distributive rules in a few specific situations, thereby eliminating the need for a foreign tax credit in such cases. Furthermore, irrespective of the principle for elimination of double taxation applied by R, N typically applies the principle of exemption under the distributive rules in respect of certain types of income, for instance in respect of income from employment exercised outside N or capital gains on movable property not forming part of a PE in N.400

400 See sub-ch. 4.3.2 as regards the situations where exemption is applied under the distributive rules.
Many continental European countries such as Germany favour the principle of exemption, whereas Anglosphere countries tend to favour the principle of credit.\footnote{Cf. Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 56, and Stockman, ‘Should the Exemption Method Have Priority over the Credit Method in International Tax Law?’, \emph{BIFD}, 1995, p. 288.} For states that base tax liability solely on territoriality, i.e. not on personal factors such as residence, the principle of credit is hardly an option. If under the internal law of a state that taxes income in accordance with the territoriality principle an item of income is regarded as attributable to that state and therefore taxed on the basis of territoriality, the foreign tax will not, at least not under internal law, be deemed attributable to foreign income and, hence, the foreign tax credit limitation under internal law would always be zero. Consequently, it would not make sense for a state that bases tax liability solely on territoriality to choose the principle of credit.\footnote{Mutén, ‘Credit-metod eller exempt-metod i dubbelbeskattningsavtal – en principfråga’, \emph{SvSkT}, 1993, p. 302.} Under the principle of credit, tax paid in the other state is credited against tax paid in the state that provides double taxation relief. According to the principle of exemption, income derived from another state is exempted, meaning that it is excluded from the tax base. Consequently, and in contrast to the principle of credit, the application of the principle of exemption does not require knowledge of the amount of tax paid in the other state.

Another option for relieving, but not eliminating, double taxation is to set a ceiling on the tax that may be imposed by a contracting state. This technique is typically applied in DTTs to reduce double taxation in respect of dividends, interest, and royalty by means of provisions that set a limit to the tax rate that may be applied by the contracting state out of which the payment of the dividend, interest, or royalty is made.\footnote{Cf. Arts. 10–11 of the OECD Model and Arts. 10–12 of the UN Model.} In this chapter, limitation of the tax rate is dealt with as a separate principle for elimination of double taxation, since it is conceptually different to the principles of exemption and credit. Double taxation that remains when the state out of which the payment is made has levied tax (subject to the tax rate limitation) is typically eliminated through application of the principle of credit by R.

In theory, it is also possible to achieve double tax relief by limiting the tax rate in R on foreign source income, but unless the N tax would be lower than the ordinary R tax and the limited R tax rate sufficiently low, the method would be incapable of achieving taxation which is equal to the tax burden
that would have applied if taxation had taken place only in R or N. It would also be conceivable to achieve double tax relief by applying a reduced R tax on foreign income in combination with a right to deduct foreign tax from taxable income, although such a combination of methods has not to my knowledge been applied in practice.404

As follows from chapter 2, a state’s choice between the principles of exemption and credit may reflect policy choices regarding the degree to which foreign investment will be treated neutrally with investments made within R or encouraged (or discouraged) in relation to investments made within R, which in turn, among other things, may depend on that state’s dependence on foreign trade and investment.405 As the choice between the principles of exemption and credit is governed inter alia by the overall economic policies of the contracting states and their preference as regards CEN and CIN, it has not been possible to agree on a single principle or method which would result in equitable sacrifice of tax revenues and which could be accepted by all states. Consequently, the OECD Model does not propose one single method in the double tax relief article, but two alternative methods: exemption with progression and ordinary credit.406 The OECD Model also provides for double tax relief in respect of dividends and interest by means of limitation of the tax rate in N in combination with the principle of credit.

Furthermore, the choice between the principles of exemption and credit is also determined by other factors than the contracting states’ preferences as regards CIN and CEN. For instance, exemption of income is generally believed to be easier to administer as it can be applied without knowledge of the amount of tax levied by the other contracting state.407 On the other hand, the principle of exemption may lead to a higher risk of double non-taxation,

404 Shaviro proposes such a combination of methods, see Shaviro, ‘Rethinking Foreign Tax Creditability’ in Lang and others (eds.), Tax Treaties: Building Bridges between Law and Economics (2010), pp. 363–380, although he has in mind a reduced tax rate under internal law on foreign source income rather than a DTT tax rate limitation.


406 The OECD Model, Commentary to Art. 23, paras. 28–29. For an account of the discussions within the OECD in the late 1950s and early 1960s (at that time named OEEC) concerning the choice between exemption and credit, see Maisto ‘Credit versus Exemption under Domestic Tax Law and Treaties’ in Lang and others (eds.), Tax Treaties: Building Bridges between Law and Economics (2010), pp. 333–339.

for instance where the treaty partner according to its internal law exempts specific items of income or where conflicts of qualification occur. As DTTs are the result of bilateral negotiations, the choice of method in a given situation may also depend on the relative negotiating power of the states concerned.

5.2 The Principle of Exemption

5.2.1 Introduction

The principle of exemption is one of the two main principles for elimination of double taxation under DTTs. The purpose of this sub-chapter is to analyse some important aspects of this principle, including the relation between DTT provisions on exemption and internal law, and to look specifically at different methods that can be subsumed under the principle of exemption.

The critical characteristics of a tax system result from the combination of the definition of the tax base and the rate or rates of tax applied to the base to determine tax liability. The principle of exemption, which may be applied on the basis of the distributive rules or on the basis of the double tax relief article, functions by excluding certain items of income from the tax base, thereby reducing the tax liability.

The exclusion of income by a contracting state from the tax base under the principle of exemption is normally independent of the level of taxation of the exempted income in the other state. It does not even matter if the right to tax reserved to the other state under the DTT is exercised by that state, unless such a condition has been expressly provided for. This means that, in principle, the state that applies exemption does not have to concern itself with the actual taxing position in the other contracting state. This is an advantage from an administrative point of view. However, where exemption with progression is applied, the administrative advantage may not be significant, since the exempted income has to be known.

Although historically Sweden has applied exemption in its DTTs as the main principle for elimination of double taxation, since the mid-1960s credit is applied as the main principle for elimination of double taxation. Sweden only has two DTTs still in force in which exemption is the main principle for elimination of double taxation: the DTT with Israel of 1959 and the DTT with Greece of 1961.

409 The OECD Model, Commentary to Art. 23, para. 34.
410 For a discussion on the reasons for the shift, see sub-ch. 5.4.1.
The principle of exemption regained some ground in the 1980s when it was used by Sweden in a number of DTTs with regard to business profits.\footnote{See \textit{inter alia} the DTTs with Bulgaria, Cyprus, Indonesia, Japan, Pakistan, Thailand, and Zimbabwe.} According to the Government Bill relating to the incorporation of the DTT with Japan, a change from the principle of exemption, which was used in the previous DTT, to the principle of credit would have caused Swedish enterprises operating in Japan considerable tax disadvantages.\footnote{Prop. 1982/83:109, p. 32.} As pointed out by Mattsson, it would have been appropriate to explain what these tax disadvantages were and why they were severe enough to justify an exception from the principle of credit in the DTT with Japan.\footnote{Mattsson, ‘Exemption or Credit of Tax: What is Sweden’s Preference’ in Andersson, Melz & Silfverberg (eds.), \textit{Liber Amicorum Sven-Olof Lodin} (2001), pp. 149–151.} Even more so, it would have been appropriate to openly discuss whether there was a need for a general policy change with regard to business profits.\footnote{Ibid, p. 153.} However, despite the use of the principle of exemption with regard to business profits, credit has remained the main principle for elimination of double taxation since the policy shift in the mid-1960s. At the beginning of the 1990s, the exception from the principle of credit with regard to business profits was terminated without any explanation in the preparatory works. The policy change in this regard might have been due to the introduction of legislation in 1986 which made clear that expenses relating to exempted income were non-deductible.\footnote{Prop. 1985/86:131, pp. 15–16. The provision can now be found in ch. 9 sec. 5 para. 1 IL.} As a result, it became clear that the principle of exemption was less favourable for enterprises investing abroad if the expenses abroad exceeded the income. This disadvantage for the business where the principle of exemption is applied may have influenced DTT policy with regard to business profits and the return to the principle of credit.\footnote{Mattsson, ‘Exemption or Credit of Tax: What is Sweden’s Preference’ in Andersson, Melz & Silfverberg (eds.), \textit{Liber Amicorum Sven-Olof Lodin} (2001), p. 152, and Mutén, ‘Creditmetod eller exempt-metod i dubbelbeskattningsavtal – en principfråga?’, \textit{SvSkT}, 1993, p. 312.}

\subsection*{5.2.2 Relation to Internal Law}

As pointed out in sub-chapter 3.1, DTTs and internal law interact in several different ways. For instance, internal law and DTT provisions may conflict with each other, or internal law may be of relevance for interpreting DTT provisions. Furthermore, internal law may complement DTT provisions. The following observations can be made as regards the role of internal law in carry-
ing out exemption of income provided for under a DTT, i.e. internal law as a complement to DTT provisions on exemption.

Where it follows from a DTT that an item of income is to be exempted, the exclusion of income from the tax base under the principle of exemption is normally less complicated than a credit of foreign tax. As a result there is generally less need for internal law regulation in the application of the principle of exemption than in the application of the principle of credit. Having said this, it must be pointed out that DTT provisions on exemption of income do not normally give detailed rules on how the exemption is to be implemented and they do not contain any rules at all in respect of procedure. As a consequence, there are many aspects of the application of the principle of exemption which will have to be determined on the basis of internal law, such as the quantification and computation of tax on the remaining income, in particular where the exempted income shall be taken into account for the purpose of determining the applicable tax rate on the remaining income, and treatment of losses in the other state.417

As regards Swedish internal law, there are no provisions that expressly provide for exemption of income where it follows from a DTT that income shall be exempted. Instead, the fact that the tax liability shall be determined excluding such items of income as have been exempted under a DTT follows from the priority over internal law normally attributed to DTTs. On the other hand, the Swedish Income Tax Act expressly provides for non-deductibility of expenses relating to income which has been exempted under a DTT418 and, specifically, foreign tax paid in respect of income which has been exempted under a DTT.419

5.2.3 Subject-to-Tax Clauses

As mentioned in sub-chapter 4.2 above, it is not possible for a taxpayer to claim treaty benefits in relation to a contracting state where no tax is imposed on that taxpayer by that state, meaning that double tax relief can typically only be achieved where two states tax the same person on the same item of income. However, the prevailing view is that treaty benefits can be claimed in relation to a contracting state that has imposed tax regardless of whether the other state has imposed tax, unless otherwise is expressly provided for in the DTT concerned. International juridical double taxation is thus not a prerequisite

417 The OECD Model, Commentary to Art. 23, paras. 38–46.
418 Ch. 9 sec. 5 para. 1 II.
419 Ch. 16 sec. 18 II.
for the application of a DTT. Where it follows from a distributive rule that a contracting state is precluded from taxing an item of income, that state shall exempt the income in question regardless of whether the other state does in fact exercise the taxing right reserved to it. Furthermore, where the double tax relief article provides for elimination of double taxation by means of the principle of exemption, R is obligated to exempt income which may be taxed in accordance with the DTT regardless of whether or not N actually subjects the item of income to tax, insofar as the DTT provisions do not expressly state otherwise. In other words, unless expressly provided for, a taxpayer is entitled to treaty protection without having to demonstrate that the non-application of the DTT would result in actual double taxation. 420

As a taxpayer is as a main rule entitled to treaty benefits regardless of whether both states do in fact impose tax under their internal laws, the application of a DTT may result in double non-taxation. In order to reduce the risk of double non-taxation, the contracting states may agree to insert a so-called subject-to-tax clause, which provides that the obligation of a contracting state to exempt income shall only apply if the income in question is subject to tax in the other state. 421 Other clauses that serve the same purpose are also applied, for instance so-called switch-over clauses that provide for a switch from the principle of exemption to the principle of credit where certain criteria (such as the payment of tax in the other state) are not fulfilled and remittance base clauses that require the remittance of income to the other state for the principle of exemption to apply in order to avoid double non-taxation of unremitting income.

In some cases, certain DTT provisions have been interpreted as subject-to-tax clauses despite the fact that it has been unclear whether the purpose of including them was to avoid double non-taxation (see for instance sub-chapter 4.4.4). An interesting Swedish HFD case in this respect is RÅ 2004

420 The OECD Model, Commentary to Art. 23, paras. 34–34.1, Baker, Double Taxation Conventions (2005), Introductory Topics, B.11–B.12, and Vogel and others, Doppelbesteuerungsaufkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Einleitung, paras. 74–75. In cases where a provision conforming to Art. 23 A.4 of the OECD Model has been inserted in the DTT, a distinction should be made between the question whether a contracting state must exempt income regardless of whether the income is subjected to tax in the other state under its internal law and the question whether R is obliged to exempt income where non-taxation in N is due to a conflict of qualification, see sub-ch. 4.4.2.2.

421 A subject-to-tax provision may take many different forms, see for instance the OECD Model, Commentary to Art. 1, paras. 15–20, where subject-to-tax provisions are discussed in relation to conduit company cases.
The case concerned Sweden’s DTT with Peru of 1968, which has now been terminated. The DTT contained a provision which stated that “… income from sources in Peru, which under Peruvian internal law and in accordance with this DTT is taxed in Peru, be it directly or by deduction on remittance, shall be exempt from tax in Sweden.” HFD noted that the provision could be perceived as a generally applicable subject-to-tax rule (on the basis of an *e contrario* interpretation), which potentially could have the effect of reserving Sweden’s taxing right in respect of capital gains on shares in Peruvian companies which would otherwise have been exempted. At the time the DTT was concluded, Peru imposed tax on the basis of the territoriality principle, i.e. Peru did not tax income from sources outside of Peru. Thus, in the absence of a subject-to-tax rule, income from a third state which under the distributive rules would have been taxable in Peru only would have been taxed by neither Sweden nor Peru. In other words, there was clearly a need for a subject-to-tax rule. On the other hand, since the provision in question merely state that income, under certain conditions, shall be exempt from tax, it can be questioned whether it was within the scope of the DTT text to interpret the provision as reserving Sweden’s taxing right, thereby overriding a distributive rule which according to its wording precluded Sweden from imposing tax.

Many interpretational problems arise as regards subject-to-tax clauses. For instance, is an insignificant amount of tax on the income sufficient to preclude the application of a subject-to-tax rule or is there a minimum tax or tax rate that has to be applied? Does the income have to be subject to tax at the regular level or is a lower tax rate accepted without triggering the subject-to-tax clause? Does the entire income have to be subject to tax or is it sufficient that a part of the income is taxable to preclude application of a subject-to-tax rule? Is the subject-to-tax rule applicable where non-taxation occurs as a result of N’s internal law rules concerning quantification of income (i.e. where the income of the taxpayer is zero or negative according to N’s internal law), where non-taxation is due to the carry forward of losses in N or where income is exempted in N on the basis of a DTT between N and a third

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422 The author’s translation. In Swedish, the whole paragraph of the provision read as follows: “Där icke bestämmelserna i artikel VIII annat föranleda skall inkomst från inkomstkällor i Peru, vilken inkomst enligt peruansk lag och i överensstämmelse med avtalet är underkastad beskattning i Peru vare sig direkt eller genom skatteavdrag, vara undantagen från svensk skatt.”

state? Such interpretational issues will have to be dealt with on a case by case basis and take as their starting point the wording of the subject-to-tax rule concerned.424

5.2.4 Deduction of Losses in N from Income in R

Where the principle of credit is applied, the pre-credit tax in R is generally computed taking into account any losses incurred to the taxpayer in N. Thus, losses in N reduce the amount of tax to be paid in R. If, on the other hand, the principle of exemption is applied by R, it is less clear whether the taxpayer shall be allowed to deduct losses incurred in N from the income of the taxpayer in R. Most states would treat losses in symmetry with income, meaning that losses are considered deductible insofar as corresponding income is taxed and non-deductible if corresponding income is tax exempt, for instance on the basis of the provisions of a DTT.425

However, as a result of non-deduction of losses, the taxable income of the taxpayer exceeds the taxpayer’s actual worldwide income in that year and, if the losses come close to or exceed the income from R, the taxpayer may even have to pay tax at an effective rate of over 100 per cent of the worldwide income. On the other hand, if the taxpayer would be entitled to deduct losses incurred in N from the income in R and, at the same time, is entitled to carry such losses forward in N, the taxpayer may be able to claim a double deduction. Furthermore, from the perspective of R, taking such losses into account would lead to asymmetrical treatment (i.e. the taxpayer benefits from the principle of exemption if income is derived from N without a corresponding disadvantage if losses are incurred in N).426


425 Correspondingly, where R excludes income from the tax base under the principle of exemption, any losses in R remain unaffected by income from N, see Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 39.

It can be argued that losses covered by a DTT exemption must be deducted from the income taxable in R if such losses would have been taken into account if no DTT would have been applicable, as otherwise the existence of the DTT would lead to higher taxation than if no DTT had been concluded, which can be seen as contrary to the principle that DTT provisions may not increase the tax burden provided for under internal law.\textsuperscript{427} However, that argument would have to be based on an interpretation of the applicable domestic law, since the principle that DTTs may not increase the tax burden is not a principle under international law, but rather has to be determined on the basis of the domestic law of the jurisdiction in which the DTT is applied (see sub-chapter 3.5). Furthermore, DTTs oblige R to exempt certain items of income from tax, but do not generally concern themselves with the taxation of the remaining income in R and therefore do not require R to reduce that income by deducting losses in N. This also means that the deduction of losses incurred in N against income in R is an issue that will normally have to be determined on the basis of the domestic law of R.\textsuperscript{428}

As regards Sweden, there was a debate prior to 1986 as to whether a resident of Sweden could offset losses derived from another state irrespective of whether exemption was applicable under a DTT in respect of income from the other state. Support for the view that the existence of a provision on exemption did not limit a taxpayer’s right to offset losses could be found in the case RÅ 1946 Fi 141, where a Swedish company manufacturing raincoats was allowed to deduct expenses relating to a branch in the US despite the fact that income from the branch would have been exempt under the DTT. Similarly, in the case RÅ84 1:27, a Swedish bank was allowed to deduct costs relating to


\textsuperscript{428} The OECD Model, Commentary to Art. 23, para. 44, and Vogel and others, \textit{Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen} (2008), Art. 23, paras. 52 and 67. Similarly, the question as to whether N shall take into account losses in R is a matter which will have to be determined according to N’s internal law. Most states would treat such losses in symmetry with income, meaning that they would not be taken into account for the purpose of computing the tax liability in N.
lending in foreign countries despite the fact that interest income on the loans was exempted from taxation in Sweden under the applicable DTTs. In 1986, new legislation was introduced to clarify the position that deduction of costs (and, consequently, losses) is not allowed where the principle of exemption would have applied under a DTT in respect of corresponding income. As Swedish internal law expressly states that if an item of income is exempted under a DTT, costs for acquiring that income are non-deductible, the non-deductibility is based on internal law rather than on an interpretation of a DTT, in which case it might have been regarded as contrary to the principle that DTTs may not increase the tax burden provided for under internal law (see sub-chapter 3.5).

5.2.5 Full Exemption

Where exemption is applied by a contracting state, the exempted income is excluded from the tax base in that state. “Full” exemption means that the exempting state does not take into account the exempted income for the purpose of calculating the amount of tax to be imposed on the income which is taxable in the state that provides double tax relief.

Compared to exemption with progression, full exemption has a considerable advantage as far as administrability is concerned, as there is no need for the state that provides double tax relief to quantify the worldwide income. It is sufficient for that state to determine which items of income shall be exempted (without having to quantify the amount of income that shall be exempted) and to quantify the remaining income according to its internal law.

Sweden generally applies the principle of credit as the main method for elimination of double taxation, but exempts certain items of income on the basis of the distributive rules. DTTs entered into by Sweden generally reserve Sweden’s right to take into account exempted income for the purpose of computing tax on the remaining income. However, there are no generally applicable internal law provisions that provide for doing so. On the contrary, Sweden regularly waives this right by unilaterally declaring in the Incorporation Act that if a resident of Sweden derives income which is exempted under the DTT, such income shall be excluded from the tax base. This practice started with the Nordic DTT of 1987 when such a unilateral declaration

was first included in the guidelines on the application of the DTT issued by the Government.430

According to statements made in the preparatory works relating to certain Incorporation Acts, the reason for not taking exempted income into account is to lower the work load of the Swedish Tax Agency and to avoid complicated legislation. The loss of tax revenue resulting from not taking exempted income into account is deemed to be negligible.431 On the other hand, the fact that a state only takes into consideration income which is taxable within its own jurisdiction and, consequently, does not take into account the full ability to pay of the taxpayer, may be considered as a disadvantage as far as equity and tax neutrality is concerned, where income which is taxed at progressive rates is split between two or more states.

As Sweden typically exempts certain items of income such as income from employment without taking it into account for the purpose of computing tax on the remaining income, a substantial progressivity advantage can often be achieved by splitting income between Sweden and one or more other states.

The following example illustrates how this works.

Both R and N tax income from employment at progressive rates. In R, income in the bracket 0–100 is taxed at 30 % whereas income above 100 is taxed at 50 %. In N, income in the bracket 0–100 is taxed at 20 % whereas income above 100 is taxed at 40 %. A is a resident of R. He is employed by a company in R. However, he is also employed by a subsidiary in N of the company in R, for which he works part-time. Under the DTT between R and N, income from an employer in N derived from work in N is only taxed in N. R applies full exemption. In year one, A receives a salary of 100 from his employer in R and 100 from his employer in N.

If the entire income were to be taxed in R, the tax would be 80 (30 % × 100 + 50 % × 100), corresponding to an effective tax rate of 40 % (80 / 200). If the entire income were to be taxed in N, the tax would be 60 (20 % × 100 + 40 % × 100), corresponding to an effective tax rate of 30 % (60 / 200). However, as the income is split in two, the tax will instead amount to 50

(30 % × 100 + 20 % × 100), corresponding to an effective rate of 25 % (50 / 200), i.e. lower than if taxation of the entire income would have taken place either in R or N.

Some Swedish DTTs contain rather complicated provisions aimed at preventing tax abuse via the possibility of splitting income.432

Many Swedish DTTs provide for full exemption in respect of dividends paid by a company in the other contracting state to a company in Sweden to the extent that the dividends would have been exempt under Swedish law if both companies had been Swedish companies, instead of a limitation of the tax rate in combination with the principle of credit. The following wording is typically applied:

Dividends paid by a company being a resident of [N] to a company which is a resident of Sweden shall be exempt from tax in Sweden to the extent that the dividends would have been exempt under Swedish law if both companies had been Swedish companies.

In almost all cases, additional requirements apply in order for full exemption to apply.433 For instance, there may be a requirement that the principal part of the profits of the company paying the dividends is derived from business activities other than the management of securities and other similar property and that such activities are carried on within N or that the profits out of which the dividends are paid have been subjected to the normal rate of corporate tax in N.

As the exemption from tax under Swedish internal law on dividends received by a Swedish company has been gradually widened and today covers most cases where dividends are paid by unlisted foreign companies to Swedish companies,434 the practical importance of such DTT provisions has decreased significantly.

Furthermore, many Swedish DTTs entered into during the 1990s and the early 2000s, such as the DTTs with Albania, Argentina, Belarus, Belgium, Bolivia, Canada, Gambia, India, Kazakhstan, Luxembourg, Macedonia, Malaysia, Malta, Mexico, the Philippines, Poland, Portugal, Russia, South Africa, and Vietnam include a provision in accordance with the following or

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432 See for instance Art. 25.7.2–3 of the Nordic DTT.
433 This is the case concerning the DTTs with Australia, Botswana, Brazil, China, Estonia, France, Germany, Ireland, Italy, Latvia, Lithuania, Mauritius, Namibia, the Netherlands, Singapore, Spain, Switzerland, Tunisia, Ukraine, the United States, Venezuela, and Zambia.
434 Cf. ch. 24 secs. 12–22 IL.
an essentially similar provision in respect of dividends paid by a subsidiary in N to a company in Sweden.

Notwithstanding the provisions of sub-paragraph [ ] of this paragraph, dividends paid by a company which is a resident of [N] to a company which is a resident of Sweden shall be exempt from Swedish tax according to the provisions of Swedish law governing the exemption of tax on dividends paid to Swedish companies by subsidiaries abroad.

Since the tax exemption under Swedish internal law applies regardless of the DTT provision, the purpose of such provisions merely seems to be to emphasise that Swedish internal law contain rules concerning tax exemption of inter-company dividends.

5.2.6 Exemption with Progression

1. Some General Comments on Exemption with Progression
Just as under full exemption, under exemption with progression the exempted income is excluded from the tax base in the state that provides double tax relief. However, in the later case the income which is excluded from the tax base may nevertheless be taken into account when calculating the amount of tax to be imposed on the income which is taxable in the state that provides double tax relief (below referred to as the “remaining income”).

Exemption with progression is the variation of the principle of exemption which is recommended by the OECD, either as the main method for elimination of double taxation or as a complement to the principle of credit applicable in respect of income which is exempted under the distributive rules.435 Where a DTT conforms to the OECD Model, R is thus expressly entitled to take into consideration income which has been exempted in that state for the purpose of determining the tax to be imposed on the remaining income.

Where a proportional (often referred to as a “flat”) tax is applied, the same result is achieved regardless of whether exemption with progression or full exemption is applied. However, the distinction between full exemption and exemption with progression is relevant insofar as the remaining income is taxed at progressive rates.436 Income is taxed at progressive rates if the effective tax rate increases as the amount to be taxed increases, i.e. higher tax rates are applied to income within higher brackets. Furthermore, where a proportional

435 Arts. 23 A.3 and Art. 23 B.2 of the OECD Model.
436 The distinction may also be of relevance where a proportional tax is applied if negative exempted income is taken into account under the exemption with progression method.
tax applies to income above a tax exempt threshold or where a generally applicable deduction is allowed regardless of any actual costs (sometimes referred to as a “basic allowance”), this effectively also amounts to progressive taxation, i.e. the average tax rates rise towards the flat marginal rate as income rises.

Provided that R takes into account the income which is taxable only in N for the purpose of determining the tax on the remaining income, the remaining income is taxed at the same rate as would have applied if the entire worldwide income would have been taxed in R. If R does not take into account the exempted income, this may lead to a lower tax on the remaining income than if the entire income would have been taxed in R, often referred to as a progressivity advantage. Similarly, unless N takes into account income which is taxable only in R for the purpose of determining the tax on income which is only taxable in N, the exemption of income by N may also lead to a progressivity advantage.

Insofar as income taxed at progressive rates is concerned, a state that applies exemption with progression must quantify the worldwide income according to its tax laws, although the amount of tax imposed by the other state does not need to be known. Thus, the advantage compared to the principle of credit with regard to administrability is less significant than if full exemption is applied.437

Articles 23 A.3 and 23 B.2 of the OECD Model state that R may take exempted income into account when calculating the amount of tax on the remaining income, but do not specify in what way this shall be achieved. Theoretically, the foreign income could be regarded as the top slice of income for the purpose of determining the amount of tax on the remaining income. However, that would have the same effect as not taking the exempted income into account, i.e. full exemption. It would also be possible to regard the exempted income as income at the bottom end of the scale. Under the assumption of identical tax bases and tax rates in both contracting states, that would ensure that the total amount of tax is the same as if the entire income had been derived in one state, provided that the other state applies full exemption, but would otherwise lead to a higher aggregate tax. However, in practice the remaining income is typically subjected to tax pro rata to its share of the tax on the worldwide income, i.e. on the basis of the average tax rate.438

438 Exel, ‘Der Durchschnittssteuersatz beim Progressionsvorbehalt’ in Gassner, Lang & Lechner
It can be noted that if R applies the principle of exemption and if the taxable income in R is zero or negative, no tax is imposed in R, as there is no tax base in R, irrespective of the amount of income derived from N. In such case it does not matter whether R applies full exemption or exemption with progression.\footnote{Lechner, ‘Befreiungsmethode und Einkommensermittlung’ in Gassner, Lang & Lechner (eds.), \textit{Die Methoden zur Vermeidung der Doppelbesteuerung} (1995), p. 158.}

Sweden regularly includes a proviso safeguarding progression in its DTTs applicable to income exempted under the distributive rules. As regards Swedish DTTs entered into since the beginning of the 1990s, this is typically achieved by means of the following text.\footnote{This wording is included in the DTTs with Albania, Argentina, Bolivia, Canada, Chile, India, Kazakhstan, Luxembourg, Macedonia, Malaysia, Malta, the Philippines, Poland, Portugal, Russia, South Africa, Venezuela, and Vietnam (insignificant differences may occur). Similar wordings are applied in several other DTTs as well.}

In the case of Sweden, double taxation shall be avoided as follows:

\begin{quote}
(b) Where a resident of Sweden derives income which, in accordance with the provisions of this Agreement, shall be taxable only in [N], Sweden may, when determining the graduated rate of Swedish tax, take into account the income which shall be taxable only in [N].
\end{quote}

The Swedish standard text for the proviso safeguarding progression is commented on below. The following questions are also addressed. Is an express proviso safeguarding progression in the DTT required in order to allow a contracting state to take into account exempted income for the purpose of determining the tax on the remaining income? If so, does the proviso safeguarding progression allow R to take into account not only income that has been exempted under the double tax relief article, but also income that has been exempted under the distributive rules? Do DTTs preclude N from taking into account income that has been exempted from taxation in N for the purpose of computing tax on the remaining income in N? Are express internal law provisions required in order for a contracting state to take into account income exempted under a DTT? Finally, does the proviso safeguarding progression require R to take into account exempted negative income, so that the exempted negative income may result in lower tax on the remaining income?
2. Is an express proviso safeguarding progression in the DTT required in order to allow a contracting state to take into account exempted income for the purpose of determining the tax on the remaining income?

As regards this question, it can be argued that DTT provisions do not limit a contracting state's right to impose tax on the remaining income, since the DTT text deals merely with the obligation to provide double tax relief by exempting income and does not concern itself with income which is not covered by that obligation. Therefore, a contracting state would always be free to determine the principles for calculating the amount of tax on the remaining income as long as it does not levy tax on income which under the DTT shall be exempted.\textsuperscript{441} Thus, according to this view, the proviso safeguarding progression is no more than a clarification.\textsuperscript{442}

On the other hand, it can be argued that the exemption of income under a DTT obligates the contracting state in question to disregard such income for the purpose of computing tax on the remaining income.\textsuperscript{443} In other words, the obligation in the DTT to exempt income and the absence of a proviso safeguarding progression would in effect be interpreted as an obligation to provide full exemption. This interpretation might be better suited to fulfil the main purpose of the DTT, i.e. elimination of double taxation, as a contracting state would otherwise in principle be allowed to reduce or eliminate the effect of the double tax relief provided for under the DTT by increasing the amount of tax on the remaining income. From a formal point of view, neither the exempted income nor the remaining income would be subjected to international double taxation where a contracting state increases the tax on the remaining income in response to an obligation to exempt income. However, if the exempting state would be free to increase without limit the tax on the remaining income, the obligation under the DTT to provide double tax relief would in effect be reduced to a moral obligation, lacking legally binding effect.

\textsuperscript{441} A similar argument has been applied as regards CFC regulation, namely that DTT provisions do not preclude a contracting state from attributing income derived by a CFC to a company resident in that state as it is free to determine the principles for quantifying such income, see Lang, 'CFC Regulations and Double Tax Treaties', \textit{BIFD}, 2003, pp. 51–58. This argument was picked up by the lower instance (the Council for Advance Tax Rulings) in RÅ 2008 ref. 24 and RÅ 2008 not. 61. HFD came to the same conclusion (i.e. that the DTT did not prevent Sweden from applying its CFC rules) on totally different grounds, see sub-ch. 3.4.


\textsuperscript{443} Vogel and others, \textit{Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen} (2008), Art. 23, para. 41.
Support for both views can be found in case law.\textsuperscript{444} HFD has so far not delivered any judgment in this matter, which may be due to the fact that Sweden on a unilateral basis regularly waives its right to take into account exempted income.\textsuperscript{445}

The interpretation of the proviso safeguarding progression as merely a clarification seems to find support in the OECD Model. Under the OECD Model there is no proviso safeguarding progression in N. However, according to the Commentaries of the OECD Model, Articles 23 A.3 and 23 B.2 of the OECD Model do not prejudice the application by N of the provisions of its internal law concerning the progression. Thus, according to the OECD view, N is not precluded from taking into account exempted income, despite the absence of a proviso safeguarding progression in N.\textsuperscript{446}

However, even though the DTT text does not expressly concern itself with the taxation of the remaining income, it can be argued that the exempting state may not levy tax on the remaining income in excess of the tax that would have been levied on that income if the entire income had been taxable in that state, as, although not formally constituting double taxation, that would be contrary to the purpose of the DTT of eliminating double taxation as it would cancel out the double tax relief.\textsuperscript{447}

In my opinion, and in accordance with the textual approach advocated by the VCLT, the absence of a proviso safeguarding progression does not normally preclude a contracting state (R or N) from taking into account exempted income for the purpose of determining the tax on the remaining income, as DTTs do not generally contain any provisions that expressly restrict a contracting state’s right to tax the remaining income. The outcome may be different if there is in a specific case evidence in the DTT text that the proviso safeguarding progression was excluded with the intention of precluding the contracting states from taking into account exempted income.

\textsuperscript{444} According to Vogel and others, \textit{Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen} (2008), Art. 23, paras. 40–41, the German Bundesverfassungsgericht holds that it follows from the DTT that the income shall be deemed as not existing and therefore may not be taken into account, whereas the German Bundesfinanzhof and the Swiss Bundesgericht is of the opposite view.

\textsuperscript{445} It is the view of the Swedish Tax Agency that exempted income may only be taken into account for the purpose of computing tax on the remaining income where this has been expressly provided for in the DTT and in domestic law, see the Swedish Tax Agency, \textit{Handledning för internationell beskattning} (2011), p. 460.

\textsuperscript{446} The OECD Model, Commentary to Art. 23, paras. 56 and 79.

Furthermore, it is in my view not contrary to the object and purpose of a DTT to take into account exempted income as long as the taxation of the remaining income does not exceed the tax on that income that would have been imposed without the DTT. If tax on the remaining income is levied in excess of that level, so that the elimination of double taxation under the DTT is in effect counteracted, there may be grounds for claiming that an interpretation of the DTT in “good faith”, taking into account the intention of the contracting states as expressed in the text, namely to eliminate double taxation, would preclude that state from acting in this way.\footnote{448}

As follows from sub-chapter 5.2.5 above, Sweden regularly waives the right to take into account exempted income by unilaterally declaring in the Incorporation Act that if a resident of Sweden derives income which is exempted under the DTT, such income shall be excluded from the tax base. Only a few Swedish Incorporation Acts contain provisions concerning the taking into account of exempted income. The most recent Incorporation Act to include such a proviso is the Incorporation Act relating to the DTT with France.\footnote{449} Consequently, on a unilateral basis, Sweden typically applies full exemption. However, many Incorporation Acts relating to earlier DTTs do not contain provisions regarding the application or non-application of the proviso safeguarding progression of the DTT in question.

It is the view of the Swedish Tax Agency that exempted income may only be taken into account where (i) a proviso safeguarding progression has been inserted in the DTT and (ii) the Incorporation Act in question states that the exempted income shall be taken into account for the purpose of computing tax on the remaining income.\footnote{450} Thus, according to the view of the Swedish Tax Agency, Sweden cannot take into account exempted income unless there is an express provision concerning this in the DTT in question. Further, accord-

\footnote{448}{See ibid, p. 189, with further references. Taxation in excess of that level may also be contrary to the non-discrimination clause of the DTT (cf. Art. 24 of the OECD Model). This is, however, an issue that goes beyond the scope of this study.}
\footnote{450}{Ibid, pp. 460–461. Cf. for instance sec. 3 lagen (1991:673) om dubbelbeskattningsavtal mellan Sverige och Frankrike (Eng. the Incorporation Act relating to the DTT with France) which states that if a person residing in Sweden derives income which shall be exempted under certain provisions of the DTT, the tax rate that should have been applied if the entire income was taxable in Sweden shall be applied to the remaining income insofar as this results in higher taxation.}
ing to the Swedish Tax Agency, Sweden is not allowed to take into account exempted income on the basis of such provisos safeguarding progression, unless legislation is enacted that expressly provide for this.

3. Does the proviso safeguarding progression allow R to take into account not only income that has been exempted under the double tax relief article, but also income that has been exempted under the distributive rules?

Where no proviso safeguarding progression has been included, there seems to be no reason to distinguish between income that has been exempted under the double tax relief article, regardless of whether a proviso safeguarding progression is considered necessary in order to allow the taking into account of exempted income for the purpose of determining the tax on the remaining income. Thus, if the absence of a proviso safeguarding progression does not preclude a contracting state from taking into account exempted income for the purpose of determining the tax on the remaining income, this would apply regardless of whether the income is exempted under the double tax relief article or the distributive rules.

If a proviso safeguarding progression has been included in the applicable DTT, it may be of interest to examine whether there is reason to differentiate between income exempted under the distributive rules and income exempted under the double tax relief article. Two different starting points for such an examination are conceivable. If the above argument that a proviso safeguarding progression is not required in order for a contracting state to take into account exempted income is accepted, the question is whether the inclusion of a proviso safeguarding progression which provides for the taking into account of income exempted under the double tax relief article shall be interpreted *e contrario*. This would mean that income exempted under the distributive rules may not be taken into account by R, regardless of the fact that such income could have been taken into account if a proviso safeguarding progression did not exist.\(^{451}\) Alternatively, if it is accepted that a proviso safeguarding progression is required in order for a contracting state to take into account exempted income, it will be a matter of examining and analysing the wording of the proviso safeguarding progression to see whether it allows R to take into account income which is exempted under the distributive rules.

\(^{451}\) According to Vogel and others, *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Art. 23, para. 41, DTT provisions are never merely clarifying and must therefore be interpreted *e contrario*.
Since 1977, the OECD Model has expressly stated that income which is exempted in accordance with any provision of the convention may be taken into account in calculating the amount of tax on the remaining income.452 Thus, exemption with progression may be applied by R irrespective of whether the income in question is exempted under a distributive rule or under the double tax relief article. According to the Commentaries, this was meant merely as a clarification.453 Previous to the 1977 amendment, paragraph 1 of Article 23 A read as follows:

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraph 2, exempt such income or capital from tax but may, in calculating tax on the remaining income or capital of that person, apply the rate of tax which would have been applicable if the exempted income or capital had not been so exempted.

The exemption under the double tax relief article applies only to income which may be taxed in the other contracting state. It would be possible to argue that income which has been exempted from tax in R under the distributive rules may be taxed in N and that, consequently, the double tax relief article applies to such income, although the exemption of the double tax relief article as such would not have any effect since exemption already follows from the applicable distributive rule. On the other hand, the phrase “shall be taxable only” is used in the distributive rules for exempting income from tax in R, whereas the phrase “may be taxed” is reserved for income which, under the distributive rules, is taxable in both contracting states. In my view, it therefore seems likely that the double tax relief article of the OECD Model of 1963 was intended to be applied only in respect of income which had been exempted from tax in R under the double tax relief article. The second part of paragraph 1, which allowed R to take into account exempted income, referred to the tax rate that would have been applicable if the income had “not been so exempted”. In my opinion, the phrase “so exempted” must be interpreted as meaning exempted under the same paragraph. Thus, there is reason to interpret the proviso safeguarding progression of the 1963 OECD Model as providing for the taking into account of income exempted under the double tax relief article but not income exempted under the distributive rules.

452 Art. 23 A.3 of the OECD Model.
453 The OECD Model, Commentary to Art. 23, paras. 55 and 79.
Furthermore, it can be argued that the double tax relief article does not apply at all where income is exempted under the distributive rules. Thus, regardless of whether the proviso safeguarding progression included in the double tax relief article refers to income “so exempted” or income exempted under “any” provision, it would not be applicable where income is exempted under the distributive rules as the double tax relief article never comes into play. However, the prevailing view seems to be that the double tax relief article can be applied regardless of whether income is exempted under the distributive rules if that is the intention of the contracting states, which it clearly is where the provision expressly refers to income exempted under “any” provision of the DTT. Where the double tax relief article does not refer to income exempted under “any” provisions of the convention it is less clear whether the double tax relief article can be applied to income which is exempted under the distributive rules.

If a proviso safeguarding progression is deemed not to be required in order for a contracting state to take into account exempted income, the question, as noted above, is whether provisos safeguarding progression such as that of the 1963 OECD Model shall be interpreted *e contrario*, so that income exempted under the distributive rules may not be taken into account. If such a provision is interpreted *e contrario*, the inclusion of a proviso safeguarding progression would in effect result in a limitation of R’s right to take into account exempted income which would not have been present if such a proviso had not been inserted into the DTT. It can be argued that it cannot normally be assumed that the reason for including such a provision was to limit the possibilities of the contracting states to take into account exempted income. Consequently, it follows that a proviso safeguarding progression shall not be interpreted *e contrario* unless there is evidence that it was actually the intention of the contracting states to preclude the taking into account of income exempted under the distributive rules. According to this view, the contracting states would be entitled to take into account exempted income for the purpose of computing tax on the remaining income regardless of whether a proviso safeguarding progression comprising income exempted under the double tax relief article has been inserted in the DTT. However, that argument would imply that the choice of words suggesting a limitation of the proviso safeguarding progression to income exempted under the double tax relief article would be meaningless. If the choice of words is to be given any meaning, R must be precluded from taking into account income exempted under the distributive rules. On the other hand, the argument would be consistent with the view that DTTs do not limit a contracting state’s right
to tax remaining income according to its internal law and that the inclusion of a proviso safeguarding progression is merely declaratory. In my view, the inclusion of a proviso safeguarding progression aimed at income exempted under the double tax relief article would therefore not preclude R from taking into account income exempted under the distributive rules.\textsuperscript{454}

If, on the other hand, a proviso safeguarding progression is deemed to be required in order for a state to take into account exempted income, a DTT modelled on the 1963 OECD Model would in my view not allow a contracting state to take into account income which is exempted under the distributive rules.

As regards Swedish DTTs, this issue only arises in relation to the DTTs with Greece and Israel, as these DTTs are the only such treaties still in force where exemption with progression is applied as the main method for elimination of double taxation. In other DTTs, Sweden applies exemption with progression as a complement to the principle of credit and hence only applies it to income exempted under the distributive rules or in respect of specific classes of income. The proviso safeguarding progression of the DTT with Israel states that “"[t]he graduated rate of Swedish tax to be imposed on residents of Sweden may be calculated as though income or capital exempted under this Agreement were included in the amount of the total income or capital”\textsuperscript{455} and the DTT with Greece contains an almost identical provision\textsuperscript{456}. As these provisions refer to income exempted under the DTT and does not confine itself to income that may be taxed in N, there is no ground for claiming that it would not apply to income that under the distributive rules shall be taxable only in N.

4. Do DTTs preclude N from taking into account income that has been exempted from taxation in N for the purpose of computing tax on the remaining income in N?

Normally, a non-resident taxpayer is subject to limited tax liability, i.e. the internal law of a state where the taxpayer is not a resident provides for tax liability only if there is a specific connection between that state and an activity or property that generates income. Thus, where a taxpayer is a non-resident of N under the internal laws of N, the question whether a DTT would preclude N from taking into account exempted income is normally of little significance.

\textsuperscript{455} Art. XVII.4 of the DTT with Israel.
\textsuperscript{456} Art. XXIII.4 of the DTT with Greece.
as the internal law of N would normally not provide for such a right. However, in cases where the taxpayer is a resident of N under N’s internal tax law, the internal law of N may often provide for the taking into account of income which is exempted under a DTT. It may therefore be of interest to see whether DTTs preclude N from taking into account exempted income for the purpose of determining the tax on the remaining income.

The wording of the double tax relief article typically makes clear that the article is directed at R. Insofar as a contracting state is considered precluded from taking into account exempted income without an express proviso safeguarding progression to that end, a proviso safeguarding progression in the double tax relief article can therefore normally not be considered to reserve such a right to N. Furthermore, if a proviso safeguarding progression is not considered to be required in order for a state to take into account exempted income, it would be possible to interpret a proviso safeguarding progression in R e contrario so as to preclude N from taking such income into account.

Above I have examined whether income exempted under the distributive rules may be taken into account by R for the purpose of computing tax on the remaining income, both in situations where a proviso safeguarding progression has been inserted in the DTT and where no such provision has been inserted. Where income is exempted from taxation in N this will be due to the distributive rules and there will typically be no provision that expressly safeguards N’s right to take into account exempted income. Consequently, the right of N to take into account exempted income will correspond to the right of R to take into account income exempted under the distributive rules where no proviso safeguarding progression which expressly refers to income exempted under the distributive rules has been inserted in the DTT.

As follows from the above, it is my opinion that a DTT does not preclude R from taking into account exempted income for the purpose of determin-

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457 Arts. 23 A and 23 B of the OECD Model use the wording “Where a resident of a Contracting State […] the first-mentioned State shall …”. See also Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 209.
458 Cf. Widhalm, ‘Rechtsgrundlagen und Anwendungsbereich des Progressionsvorbehalts’ in Gassner, Lang & Lechner (eds.), Die Methoden zur Vermeidung der Doppelbesteuerung (1995), p. 168, footnote 69, who refers to a ruling delivered in 1973 by the Austrian Verwaltungsgerichtshof on the DTT between Switzerland and Austria of 1955 where the court pointed out that the DTT in question, in contrast to other Austrian DTTs, expressly reserved N’s right to take into account exempted income and that Austria in its capacity as N was therefore entitled to do so.
ing the tax on the remaining income, as DTTs do not normally deal with the taxation of the remaining income. Consequently, it is also my opinion that N is unhindered from taking into account exempted income. This view is supported by the OECD Model, which states that N may take into account exempted income, despite the absence of an express DTT provision to that end.\(^{459}\) Furthermore, in accordance with the above, it is my opinion that a proviso safeguarding progression in R cannot normally be assumed to have been included with the purpose of limiting N’s right to take into account exempted income. As a consequence, such a provision shall not be interpreted *e contrario*, unless there is evidence in the DTT text that it was actually the intention of the contracting states to limit N’s right in this respect.

5. Are express internal law provisions required in order for a contracting state to take into account income exempted under a DTT?

Another interesting question is whether internal law provisions are required in order for a contracting state to take into account exempted income. In a situation where internal law provides for taxation of the worldwide income, it can be argued that the taking into account of income which is exempted under a DTT for the purpose of computing tax on the remaining income is within the frames set by internal law, i.e. that the tax burden under internal law is not increased by the DTT provisions.\(^{460}\) On the other hand, it can be argued that it would be illogical to interpret rules that provide for taxation of the worldwide income as allowing a state to take into account income which has been exempted under a DTT for the purpose of determining tax on the remaining income without express provisions to that end, as income which has been exempted under internal law is not taken into account for that purpose.\(^{461}\)

In my view, the weight of these arguments will depend on the applicable internal law provisions and principles. For instance, in Swedish internal law there are no provisions that provide for the exclusion from the tax base of income exempted under a DTT (rather, this follows from the priority over


6. Does the proviso safeguarding progression require R to take into account exempted negative income, so that the exempted negative income may result in lower tax on the remaining income?

Insofar as income taxed at progressive rates is concerned, both positive and negative foreign income have an impact on the tax rate. It can be argued that exempted losses must be taken into account for the purpose of computing tax on the remaining income if such losses would have been taken into account if no DTT would have been applicable, as otherwise the existence of the DTT would lead to higher taxation than that provided for under internal law, which would be contrary to the principle that a DTT may not increase the tax burden provided for under internal law. However, such an argument would have to be based on an interpretation of internal law (and in particular the above mentioned principle) as DTTs do not generally require the taking into account of exempted income (be it positive or negative). Instead, provisos safeguarding progression typically state that exempted income may be taken into account.

462 According to the wording of for instance sec. 3 lagen (1991:673) om dubbelbeskattningsavtal mellan Sverige och Frankrike (Eng. the Incorporation Act relating to the DTT with France), which provides for the taking into account of exempted income, the provision applies where a person resides in Sweden. This seems to refer to the criteria for unlimited taxation under Swedish internal law and is thus not restricted to cases where Sweden acts in capacity as R. Consequently, in relation to France, internal law provides for the taking into account of exempted income also where Sweden acts in capacity as N. However, the proviso safeguarding progression of the DTT with France (Art. 23.1 (g)) provides for the taking into account of exempted income only where a person who is a resident of Sweden for the purpose of the DTT derives income, which leads back to the above discussion concerning the need for an express proviso safeguarding progression.

463 Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, paras. 46–52.

464 Cf. Arts. 23 A.3 and 23 B.2 of the OECD Model and Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, paras. 46–52.
If such losses are taken into account, remaining income taxed at progressive rates may be taxed at a lower rate than would otherwise apply. If a zero tax rate is applied to income in the lowest bracket, and if the worldwide income is negative or within that bracket, then the taking into account of exempted losses would even result in non-taxation of the remaining income. If, instead, the worldwide income just exceeds the first tax bracket, then the entire income would be taxed, albeit at the lowest applicable rate. In other words, such an increase in worldwide income would result in a tremendous marginal effect.465

Incorporation Acts relating to Swedish DTTs typically state that the DTT provisions shall only be applied insofar as they limit the tax liability in Sweden that would otherwise apply, i.e. the principle that a DTT may not increase the tax burden beyond the burden determined under internal law has been codified. If Sweden does not allow the taking into account of exempted negative income for the purpose of computing tax on the remaining income that would have been taken into account in the absence of a DTT, it can be argued that the DTT does in fact extend the tax liability that would otherwise apply. However, there is frequently a provision in the Incorporation Act which states that exempted income shall be excluded from the tax base. Alternatively, where Sweden does not unilaterally refrain from its right under the DTT to take into account exempted income, there is typically a provision in the Incorporation Act which states that exempted income shall only be taken into account insofar as this leads to higher taxation of the remaining income.466 Furthermore, Swedish internal law expressly makes it clear that if an item of income is exempted under a DTT, then costs for

466 Cf. for instance sec. 3 lagen (1991:673) om dubbelbeskattningsavtal mellan Sverige och Frankrike (Eng. the Incorporation Act relating to the DTT with France).
acquiring that income are non-deductible. It can therefore be argued that the disregard of exempted negative income for the purpose of computing tax on the remaining income is a consequence of Swedish internal law and that it is not the DTT as such which extends the tax liability. Consequently, the disregard of exempted negative income would not be contrary to the principle codified in the Incorporation Act (cf. sub-chapter 3.5).

7. Conclusions
The significance of including a proviso safeguarding progression in a DTT is unclear. It can be argued that such a provision is merely declaratory and that a contracting state would be able to take into account exempted income regardless of such a provision since DTTs do not restrict a state’s right to tax the remaining income. As a consequence, a contracting state would be able to take into account exempted income not only where it acts in capacity as R under the DTT but also where it acts in capacity as N, regardless of whether the DTT expressly reserves N’s right to take into account exempted income.

The view that provisos safeguarding progression are merely declaratory is not undisputed. For instance, it is the view of the Swedish Tax Agency that an express DTT provision would be required in order for Sweden to be able to take into account exempted income. As regards Sweden, this issue is of limited practical importance as Sweden regularly refrains from taking into account exempted income on a unilateral basis.

5.2.7 Modified Exemption
If the amount of income as determined for income tax purposes is applied for other purposes, for instance as a basis for determining social benefits, the exclusion of foreign income may lead to an inappropriate result. As an alternative to excluding income which under the DTT may be taxed in N, double tax relief may therefore be provided by allowing as a credit an amount equal to the part of the total tax in the state providing the relief appropriate to the foreign income which is covered by modified exemption. Thus, the following formula can be used for computing the post-credit tax liability.

\[
\text{Post-credit tax liability} = \frac{\text{pre-credit tax due in R} - \frac{\text{Foreign income} \times \text{pre-credit tax due in R}}{\text{Worldwide income}}}{\text{pre-credit tax due in R}}
\]

This method for double tax relief is often referred to as “modified exemption”.

467 Ch. 9 sec. 5 para. 1 IL.
Although under this method the foreign income is included in the tax base, the same tax reduction is normally achieved as if the foreign income had been exempted but taken into account for the purpose of determining the tax on the remaining income, i.e. exemption with progression. As the credit is equal to the domestic tax appropriate to the foreign income, the reduction typically also coincides with the foreign tax credit limitation that would have applied if double tax relief had been provided by means of ordinary credit and the N tax would have exceeded the R tax. Modified exemption technically works by crediting tax, but it should be pointed out that it is conceptually different to the principle of credit, as it is the R tax and not the N tax which is credited and as relief is provided independent of the taxing position in N.468

The DTT does not normally specify in what way tax shall be attributed to the foreign income. In principle, it would be possible to regard the foreign income as the top slice or bottom slice of income, which may result in a significantly higher or lower credit in respect of income taxed at progressive rates than if R determines the amount of tax attributable to the foreign income on the basis of the average tax rate, as would typically be the case.

As the credit is independent of the tax in N, there is no need for offsetting excess credits relating to one item of income, country, etc. against tax on another item of income, country etc. In this respect, it does not matter whether R applies modified exemption on a per-item basis, per-country basis, overall basis, etc. The credit is the same, i.e. the R tax appropriate to the income covered by modified exemption.469

From an administrative point of view it can be noted that the application of the modified exemption method, just as exemption with progression, requires knowledge of the worldwide income (but not of the foreign tax) in order to calculate the post-credit tax on income taxed at progressive rates. Furthermore, although it would be possible to calculate the post-credit tax in R without knowing the foreign income if the income in question is taxed in R at a flat rate (since the credit would be proportional to the foreign income and would therefore not affect the amount of tax on the domestic income), information on the foreign income may anyway be required for the purpose of determining social benefits etc.

468 The OECD Model, Commentary to Art. 23, para. 37.
469 For a different view, see Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 42.

198
As the credit shall be equal to the part of the tax in R on the worldwide income which is appropriate to the foreign income, income must be attributed and costs allocated to either R or N (see sub-chapter 4.3.4).

If the costs attributable to R are equal to or exceed the income allocated to R so that zero income or a loss arises in R, the entire pre-credit tax in R on the worldwide income (if any) will be attributable to income from N and therefore creditable, i.e. no tax will be payable in R. As modified exemption works by including foreign income in the tax base it can be argued that the losses in R shall be consumed by being offset against the income from N, so that a lower amount of losses may offset against other income or carried forward.\(^{470}\) Since the post-credit tax payable in R (which is zero) is the same regardless of the amount of losses, such an offset would be of no use for the taxpayer. The modified exemption clause does not normally concern itself with the computation of income and therefore does not normally prevent R from considering the losses to have been consumed.

The following example illustrates the issue.

*The company X conducts business in R as well as in N through a PE. Its activities in R have resulted in losses of 50 whereas it has derived income of 100 attributable to its PE in N. According to the DTT, the income is covered by modified exemption.*

If the losses in R are offset against the income from N, the tax base will be 50. Otherwise, it will be 100. In either case, the entire tax paid in R will be attributable to the income derived from N and will therefore be creditable under the DTT. If the losses have reduced the tax base and, hence, the pre-credit tax, they may be considered consumed, even though they have had no effect on the post-credit tax (the entire R tax is attributable to the foreign income and, thus, creditable). If the losses are considered consumed, X will lose the possibility of utilising them to reduce taxes on other income.

HFD dealt with this issue in the court case RÅ85 1:6. The facts of the case were as follows. Due to employment at a Finnish university, a professor, who for tax purposes was considered resident in Sweden, derived income from Finland. His income from Sweden was insignificant and he had made losses relating to a property in Sweden which under Swedish law was deductible against income from employment. The question was whether the loss was consumed due to the fact that his Finnish income was taken into account?

for the purpose of computing the pre-credit tax. According to the legislation applicable in the case, a loss was to be considered consumed only to the extent that it had been offset against taxable income. HFD held that income covered by modified exemption (i.e. the income derived from Finland) was considered not taxable and that the loss was therefore not consumed. As a result, the loss could be offset against other income. Thus, HFD held that for the purpose of computing the loss in Sweden income covered by modified exemption was to be treated as exempted income despite the fact that positive income covered by modified exemption would have been included in the tax base.

In my view, the conclusion drawn by HFD is consistent with the intention of the contracting states in including a modified exemption clause in the DTT, namely to achieve in principle the same result as under exemption with progression without excluding income from the tax base for the purpose of determining social benefits etc. However, as the DTT provisions do not provide for exclusion of income covered by modified exemption from the tax base, the Finnish income was from a formal point of view not exempted and it can therefore be questioned whether it was correct to treat it as not taxable.

If instead the costs attributable to N exceed the income allocated to N, such that a loss arises in N, there will be no R tax applicable to the N income. However, in such situation the question arises whether the loss in N shall be offset against income in R for the purpose of computing the taxable income. If so, the R tax will be reduced even though there is no R tax attributable to the income from N. If the losses in N exceed the income attributable to R so that the worldwide income is zero or negative, there will be no tax at all in R.

The following example illustrates the issue.

The company X conducts business in R as well as in N through a PE. It has derived income of 100 in R whereas its activities in N attributable to the PE have resulted in losses of 50. According to the DTT, the income is covered by modified exemption.

If X’s losses in N shall be offset against X’s income in R, the pre-credit tax in R will be computed on income of 50. Otherwise, the pre-credit tax in R tax will be computed on income of 100. In either case, there is no R tax attributable to the income from N and, hence, no credit is given.

As the modified exemption clause does not normally concern itself with the computation of income in R, it does not obligate R to allow deduction

471 Cf. the OECD Model, Commentary to Art. 23, para. 37.
of the losses in N from the income in R. Consequently, this issue will have to be determined on the basis of R’s internal law.

Under Swedish internal law, costs relating to exempted income are non-deductible, which means that foreign losses shall not be deducted from income in Sweden if corresponding foreign income would have been exempt under a DTT. However, since modified exemption does not function by exempting income, it is unclear whether losses incurred in N which are covered by modified exemption are deductible from Swedish domestic income. Does the conclusion of HFD in RÅ85 1:6 have any consequence for this situation, i.e. where the income in R is positive and the income derived from N is negative rather than the other way around? It can be argued that if income covered by modified exemption for Swedish internal law purposes shall be treated as income exempted under a DTT, then losses in N covered by modified exemption shall be deemed non-deductible under the internal rule which provides for non-deductibility of losses exempted under a DTT.

In some countries, such as Denmark and the Netherlands, modified exemption is used as the standard method for exempting income under a DTT. During the years 1976–1985, Sweden applied modified exemption in respect of income which shall be taxable only in N in all of its DTTs, except as regards the DTTs with Pakistan and New Zealand. Exemption with progression was reintroduced in respect of such income in the DTTs with China and Ireland. The preparatory works relating to the DTTs entered into in connection with the shift from exemption with progression to modified exemption and the shift back to exemption with progression do not contain any information as to the reasons for these shifts. According to the

472 Ch. 9 sec. 5 para. 1 IL.
473 Ibid.
474 Winther-Sørensen, Beskatning af international erhvervsindkomst (2000), p. 123, and Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 42. In Danish literature modified exemption is referred to as “new” exemption with progression as opposed to the “old”, regular exemption with progression, see Winther-Sørensen, Beskatning af international erhvervsindkomst (2000), p. 123.
475 DTTs with Australia, Bangladesh, Czechoslovakia, Hungary, Italy, Jamaica, Romania, South Korea, Spain (in respect of income from employment only), Sri Lanka, Tanzania, Trinidad and Tobago, Tunisia, United Kingdom (in respect of income from shipping and air transport, capital gains from the alienation of ships or aircraft operated in international traffic and government service only), and Yugoslavia.
Swedish Tax Agency, the shift back from modified exemption to exemption with progression was due to certain unintended consequences of modified exemption, such as the offsetting of foreign income against domestic losses despite the fact that such foreign income would in effect have been exempted in a situation where the domestic income would have been positive.\textsuperscript{477} As follows from HFD case RÅ85 1:6 referred to above, HFD has made clear that foreign income covered by modified exemption shall not be offset against domestic losses, so that particular “unintended consequence” is no longer relevant as an argument against modified exemption (unless changes in the legislation are considered to have made the judgment irrelevant).

\subsection*{5.2.8 Tax Sparing Exemption/Matching Exemption}

Normally, exemption is provided regardless of the taxation in N. However, it is possible to limit the applicability of the principle of exemption to situations where certain criteria concerning the taxation in N are fulfilled, for instance by providing a minimum rate at which tax must have been levied (see sub-chapter 5.2.3). Similarly, an exemption may be provided for under internal law only if certain criteria concerning the taxation in N are fulfilled.

If such requirements concerning the taxing position in N have been provided for, tax incentives granted by N may lead to the non-application of the principle of exemption. To counter this, the contracting states may agree that R shall treat the income in question as if N had imposed tax under its general tax legislation, disregarding any tax incentives given by N for the purpose of exempting the income. Alternatively, the contracting states may agree that R shall treat the income in question as if tax had been levied in N at a fictitious, higher rate, disregarding the actual taxation in N for the purpose of exempting the income. By analogy with tax sparing credit and matching credit, these kinds of provisions can be referred to as “tax sparing exemption” and “matching exemption” respectively. However, strictly speaking they are not methods for elimination of double taxation, but rather exceptions in DTTs from requirements under a DTT or internal law for the application of full exemption or exemption with progression.

For instance, formerly Swedish internal law only provided for exemption of dividends paid by foreign companies to a company in Sweden if tax had been imposed on the profits of the foreign company at a certain minimum rate. Sweden frequently waived this requirement in its DTTs with developing countries by stating that the Swedish rules on tax exemption of dividends shall

be applied as if tax had been levied at the regular rate in N or at a fictitious rate of 15 per cent. It should be noted that as the requirement under internal law for a certain minimum level of taxation has now been abolished, such provisions are no longer relevant. Furthermore, a number of Swedish DTTs state that dividends paid by a company in N shall be exempt insofar as dividends paid by a Swedish company to another Swedish company would have been exempt in the same situation, provided that the profits out of which the dividends are paid have been subject to tax at the regular rate in N or a comparable tax. The last-mentioned requirement was also frequently waived. However, since the exemption under internal law with respect to dividends paid by a foreign company to a Swedish company is now substantially wider than it was when these DTTs were entered into, such waivers are now of little practical importance.

5.3 Limitation of the Tax Rate

5.3.1 Introduction
As an alternative to placing the obligation to eliminate double taxation either on R or N, the obligation can be allocated between both states by combining (i) a tax rate limit that puts a ceiling on N’s taxing right and (ii) an obligation for R to eliminate remaining double taxation by means of the principle of credit. In cases where the taxation in N exceeds the limit stated in the relevant article, the tax rate limitation reduces (but does not completely eliminate) double taxation. Limitation of the tax rate can therefore be described as a separate method for elimination (or strictly speaking reduction) of double taxation under DTTs.

The OECD Model provides for such a combination of methods in respect of dividends paid by a company which is a resident of N and interest arising in N. According to the OECD Model, the limit is five per cent of the gross amount of dividends if the beneficial owner is a resident of R and is a company which holds at least 25 per cent of the capital of the company paying the dividends, 15 per cent of the gross amount of dividends in other cases where the beneficial owner is a resident of R, and 10 per cent of the gross amount of interest if the beneficial owner is a resident of R. The UN Model provides for such a combination of methods also in respect of royalty arising in N, but leaves it up to the contracting states to agree on a specific maximum rate.

478 Arts. 10.2, 11.2, 23 A.2, and 23 B.1 of the OECD Model.
479 Arts. 12.2, 23 A.2, and 23 B.1 of the UN Model.
Solutions aimed at imposing an obligation to eliminate double taxation in respect of dividends or interest solely on R or N have not won general acceptance within the OECD. On the one hand, the state of residence is usually not willing to give up its right to tax its residents in respect of interest and dividend income (although exceptions often apply under internal law or DTTs with regard to inter-company dividends from substantial shareholdings). On the other hand, the state of source is often unwilling to refrain from its right to deduct tax at source, especially if the state of source is a net receiver of foreign investment. Thus, the OECD provisions on dividends and interest income are the result of a compromise. As regards dividends, the OECD Model states that taxation exclusively in the state of the beneficiary’s residence “would be more in keeping with the nature of dividends, which are investment income, but it would be unrealistic to suppose that there is any prospect of it being agreed that all taxation of dividends at the source should be relinquished”.\(^{480}\) Similarly, the OECD Model states that “[a] formula reserving the exclusive taxation of interest to one State, whether the State of the beneficiary’s residence or the State of source, could not be sure of receiving general approval”.\(^{481}\) Furthermore, although the royalty article of the OECD Model, in contrast to the royalty article of the UN Model, provides for an exclusive right of R to tax royalties, a number of states have entered reservations on that article, reserving their right to tax royalties at source.\(^{482}\)

Where neither of the contracting states is a net-recipient of investments from the other, the allocation of taxing rights between R and N does not have an impact on the overall allocation of tax revenue between the contracting states. In such cases it may be feasible for the contracting states to agree that the income shall be taxed in R or N only. However, normally one contracting state is a net-recipient of investments from the other and in such cases the approach suggested by the OECD Model concerning dividends and interest, i.e. a split of the obligation to provide double tax relief by limitation of the tax rate in N and by credit of the reduced N tax in R, seems like a sensible compromise.\(^{483}\)

\(^{480}\) The OECD Model, Commentary to Art. 10, para. 6.
\(^{481}\) The OECD Model, Commentary to Art. 11, para. 3.
\(^{482}\) Cf. the OECD Model, Commentary to Article 12, paras. 33–37 (reservations made against Art. 12.1).
\(^{483}\) Although rarely applied in practice, the right to levy tax on an item of income can also be allocated between the contracting states by splitting the tax base, i.e. by obligating each contracting state to exempt a certain portion of the income, see Jann, ‘Die abkommens-
Although the tax rate limitations applicable under DTTs in respect of dividends, interest, and royalty payments may seem relatively low at first glance, the fact that N is entitled to tax both the recipient and the payer must be taken into consideration. As regards dividends, which are normally not deductible for the paying company, the profits out of which the dividends are paid may already have been subjected to taxation in N when N taxes the dividends and may therefore be subject to economic double taxation. Interest and royalty on the other hand are normally deductible for the payer.

Furthermore, tax rate limitations are computed on the basis of the gross payments, i.e. regardless of expenses incurred. For instance, where a lender has borrowed to finance a loan to a resident of N, there may be small or no profits as a result of the interest costs. In such case, the tax in N on the interest payment, although limited to a low percentage of the gross amount, may in fact correspond to a significantly higher effective tax rate, in some cases exceeding 100 per cent of the net profits of the recipient.\footnote{Cf. the OECD Model, Commentary to Art 11, para. 7.1.} Similarly, where royalty is paid for the use of or right of use of a copyright, patent, trade mark, know-how, etc., the development or production of the property may have caused the recipient of the royalty substantial costs, meaning that the N tax rate limitation on the gross payment provided for under the DTT may in fact correspond to a much higher tax rate computed on a net basis. As a result, the tax imposed by N, although within the limit provided by the DTT, may exceed the tax in R on the foreign income and may therefore not be creditable in its entirety or (where the taxable income in R is zero or negative) at all.\footnote{Cf. the OECD Model, Commentary to Art. 23, para. 63.}

5.3.2 Relation to Internal Law

Typically, tax rate limitations come into play where tax is provided for under the internal law of N in respect of dividends, interest, or royalty on the basis of a connection between the payer and N. In such cases, tax is typically levied in N by deduction at source.

For instance, according to Swedish internal law, non-resident shareholders are generally subject to withholding tax in Sweden at a rate of 30 per cent on dividends distributed by a Swedish company.\footnote{Sec. 5 Kupongskattel. No tax is levied in Sweden on interest paid to non-resident lenders.}
However, taxation may also take place by individual assessment. For instance, under Swedish internal law, royalty or periodic payments for the use of property paid from a permanent establishment in Sweden to a non-resident taxpayer is deemed as income attributable to a permanent establishment in Sweden of the non-resident taxpayer.\footnote{Ch. 3 sec. 18 para. 2 and ch. 6 sec. 11 para. 2 IL.} Thus, royalty paid to a non-resident taxpayer is not taxed in Sweden at source on the gross amount of payment, but by individual assessment.\footnote{Historically, a reason for taxing royalty payments by individual assessment seems to have been the idea that the payer in some way takes part in the business of the recipient, see Wiman, ‘Beskattning av royalties m.m till utlandet’ in Thorell (ed.), Studier i skatterät tillägnade Nils Mattsson på 50-årsdagen (1988), pp. 171–175.}

The tax rate limitations may also be relevant where the taxpayer is resident for tax purposes and subject to tax on the worldwide income (including dividends, interest, and royalty income) in both N and R according to their internal laws.\footnote{This was the case in RÅ 1996 ref. 38. The taxpayer in question was regarded as resident for tax purposes in Sweden under Swedish internal law, but as resident in Kenya for the purpose of the DTT and was taxed in Sweden on her worldwide income, subject to the limitations provided in the DTT.} In such cases, tax is normally imposed in N by individual assessment.\footnote{For instance, according to Swedish internal law (ch. 3 sec. 8 and ch. 6 sec. 4 IL), Swedish residents are subject to taxation on their worldwide income (including dividends, interest, and royalty) regardless of whether they are non-resident in Sweden for the purpose of a DTT.}

Where taxation is imposed by individual assessment, the tax rate limitations under the DTT, which are formulated as limitations to the tax rate on the gross amount, require that the amount of tax on the net income does not exceed an amount corresponding to the tax rate limitation in question applied to the gross amount.

Where a taxpayer is subject to tax in N on the worldwide income, taxation may take place in N even though the income is not derived from N. However, generally the DTT provisions on dividends, interest, and royalty, and hence the tax rate limitations, are only applicable where the payment originates in N and not where a payment is made by a person in R or in a third state, meaning that dividends must have been paid by a company which is a resident of N and that interest and royalty must have arisen in N in order for the tax rate limitations to apply. In other cases, the other income article of the DTT may be applicable, normally providing for exclusive taxation by R.\footnote{See Ward and others, ‘The Other Income Article of Income Tax Treaties’, BTR, 1990,}
Where the tax liability under N’s internal laws exceeds the limitation of the tax rate under the DTT, there are two ways of implementing the limitation: (i) by way of a direct reduction of the tax deducted on remittance, or (ii) by taxing in full and making a refund.

The OECD Model does not say in what way the limitations shall be realised by the contracting states. According to the Commentaries, each state should therefore be able to use the procedure provided for in its own laws. However, the contracting states are of course free to agree on a specific procedure.

As regards withholding tax on dividends, Sweden generally offers both alternatives for achieving a reduced rate in accordance with DTT tax rate limitations. Legislation on direct reduction exists only in relation to payments made through the Swedish Central Securities Depository, stating that the depository shall deduct withholding tax at the reduced rate provided for under the DTT, unless a refund is the only available option under the DTT, and according to a few government decrees on the application of certain DTls. Furthermore, it can be argued that the EU treaty requires that direct reduction is applied in relation to non-resident shareholders within the EU, since a refund procedure would make cross border investment less efficient and less

492 Cf. Arts. 10.2 sub-para. 2 first sentence and 11.2 second sentence of the OECD Model, which state that the competent authorities of the contracting states shall by mutual agreement settle the mode of application of the limitations. In contrast, Staringer holds that the wording of the DTT provisions, which typically state that the "tax so charged shall not exceed x percent", as well as a teleological interpretation of the DTT speak in favour of direct reduction, see Staringer, ‘Verfahrensrecht und die Methoden zur Vermeidung der Doppelbesteuerung’ in Gassner, Lang & Lechner (eds.), Die Methoden zur Vermeidung der Doppelbesteuerung (1995), pp. 218–222. However, the view that the procedure chosen for carrying out the reduction falls outside the scope of the DTT unless it is expressly dealt with by the DTT provisions seems to be generally accepted, as indicated by the above referred provisions of the OECD Model.

493 The OECD Model, Commentary to Art. 10, para. 19, and Commentary to Art. 11, para. 12.

494 Euroclear acts as Central Securities Depository for Sweden.

495 Sec. 3 kupongskatteförordning (1971:49) (Eng. the Government Decree on Withholding Tax).

attractive compared to domestic investment.\textsuperscript{497} However, subject to certain procedural requirements, all DTT tax rate limitations on dividends except those under the DTT with Switzerland are fulfilled by the Swedish Tax Agency by means of direct reduction – in many cases without a legal basis for doing so. The reason is probably that direct reduction has significant advantages with regard to administrability compared to a refund procedure.\textsuperscript{498}

According to Article 5 of the agreement between Sweden and Switzerland made on 17 August 1993 on the implementation of the limitations under Articles 10 and 11 of the DTT with Switzerland,\textsuperscript{499} the tax rate limitations in Article 10 of the DTT shall be implemented by means of a refund. In other words, the only option for achieving the reduced rates under the DTT with Switzerland is to apply for a refund. No other DTTs preclude direct reduction.\textsuperscript{500}

If withholding tax has been paid at a higher rate than that provided for under the DTT, the Swedish Central Securities Depository, the distributing company, the taxpayer or the agent or nominee of the taxpayer may apply for a refund. Such application must be submitted before the end of the fifth calendar year following the year of the dividend payment.\textsuperscript{501}

Where tax is levied in N by individual assessment, following the filing of a tax return, there is no need for direct reduction. Instead, the tax payable will be computed taking into account the reduced rate, provided that all relevant procedural requirements have been fulfilled.

\section*{5.3.3 Economic Double Taxation}

DTTs typically do not concern themselves with economic double taxation, i.e. taxation of two different persons in respect of the same subject matter. Economic double taxation takes place for instance where the profits of a company are taxed first at the level of the company and then again at shareholder level upon distribution. Insofar as interest and royalty is concerned, economic double taxation normally does not occur as such payments are

\textsuperscript{497} The Fiscal Compliance Experts’ Group (FISCO), \textit{Fact-Finding Study on Fiscal Compliance Procedures Related to Clearing and Settlement within the EU}, 2006, pp. 32–33.

\textsuperscript{498} An interesting question is whether this practice could create a legitimate expectation for a taxpayer that the Swedish Tax Agency will continue to apply direct reduction and that it will be granted in accordance with the same procedural requirements as are presently applied, cf. Påhlsson, ‘Berättigade förväntningar i svensk skatterät’, \textit{SvSkT}, 2010, No. 3, pp. 316–317.

\textsuperscript{499} An account of the agreement is given by the Swedish Tax Agency in Riksskatteverkets meddelande (Eng, the Swedish Tax Agency’s information) RSV S 1994:7.


\textsuperscript{501} Secs. 9, 16, and 27 KupongskatteL.
generally deductible for the payer. The situation is different insofar as dividends are concerned, since dividend payments are typically not deductible.

According to the OECD Model, economic double taxation need not be relieved at the international level when such double taxation remains unrelieved at the national level. However, there is reason to distinguish between, on the one hand, economic double taxation arising as a result of taxation of the profits of a company both at the level of the company and upon distribution to a shareholder who is an individual and, on the other hand, economic double taxation in the form of recurrent corporate taxation. Some states, such as Sweden, do not consider it necessary to relieve economic double taxation at the national level for dividends distributed to individuals. However, most states provide some form of relief for inter-company dividends. The idea is that recurrent corporate taxation should be avoided, so that the same amount of tax is levied regardless of whether the business is organised in the form of a single company or as a group of companies. Where domestic recurrent corporate taxation is dealt with by internal law, there may be reasons for dealing at the international level with recurrent corporate taxation of companies in different states.

In a domestic situation, recurrent corporate taxation may be eliminated by allowing a corporate shareholder a credit for tax paid on the profits of the distributing company or by exempting the dividends received by a shareholder altogether. In practice, relief is often subject to the holding of a certain percentage of the votes or capital of the distributing company for a certain period. However, where the dividends are taxed at source in the state of the distributing company and are paid to a corporate shareholder in another state, it becomes more difficult to completely eliminate recurrent corporate taxation. Regardless of whether R is obligated under the DTT to exempt the dividend income or to credit tax imposed in N on the dividend income, thereby eliminating double taxation of the shareholder, provisions imposing such obligations do not prevent recurrent corporate taxation, once at the level of the distributing company when it is taxed on its profits and once again at the level of the corporate shareholder when it is taxed on the profit distribution.

In order to relieve recurrent corporate taxation in such situations, N must refrain from taxing the profits of the distributing company, for instance by providing a deduction for dividends paid. Alternatively, both R and N must

502 The OECD Model, Commentary to Art. 10, para. 41.
503 The OECD Model, Commentary to Art. 23, para. 50.
refrain from taxing the corporate shareholder on the dividend payment. DTTs do not generally require the contracting states to act in this way. Alternatively, R must provide a credit not just for tax paid by the shareholder in N but also for underlying taxes, i.e. for tax paid by the distributing company in N on the profits distributed, but this alternative would only eliminate recurrent corporate taxation where the tax in N can be credited in its entirety. No uniform solution to this problem has been agreed on by the OECD member countries within the framework of the OECD Model.504

Rules for dealing with recurrent corporate taxation by completely abolishing taxation of inter-company dividends may apply under the internal laws of the contracting states. Insofar as EU member states are concerned, such legislation may have been introduced on the basis of the Parent-Subsidiary Directive.505

5.3.4 DTT Provisions on Limitation of the Tax Rate

As described above, the OECD Model sets out limitations to the tax imposed by N in respect of dividends and interest. There is no requirement under the OECD Model that the shares must have been held for a specific period. The reason stated in the Commentaries for not requiring a holding period is to avoid extensive inquiries, i.e. for reasons of administrability.506 The holding requirement in respect of dividends, at least according to the wording of the OECD Model, only takes into account shares that are held directly, i.e. it does not apply where a company holds directly less than 25 per cent of the capital of the paying company, regardless of whether it exercises control over 25 per cent or more of the paying company through indirect ownership or other means.

The distributive rule on dividends typically does not specify at which time the holding requirement must be fulfilled. For instance, the condition may be satisfied when a meeting of the shareholders resolves that distribution shall take place, but not when the payment is made or vice versa. According to the OECD Model, the relevant time is the time material for the coming into existence of the liability to the tax to which the paragraph applies.507

504 The alternatives “a) Exemption with progression” and “c) Assimilation to a holding in a domestic subsidiary” presented in the OECD Model, Commentary to Art. 23, para. 52, do not solve recurrent corporate taxation in N.
505 Cf. for instance sec. 4 paras. 4–7 KupongskatteL.
506 The OECD Model, Commentary to Art. 10, para. 16.
507 Ibid. Concurring, Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 99.

210
other words, the relevant time for determining whether the holding requirement is fulfilled is when the taxable event occurs under the tax law of N.

In some of its DTTs, mainly with industrialised countries, Sweden and the treaty partner have agreed to exempt dividends on substantial holdings from taxation in N altogether.\textsuperscript{508} Similarly, a number of Swedish DTTs provide for exclusive taxation in R of interest income.\textsuperscript{509} Insofar as royalties are concerned, Sweden's DTTs with industrialised countries typically follow the OECD Model by providing for exclusive taxation in R of royalty income whereas its DTTs with developing countries generally follow the UN Model and reserve N's right to tax, subject to a tax rate limitation.\textsuperscript{510}

The limitations to the taxing right of N in the distributive rules on dividends, interest, and royalty often require that a resident of R beneficially owns the dividend, interest, or royalty, in most cases without beneficial ownership being defined in the DTT.\textsuperscript{511} The purpose of using the concept of beneficial ownership is to clarify that it is not sufficient that a payment is made to a person in R in order for the limitations to apply. Where the recipient is merely an intermediary or acts as an agent or nominee and does not beneficially own the income the recipient shall be disregarded for the purpose of determining whether the limitation to N's taxing right applies.\textsuperscript{512} A taxpayer that is not a resident of one of the contracting states should not be able to obtain treaty benefits by interposing between the payer of the dividends, interest, or royalty and the taxpayer an intermediary that is a resident of a contracting state. In other words, the concept is intended to counter so-called treaty shopping. However, there is no consensus on the exact meaning of beneficial ownership, not least because it is a concept which is taken from British legal tradition but which may not be familiar to other legal traditions.\textsuperscript{513}

\textsuperscript{508} For instance the DTTs with France, Germany (subject to conditions in addition to the holding requirement if the distributing company is resident in Germany), Luxembourg, Mexico (subject to conditions in addition to the holding requirement), the Netherlands, South Africa (provided that the dividend is exempt from tax in R as well), Switzerland, the United Kingdom, the United States (subject to conditions in addition to the holding requirement), and the Nordic DTT.

\textsuperscript{509} For instance the DTTs with France, Germany, Luxembourg, the Netherlands, South Africa, the United Kingdom, the United States, and the Nordic DTT.

\textsuperscript{510} For instance the DTTs with Albania, Bangladesh, Barbados, India, the Philippines, Malaysia, and Thailand all reserve N's right to tax royalty income.

\textsuperscript{511} Cf. Arts. 10–12 of the OECD Model.

\textsuperscript{512} Cf. Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Arts. 10–12, paras. 12–19.
For instance, Swedish legal tradition is not familiar with the idea that a person can have legal title to a property separate from the beneficial ownership. Instead, income is attributed for tax purposes to a person on the basis of a number of factors such as formal aspects, the allocation of benefits and risks relating to the property, etc., normally without determining whether the person is the owner of the property. Under Swedish law, income would normally not be attributed for tax purposes to a nominee or an agent where the nominee or agent receives a dividend, interest, or royalty payment on behalf of another person. On the other hand, dividends received by a holding company would typically be attributed to that company for tax purposes regardless of whether the company merely serves the purpose of forwarding the dividend payment to its shareholders. As there is to my knowledge no Swedish case law on the DTT expression “beneficial ownership”, it remains unclear as to whether it could have any other meaning than the person to whom an item of income is attributed for tax purposes under Swedish internal law.

In this context, it can be noted that Article 43.3 of the DTT with Germany defines beneficial owner, or rather the Swedish phrase “anses ha rätt till” (Eng. “be considered entitled to”) and the German term “Nutzungs­berechtiger”, as follows.

A person that is a resident of a contracting state shall for the purposes of Articles 10–12 be considered entitled to dividends, interest, or royalty if he according to the legislation of that state is considered for tax purposes to have derived the income. However, such person shall not be considered entitled to the payment where the payment according to the legislation of the other state for tax purposes is considered attributable to other persons who have received the income and who are not residents of the first-mentioned state. [author’s translation514]

Thus, according to the definition of the DTT with Germany, a person is normally only considered as a beneficial owner of the dividends, interest, or royalty if the income is attributable for tax purposes to that person according to the legislation of both contracting states.

514 In Swedish, the passage reads as follows: “En person med hemvist i en avtalsslutande stat skall vid tillämpningen av artiklarna 10–12 anses ha rätt till utdelning, ränta eller royalty om han enligt lagstiftningen i denna stat är den person som i beskattningshänseende anses ha förvärvat inkomsten. Sådan person skall emellertid inte anses ha rätt till ersättningen, när ersättningen enligt lagstiftningen i den andra staten i beskattningshänseende anses ha tillfallet andra personer som kunnat tillgodogöra sig inkomsten och som inte har hemvist i den förstnämnda staten.”
Where the expression “beneficial owner” is undefined in the DTT it may be necessary to fall back on internal law, which, at least as regards the meaning that shall be given to the expression where the DTT is applied in Sweden, leads to considerable uncertainty.

5.4 The Principle of Credit

5.4.1 Introduction

In contrast to the principle of exemption, the principle of credit does not work by excluding income from the tax base. Instead, under the principle of credit a pre-credit tax is computed on the basis of the taxpayer’s worldwide income, from which a credit is granted for tax paid in another state.

Under the principle of credit the tax revenue of R is dependent on the tax law of N, since the tax revenue of R decreases if the N tax is increased, insofar as the N tax before the increase fell below the R tax. On the other hand, as the principle of credit increases the aggregate tax to the higher level of the tax in R or N, any tax reduction in N will be “absorbed” by R insofar as the tax in N before the reduction was lower than the tax in R. This can be seen as a disadvantage from the viewpoint of N and, naturally, the taxpayer, but may be seen as either an advantage or disadvantage by R, depending on its policy with regard to investments abroad.

In 1918 the United States introduced legislation for the elimination of double taxation by means of the principle of credit. By doing so, it was the first country to apply the principle of credit on a worldwide basis. The principle and many of the features connected with it, such as the foreign tax credit limitation, indirect credit, and carry forward and carry back of excess credits, have been developed in the United States.

Historically, Sweden applied exemption as the main principle for elimination of double taxation under DTTs. As mentioned above in sub-chapter 5.2.1, a shift in policy occurred in the mid-1960s when the principle of credit was adopted as the main principle for elimination of double taxation in three new DTTs, and a fourth DTT was amended so that the principle of exemption was replaced by the principle of credit as the main principle for

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515 Cf. the interpretational rule of the DTT, which is discussed in sub-chapter 3.8.6.
elimination of double taxation. The DT Ts in question were entered into with Switzerland, Belgium, and Brazil (in that order) and the amendment agreement was made with Italy. The reasons for the shift are not clear. It has been suggested that the change may have been due to the inclusion of a provision on so-called reverse credit in the DTT with Switzerland, although the preparatory works relating to the approval of the DTT with Switzerland give no support for this. According to the DTT with Switzerland, Sweden’s right in its capacity as N to tax Swedish citizens who moved to Switzerland was reserved in certain situations in order to reduce tax incentives for moving to Switzerland, but the taxing right so reserved was limited by an obligation to credit tax paid in Switzerland on the income in question. It may be possible that the inclusion of the reverse credit clause, which is applicable where Sweden imposes tax in its capacity as N, would not have been accepted by Switzerland if Sweden had applied the principle of exemption as the main method for elimination of double taxation, but in my view the argument is not convincing as the main method to be applied by Sweden was not an inevitable consequence of the application of reverse credit by Sweden.

The Government Bill relating to the approval by the Swedish Parliament of the DTT with Brazil (the first DTT out of the four mentioned above to be approved by the Swedish Parliament) provides some clues to other reasons for the shift. In the Government Bill, it was pointed out that many states, in particular the Anglo-Saxon states, apply the principle of credit in its DT Ts with respect to the majority of the classes of income and that several of these states apply the same principle on the basis of specific legislation also in relation to states that have not entered into DT Ts with the state in question. Thus, a link was made between the main principle for elimination of double taxation applied in a state’s DT Ts and the principle applied for unilateral relief. Further, it was pointed out that a Swedish Government Official Report had proposed the introduction of such unilateral credit rules in Sweden. It seems likely that it was considered inconsistent to apply exemption as the main principle in relation to treaty partners and, at the same time, apply credit rules on a unilateral basis in relation to all other states. The contemplated

519 Prop. 1965:177.
520 Art. 25.2-4 of the DTT with Switzerland.
521 Prop. 1965:164.
introduction of unilateral credit rules is therefore likely to have influenced the DTT policy shift.

Some further explanation can also be derived from the following statement that was made in the Government Bill.523

A novelty in the technical design of the proposal for a DTT with Brazil is the provisions on compensation for double taxation that arises for persons who are resident in Sweden for tax purposes through credit of Brazilian tax from tax that has been levied in Sweden. This procedure is proposed to be applied on a more general basis in relation to Brazil than that which has been the case according to previous DTTs entered into by Sweden. The proposal to introduce a procedure for credit of tax, which should be seen against the background of the provisions on the classes of income in the DTT proposal, is primarily intended to maintain a uniform taxation of persons that are resident in Sweden for tax purposes. [author’s translation]

Thus, the uniform taxation of persons that are residents in Sweden was stated as the primary reason for applying the principle of credit. In other words, the statement in the Government Bill indicates that the objective of CEN, i.e. uniform taxation of Swedish residents regardless of any cross border activities undertaken by them, was important for the shift in policy.

As has been pointed out by Mattsson, the lack of substantial discussion on the pros and cons of the principles and their relation to Sweden’s preferences in regard to CEN and CIN (at least in any form available to the public) in connection with this fundamental change of DTT policy is regrettable.524 However, some arguments were presented in the Swedish Government Official Report 1962:59 Internationella skattefrågor (Eng. International Tax Matters)525 that resulted in the introduction of unilateral credit rules, which were also referred to in the Government Bill relating to the enactment of the unilateral credit.526 Insofar as the introduction of unilateral credit rules is accepted as a component in the shift to the principle of credit in Sweden’s DTTs, these arguments may very well have also influenced the change of DTT policy. In the report, the risk of double non-taxation connected with the application of the principle of exemption was highlighted as speaking in favour of the principle of credit. Further, the fact that the principle of credit

523 Ibid, pp. 48–49.
does not put a taxpayer who has derived income from abroad in a better position than a taxpayer who has derived domestic income was considered as an additional advantage. In other words, the capacity of the principle of credit to remove tax incentives for investing abroad was taken into account. The fact that legislation on credit is more complicated and more difficult to apply than legislation on exemption was noted but it was not considered a decisive argument against the principle of credit.

5.4.2 Relation to Internal Law

As regards the principle of credit, internal law plays an important role in complementing the general principle laid down in the double tax relief article. DTTs do not contain detailed rules on credit of foreign tax and they do not contain any rules at all in respect of procedure. This means that many aspects of the application of the principle of credit have to be dealt with in the internal laws of the contracting states. Many DTTs therefore contain an express reference to the internal laws of the contracting states. For instance, many Swedish DTTs refer to “the provisions of the law of Sweden concerning credit for foreign tax”. However, regardless of whether an express reference to internal law is made, it is necessary to fall back on internal rules to carry out the credit. Thus, references to internal law in this respect seem to be merely declaratory. On the other hand, it can be argued that any limitations under internal law which would otherwise have been regarded as conflicting with DTT obligations become integrated in the DTT by means of the reference to internal law and that, hence, there is less room for claiming a credit on the basis of the DTT contrary to such limitations.

To my knowledge, the first Swedish DTT which includes an express reference to the Swedish internal law provisions concerning credit for foreign tax is the DTT with the United Kingdom of 1983. In the preparatory works relating to the Incorporation Act, it is pointed out that this DTT follows closely the OECD Model. No explanation is given for the deviation from the OECD Model with regard to the double tax relief article.

527 For instance, according to Avery Jones and others, ‘Credit and Exemption under Tax Treaties in Cases of Differing Income Characterization’, ET, 1996, Issue No. 4, p. 121, a reference to internal law credit rules can be found in DTTs entered into by Australia, Belgium, Canada, Germany, Japan, Switzerland, the United Kingdom, and the United States.

528 Cf. the OECD Model, Commentary to Art. 23, para 60.

529 Art. 22.2.a of the DTT with the United Kingdom of 1983.

530 Prop. 1983/84:5.
In connection with the reference to the internal law provisions on credit, many DTTs state that the reference to internal law shall not affect the general principle laid down in the provision in question. For instance, Swedish DTTs frequently state that Sweden shall allow a credit “subject to the provisions of the law of Sweden concerning credit for foreign tax (as it may be amended from time to time without changing the general principle hereof)”. This seems to provide some protection against internal legislation being changed in a way which would fail to provide relief in accordance with the obligation laid down in the DTT provision.531

Although in a few specific situations Sweden provides unilateral double tax relief by means of the principle of exemption,532 the principle of credit has been applied as the general method for unilateral relief since the mid 1960s,533 and since 1986 has been regulated in a specific Act, namely the Foreign Tax Credit Act534.

As regards Sweden, the detailed rules of the Foreign Tax Credit Act apply in respect of both credit under a DTT and unilateral credit. The purpose of applying the same provisions in respect of both unilateral credit and credit under a DTT is that an identical credit shall be given irrespective of the basis for the credit, so as to avoid a situation where the DTT credit or the unilateral credit would be more favourable than the other.535 Even so, the Foreign Tax Credit Act expressly provides that additional credit shall be given to the extent that an applicable DTT provides for a higher tax credit than the Foreign Tax Credit Act.536 Thus, in a situation where the double tax relief article of a DTT provides for a more generous credit, the conflict between that DTT provision and the Foreign Tax Credit Act is resolved by giving preference to the DTT.

As regards the relationship between the credit under a DTT and the credit under internal law, some countries allow the taxpayer to choose between the two so that a unilateral credit can be applied even though there is an applicable DTT if this is more favourable than the credit provided under the DTT.537 Under the Foreign Tax Credit Act, no such choice is available.

532 For instance the so-called six-months-rule in ch. 3 secs. 9–13 IL, which, subject to certain conditions, exempts income from employment abroad.
533 SFS 1966:730.
534 Lag (1986:468) om avräkning av utländsk skatt, abbreviated to “AvrL”.
536 Ch. 1 sec. 7 AvrL.
537 Vogel and others, Doppelbesteuungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 136.
According to this Act the unilateral credit does not apply if the national income tax, the municipal income tax, the foreign tax and the foreign income is covered by a DTT, i.e. where a DTT is applicable to the double taxation or potential double taxation in question.\(^{538}\) However, as double tax relief would normally not be provided under a DTT to a non-resident taxpayer, the unilateral credit may still apply in respect of such taxpayers, regardless of whether income derived by that taxpayer and tax relating to such income would in principle be covered by a DTT.\(^{539}\)

In countries that do not offer a choice between unilateral credit and DTT credit, this gives rise to the question as to whether the taxpayer can disregard the DTT credit and apply a unilateral credit if this is more favourable to the taxpayer or apply unilateral credit to the extent that it exceeds the DTT credit, on the basis of the principle that DTT provisions may not increase the tax burden provided for under internal law, since otherwise the effect of the DTT would be to increase the tax burden.\(^{540}\) First, it must be noted that the principle saying that DTT provisions only apply insofar as they limit taxing rights otherwise provided by internal law provisions is normally not included in the DTT and therefore does not create obligations under international law. Consequently, there is no international law obligation preventing R from limiting the unilateral credit as long as the obligation under the DTT to provide double tax relief is respected (cf. sub-chapter 3.5). Second, an argument based on that principle is likely to be rejected as the taxing right of R is not extended by the DTT provisions \textit{per se}. Rather, the existence of a DTT is used as a prerequisite for the application of internal law provisions extending the taxing right (in this case by limiting the credit) that would otherwise follow from other internal law provisions. As regards Sweden, most of the provisions of the Foreign Tax Credit Act apply to DTT credit as well as unilateral credit, so the same result is normally achieved regardless of whether the application of the DTT credit rules out the use of the unilateral credit.

A related question is whether the unilateral credit can be applied where the taxpayer has refrained from claiming treaty benefits in N that were available to him. That question must be answered on the basis of the internal law of the state that provides a credit. As noted above, in Sweden no unilat-

\(^{538}\) Ch. 2 sec. 2 para. 1 AvrL.

\(^{539}\) Ch. 2 sec. 2 para. 2 AvrL.

\(^{540}\) Cf. Vogel and others, \textit{Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen} (2008), Art. 23, para. 27.
eral credit would be available where the national income tax, the municipal income tax, the foreign tax, and the foreign income is covered by a DTT.

The question as to whether a credit can be granted where a taxpayer has refrained from claiming treaty benefits in N is linked to a more general issue inherent in the principle of credit, namely that the principle of credit may remove a taxpayer’s incentive to minimise foreign tax insofar as the foreign tax falls below the foreign tax credit limitation. Not claiming treaty benefits may cause the taxation in N to be “not in accordance with the DTT” and therefore disqualify the taxpayer from a credit, for instance where N tax has been imposed in excess of tax rate limitations under the DTT as a result of the fact that the taxpayer has refrained from applying for a reduced rate or a refund (see sub-chapter 4.4.5). However, in other situations, such a lack of incentive to be “foreign tax-conscious” may lead to a shift of tax revenue from R to N, which would not have occurred if the taxpayer had been equally cost-conscious when it comes to the N tax as regards the R tax.

Although the procedure for double tax relief by means of credit of foreign tax is not regulated in DTTs it can be argued that since the DTT places an obligation on the contracting states to eliminate double taxation, the DTT sets a minimum standard as regards procedure. If the procedural requirements under internal law are too strict so that it becomes unreasonably difficult for the taxpayer to obtain double tax relief it would be possible to argue that the contracting state in question has not fulfilled its treaty obligations.

Insofar as foreign tax cannot be credited, it can be considered as a cost for the taxpayer. As a consequence, internal law may provide for deduction of uncredited foreign tax from the taxable income of the taxpayer. Where deduction of foreign tax from the taxable income of the taxpayer would be more favourable to the taxpayer than a credit of the foreign tax, the question arises whether internal law provides for a choice between deduction and credit or whether the principle that a DTT may not increase the tax burden provided for under internal law entitles the taxpayer to a choice regardless of the internal regulation, as the taxpayer may otherwise be worse off than if no DTT had been in place. However, as pointed out above, the principle that a DTT may not extend the taxing rights of a state beyond what follows from

its internal laws is not a principle under international law, but a domestic principle, meaning that this question would have to be answered on the basis of the legislation and legal principles of the contracting state in question.

According to Swedish internal law, foreign tax is regarded as a deductible item, with the exception of tax on exempted income. Thus, foreign tax is deductible regardless of whether it is also creditable against Swedish tax. However, the foreign tax shall for the purpose of determining the creditable tax be decreased by an amount that corresponds to the reduction in tax resulting from the deduction. Furthermore, the foreign tax credit limitation shall be determined as if no deduction had been made. In other words, the tax effect of the deduction is reversed. However, since foreign tax is deducted in connection with the tax assessment whereas the credit (and the reversal of the tax effect of the deduction) may take place at a later time, the deductibility of foreign tax may still be an advantage for the taxpayer even though the tax effect is eventually reversed.

5.4.3 Deduction of Losses in N from Income in R

Where the principle of credit is applied, the pre-credit tax in R is usually computed on the basis of the worldwide income, taking into account any losses incurred to the taxpayer in N. Thus, losses in N reduce the amount of tax to be paid in R. This is a considerable advantage to the taxpayer as compared to the principle of exemption which in many cases precludes the taxpayer from offsetting losses in N against income in R. However, as DTTs do not generally concern themselves with the computation of taxable income in R, DTTs do not oblige R to take such losses into account. The question as to whether R shall allow losses in N to be deducted will therefore have to be determined in each case on the basis of the internal law of R.

543 Ch. 16 sec. 18 IL.
544 Ch. 2 sec. 15 para. 1 AvrL.
545 Ch. 2 sec. 9 para. 2 AvrL.
546 Some of the difficulties that may arise in connection with the coordination of the principle of credit and deduction of foreign tax are illustrated by RÅ 2009 not. 24, see Berglund & Bexelius, ‘Sweden’ in Blanluet & Durand (general reporters), Key Practical Issues to Eliminate Double Taxation of Business Income (2011), p. 640.
In contrast with situations where the principle of exemption is applied, the objective of treating losses in symmetry with income does not speak unequivocally in favour of denying deduction. Provided that the losses incurred in N can be carried forward, the decrease in R’s tax revenue in the year in which the losses are deducted may be compensated by an increase in tax revenue in a future year caused by a reduction of creditable tax due to the carry forward of losses in N. Thus, in effect a deduction of losses in situations where the principle of credit is applied results in a tax deferral but not in a permanent relief.

5.4.4 Full Credit
A credit for the entire amount of tax paid in N, regardless of whether the tax paid in N exceeds the tax in R on the income which is taxable in N, is usually referred to as “full credit”. Where the tax in N is higher than the R tax paid on the income which is taxable in N, full credit typically means that a credit is allowed against tax on domestic income. In practice, a contracting state would normally not accept a credit from tax on domestic income as that would mean that taxing power relating to domestic income is handed over to N, since a decision by N to increase taxation on income which is taxable in N might reduce R’s tax revenue on income which is taxable only in R. Therefore, some form of foreign tax credit limitation normally exists to put a ceiling on the credit, for instance by limiting the credit to that part of the tax in R which is appropriate to the income that is taxable in N.

For the taxpayer, the cost is the same regardless of whether tax has to be paid in R or N. From the perspective of a taxpayer in R it would therefore make sense to allow the taxpayer to reduce the tax liability in R with tax paid in N, so that, in the end, the aggregate tax corresponds to the tax that would have applied if the income had been taxable in R only, i.e. CEN. Furthermore, by doing so, the taxpayer’s ability to pay would be taken into account in R in the same way as it would if the entire income had been derived from R. If the tax on domestic income does not suffice, CEN can only be achieved by means of a “negative” tax, i.e. a contribution. However,

548 Schuch, ‘Der Anrechnungshöchstbetrag’ in Gassner, Lang & Lechner (eds.), Die Methoden zur Vermeidung der Doppelbesteuerung (1995), p.15, points out that the term “full credit” is misleading as a credit of N tax in excess of the amount of tax paid in R, i.e. a negative tax, would not be accepted.
this is a rather theoretical approach. Although a contracting state may have CEN as its objective, it would not go so far towards reaching that objective as to accept a negative tax, the size of which would be totally dependent on the level of tax decided by N.

Full credit is illustrated by the following example.

Sweden levies corporate tax at a rate of 26.3 % whereas State A levies corporate tax at a rate of 40 %. If a company which is a resident of Sweden derives income of 100 from Sweden and 100 from a PE in state A, pre-credit tax would be payable in Sweden in an amount of 52.6 (26.3 % × 200), assuming the same taxable base for Sweden and state A. Under a full credit system, the entire amount of tax in A, 40 (40 % × 100), would be allowed as a credit against the Swedish tax. Thus, the tax liability on the income derived from Sweden, 26.3 (26.3 % × 100) would be reduced by 13.7 (26.3 – 40 = –13.7), resulting in a post-credit tax in Sweden of 12.6 (52.6 – 40).

Sweden does not apply full credit under any of its DTTs. However, Swedish legislation provides unilaterally for full credit in respect of interest payments that have been subject to withholding tax in accordance with the EC Savings Directive or certain bilateral treaties (for instance with Jersey and the British Virgin Islands) entered into by Sweden which have been modelled on the EC Savings Directive. Furthermore, full credit is applied where withholding tax has been levied in accordance with certain corresponding treaties entered into by the EU (for instance with Switzerland and Monaco).

5.4.5 Ordinary Credit

In contrast to the full credit method, the tax credit given by a contracting state is in almost all cases limited to the tax liability in that state on foreign income in order to ensure that the tax credit does not reduce the taxes on the taxpayer’s domestic income. Where the DTT provides for such a maximum amount of credit, the method applied is usually referred to as “ordinary credit”. As an example, Article 23 B of the OECD Model states that the credit shall not exceed that part of the income tax, as computed before

550 Ch. 56 sec. 9 para. 2 item 8 SFL.
551 Ch. 56 sec. 9 para. 2 item 4 SFL.
552 The Swedish Tax Agency considers the articles of these treaties on credit and repayment of foreign tax to have direct effect, see the Swedish Tax Agency, Ställningstagande (Eng. Published Position), 20 November 2007, dnr 131 696178-07/111.
the credit is given, which is attributable to the income which may be taxed in the other state.553

In this study, the maximum amount of credit is referred to as “the foreign tax credit limitation”, in accordance with US terminology. DTTs do not normally set out detailed rules specifying how the foreign tax credit limitation is to be computed. Therefore, the foreign tax credit limitation is generally determined on the basis of the law and practice of the contracting state which is obliged under the DTT to provide double tax relief. An analysis of the foreign tax credit limitation is made in sub-chapter 5.4.13 below.

In principle, the effects of ordinary credit can be described as follows. When the foreign tax on the item of income in question exceeds the R tax, the credit in effect cancels the tax liability in R, so that only N tax is payable. On the other hand, when the foreign tax on the item of income in question falls below the R tax, tax is paid in R in an amount equal to the excess over the N tax. In principle, the application of the principle of credit results in aggregate taxation equal to the highest of the R or N tax. As the taxpayer does not benefit from a lower N tax, tax incentives for investing abroad rather than making domestic investments are removed.

The choice of the principle of credit can be justified by the following reasoning. As long as the aggregate tax does not exceed the highest of the R or N tax, double taxation can be considered to have been successfully removed. Ordinary credit therefore achieves the objective of eliminating double taxation. A complete shift to the N level of tax, as would have been the case if R had applied the principle of exemption, is therefore unnecessary since the burden of double taxation is deemed to be only the excess taxation occurring when the taxpayer is subjected, because it pays taxes to more than one country, to an aggregate tax which exceeds the highest of the R or N taxes on the item of income in question. Thus, the principle of credit can be said to be based on two principles: (i) that N has the first claim on the taxpayer's income and (ii) that R is entitled to impose an additional tax to the extent that income has not already been taxed in N at a rate as high as that of R.554

To the extent that a credit system is regarded as a means of achieving tax neutrality between those taxpayers who engage in foreign activities and those who do not, i.e. CEN, it would in principle be appropriate to apply full

553 The OECD model uses the phrase “deduction from the tax”. In this study, the term “credit” is used instead of “deduction”, so as to avoid confusion between deduction from tax (meaning a reduction of tax liability) and deduction from income (meaning a reduction of taxable income).

credit, i.e. not restricted to the R tax attributable to the income which under
the DTT may be taxed in the other state, and to allow a credit from tax on
domestic income or a “negative” tax in cases where the N tax exceeds the R
tax on the income which may be taxed in N. However, that would constitute
a substantial limitation of R’s sovereign right to tax its residents and as such
has not been considered an acceptable option. Thus, a higher tax in N will
normally result in effective taxation in excess of the R tax and in such cases
CEN is not achieved. A compromise can be found in the application of a
form of foreign tax credit limitation which allows cross-crediting of excess
foreign tax against tax in R on income which has been subjected to foreign
tax at a lower rate than in R (often referred to as “overall limitation”), as that
will increase the chances of achieving CEN without giving up more of R’s
taxing rights than is necessary.555

In practically all cases, it is R which applies the principle of credit.556 This
is in line with the idea that the principle of credit is used by the state of resi-
dence to avoid situations where the taxation creates incentives for a taxpayer
to invest abroad instead of making domestic investments. As it is almost
always R which is obliged to apply the principle of credit, DTT provisions
on the principle of credit are in principle only found in the double tax relief
article, which pins down R’s obligation to eliminate double taxation, and not
in the distributive rules, which place obligations on both R and N.

Although the basic idea of ensuring that the tax credit does not reduce
tax on domestic income is the same, the basis for computing the foreign
tax credit limitation may differ significantly. For instance, the foreign tax
credit limitation may be computed for all foreign income collectively, for
each country separately, or for each item of income separately. This results in
differences with respect to the possibilities of cross-crediting foreign tax on
inter alia one item of income against domestic tax on another item of foreign
income. It also has implications with regard to the effects of negative items
of income. The credit allowed under ordinary credit may therefore differ sig-
ificantly, depending on how the foreign tax credit limitation is computed.

Where Sweden applies the principle of credit under its DTTs, this is
always made in the form of ordinary credit. The double tax relief article of
Swedish DTTs typically includes the following provision regarding credit of
tax:

556 In this respect, reverse credit is an exception, see sub-ch. 5.4.7.
In the case of Sweden, double taxation shall be avoided as follows:

(a) Where a resident of Sweden derives income which under the laws of [N] and in accordance with the provisions of this Agreement may be taxed in [N], Sweden shall allow – subject to the provisions of the laws of Sweden concerning credit for foreign tax (as it may be amended from time to time without changing the general principle hereof) – as a deduction from the tax on such income, an amount equal to the [N] tax paid in respect of such income.557

It can be noted that the provision does not conform to the credit provision of Article 23 B.1 of the OECD Model and that it makes applicable by direct reference any credit limitations under Swedish internal law. The effect of such a reference to internal law is commented on above in sub-chapter 5.4.2. Further, the addition of the phrase “as it may be amended from time to time without changing the general principle hereof” is also commented on in that sub-chapter.

Article 23 B of the OECD Model obligates R to give relief in respect of tax on income which in accordance with the provisions of the DTT may be taxed in N. This means, among other things, that R is not obligated to allow a credit for N tax where N according to the relevant distributive rule is precluded from taxing the item of income in question (see sub-chapter 4.4.5). Instead, N is in such case required to eliminate double taxation by acting in conformity with the DTT, i.e. by not imposing tax.

Under the above quoted DTT provision, there is, in addition to the requirement that the income in accordance with the provisions of the DTT may be taxed in N, a requirement that the income under the laws of N may be taxed in N in order for the obligation to provide double tax relief to apply. Normally, this additional requirement would not have any practical consequences. In the rather unlikely situation that N would be entitled under the DTT to tax an item of income and would do so even in the absence of internal law provisions which allows it to tax the item of income, the taxpayer would be excluded from treaty relief and would have to seek remedy under N’s internal law. However, absence of internal rules on tax liability in N would normally lead to no tax being imposed by N and, hence, no need for a credit.

557 This wording is applied in the DTTs with Albania, Argentina, Barbados, Belarus, Bolivia, Botswana, Bulgaria, Canada, Chile, China, Egypt, Estonia, the Gambia, India, Kazakhstan, Latvia, Lithuania, Luxembourg, Macedonia, Malaysia, Malta, Mauritius, Mexico, Namibia, the Netherlands, the Philippines, Poland, Portugal, Russia, South Africa, Thailand, Turkey, Ukraine, Venezuela, Vietnam, and Zimbabwe (some minor differences may occur). Similar wordings are applied in several other DTTs, such as the one with the United Kingdom.
5.4.6 Tax Sparing Credit/Matching Credit

1. Introduction

Many states use tax incentives to attract foreign investment. Where R applies the principle of exemption, tax incentives reduce the aggregate tax. However, in cases where R applies the principle of credit any attempts by N to use tax incentives risk being thwarted. If the tax in R which is attributable to the income from N is higher than the tax paid in N, the entire tax paid in N is in principle creditable. This means that a reduction of the N tax structurally produces a corresponding increase in the post-credit tax in R. In other words, any tax incentives granted by N are “absorbed” by R.

In some cases, typically where N is a developing country, R may accept tax incentives for investments into N as an appropriate means of attracting investment. To counter the absorption of the tax incentives by R, the contracting states may in such cases agree that R shall allow as a credit an amount corresponding to the tax that N would have imposed under its general tax legislation (where applicable, subject to tax rate limitations that would have applied under the DTT, for instance in respect of dividends or interest). Thus, any tax incentives granted by N would be disregarded for the purpose of the credit allowed by R for tax paid in N. Alternatively, the contracting states may agree that R shall allow a credit of an amount computed on the basis of a fixed rate, regardless of whether N actually imposes tax at a lower rate. Such forms of credit are usually referred to as “tax sparing credit” or “matching credit”. Tax sparing credit or matching credit often applies in respect of business profits and relatively frequently also in respect of dividends, interest, and royalty.

The terms “tax sparing credit” and “matching credit” are often used interchangeably. However, a distinction between the two is sometimes made. Where N grants a tax incentive to certain groups of taxpayers or to taxpayers that meet certain criteria and R allows a credit as if no tax incentive had been granted, i.e. on the basis of the ordinary tax rate in N, subject to DTT tax rate limitations, this is referred to as “tax sparing credit”. If R allows a credit at a fixed, higher rate than what is actually applied by N, irrespective of whether N

559 The OECD Model, Commentary to Art. 23, para. 74.
grants any tax incentives, this is referred to as “matching credit”. The same distinction is made below.

2. Reasons for Applying Tax Sparing Credit and Matching Credit

Although the absorption by R of any tax incentives granted by N is line with the objective generally associated with the application of the principle of credit of treating foreign investment neutrally with investments made within R, many states recognise that there may be a legitimate need for developing states to promote inflow of capital by offering tax incentives, which justifies the inclusion of tax sparing or matching credit provisions in DTTs with developing states. In a given case, the inclusion of such provisions may be part of the normal DTT negotiation, i.e. a price that is paid in exchange for something else, but it is often seen as a form of development assistance which is given to promote industrial, commercial, and scientific development in developing countries. For the contracting state which grants tax incentives, the purpose of such provisions is to allow non-residents to obtain a foreign tax credit for the taxes that have been “spared” under the tax incentive programme.

Where tax sparing credit or matching credit results in a credit in excess of the tax actually paid in N, the foreign investment is treated more favourably than investments made within R. Thus, the use of tax sparing credit or matching credit in a DTT means that the objective of treating investments abroad neutrally with investments within R normally associated with the principle of credit is lost.

Since tax incentives granted by N are disregarded by R where tax sparing credit or matching credit is applied, tax sparing credit has the same effect as if N would subsidise the taxpayer and R would disregard the subsidy for tax purposes. Matching credit on the other hand applies regardless of whether N has granted a tax incentive. It can therefore be regarded as a form of modified exemption, in part or in full depending on whether the creditable tax

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563 The OECD Model, Commentary to Art. 23, para. 73.

564 Vogel and others, *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Art. 23, para. 194.
computed on the basis of the fictitious rate falls below the R tax or not.\textsuperscript{565} However, it should be noted that tax sparing credit and matching credit are generally subject to a foreign tax credit limitation, meaning that the credit normally cannot exceed the tax paid in R which is attributable to the foreign income and therefore does not result in a credit from R tax on domestic income or a “negative” tax in R.

Since a credit is given in R in excess of the N tax actually paid, the aggregate tax will fall below CEN (with the exception of the rather unlikely case that the reduced N tax equals or exceeds the R tax). Where N grants tax incentives to foreign investors which are not granted to domestic investors and the R pre-credit tax does not exceed the tax sparing credit or the matching credit (based on the ordinary tax rate in N or a fictitious tax rate) to such an extent that the tax incentive in N is eliminated, the aggregate tax will fall below the regular N tax. Thus, if neutral taxation in N is considered to be present where the item of income in question is subjected to the regular tax in N, the aggregate taxation may, depending on the amount of post-credit tax in R, fall below CIN as well as CEN.

3. Risk of Tax Base Erosion and Taxpayer Abuse
As the purpose of offering tax incentives is to attract investment, many countries are worried that the availability of such incentives in other states will erode their tax bases, in particular when it comes to geographically mobile business such as financial services. Consequently, there is some reluctance among developed countries towards facilitating tax incentives by including tax sparing credit or matching credit in their DTTs. This scepticism was reflected in a 1998 report by the CFA entitled Tax Sparing: A Reconsideration\textsuperscript{566} and in the changes to the Commentaries of the OECD Model that were implemented in 2000 as a result of the report.\textsuperscript{567}

The Commentaries to the articles of the UN Model of 1999 regards the then OECD Model Commentary to Article 23 as fully relevant.\textsuperscript{568} However, the positive attitude expressed in the Commentaries of the UN Model towards tax sparing credit contrasts with the sceptical attitude towards tax sparing credit displayed in the Commentaries of the OECD Model post the changes


\textsuperscript{566} \textit{Tax Sparing: A Reconsideration}, OECD, 1998.


\textsuperscript{568} The UN Model, Commentary to Art. 23, paras. 14 and 18.
in 2000 that were implemented as a result of the 1998 report. According to the UN Model “[o]ne of the principal defects of the foreign tax credit method, in the eyes of the developing countries, is that the benefit of low taxes in developing countries or of special tax concessions granted by them may in large part inure to the benefit of the treasury of the capital-exporting country rather than to the foreign investor for whom the benefits were designed” and that, thus, “revenue is shifted from the developing country to the capital-exporting country”. The principle of exemption, which allows foreign investors to benefit from low tax in the developing country is, in contrast, considered “eminently suitable”. Further, it was pointed out that “[t]his undesirable result is to some extent avoided in bilateral treaties through a “tax-sparing” credit, by which a developed country grants a credit not only for the tax paid but for the tax spared by incentive legislation in the developing country”. Despite the fact that many members from both developed and developing countries agreed with the view that tax-sparing credits should be included in treaties between developed and developing countries where the developed country used the principle of credit, some states raised objections and no specific treaty text on tax sparing credit was agreed on in the UN Model.

As a consequence of the fact that many states are concerned that tax incentives offered by other states will erode their tax bases with regard to geographically mobile business, some states that provide tax sparing credit or matching credit with regard to business profits limit the benefit to certain kinds of business activities, typically to business activities which are less mobile. For instance, financial services may be excluded from the benefit or the credit provisions may cover only certain listed activities that require a substantial presence or investment in the other state. For instance, the tax sparing and matching credit clauses of Swedish DTTs frequently apply only to business activities such as manufacturing, agriculture, fishing, and tourism.

In addition to the risk of erosion of tax bases, the Commentaries point out that tax sparing is vulnerable to taxpayer abuse. For instance, where interest income arising in N is covered by a tax sparing credit or matching

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569 The OECD Model, Commentary to Art. 23, paras. 72–78.1 and the UN Model, Commentary to Art. 23, paras. 3–12.
570 The UN Model, Commentary to Art. 23, para. 3.
571 The UN Model, Commentary to Art. 23, paras. 4–12.
573 Cf. Art. 24.8 b) of the DTT with Ireland.
574 The OECD Model, Commentary to Art. 23, paras. 76 and 78. See also Tax Sparing: A Reconsideration, OECD, 1998, pp. 28–30.
credit provision, a taxpayer in R could borrow funds and lend them to a related party in N in order to avoid tax. The interest costs on the loan taken by the taxpayer in R would be deductible and would thus decrease the tax liability of the taxpayer. The interest income on the loan to the related party would be taxable in R, but would not lead to a corresponding increase in tax liability insofar as the taxpayer would be allowed a credit in excess of the tax actually paid in N.

The Commentaries also tries to tone down the effects of not including tax sparing provisions in DTTs by pointing out that the absence of tax sparing credit does not necessarily mean that any tax incentives in N are eliminated, as a reduction of tax in N by means of a tax incentive may enable the taxpayer to credit other taxes which would otherwise have been uncreditable due to the foreign tax credit limitation under the law of R. Furthermore, the Commentaries point out that an investor may often benefit from a reduction of the tax in N by investment through a subsidiary, at least until the profits are repatriated, regardless of whether R applies tax sparing credit or matching credit.575

4. Other Objections

Tax sparing credit or matching credit puts investment that is covered by a tax sparing credit or matching credit clause at a competitive advantage in comparison with domestic investment and, to the extent that tax sparing credit or matching credit results in taxation that falls below CiN, it also puts investment covered by such a clause at an advantage in comparison with other investment in the country in question which is not covered. Thus, tax sparing credit and matching credit can be criticised for being contrary to the goal of efficient use of capital.576

5. Interpretational Difficulties

In order to apply tax sparing credit it is necessary to distinguish between the regular taxation and taxation under tax incentives as a credit in excess of the tax that has actually been paid shall only be allowed insofar as a tax incentive has been given.577 This should be straightforward where a lower than normal rate is applied under the tax incentive. However, the situation is often more complex. For instance, the tax law may be favourable to certain taxpayers,

575 The OECD Model, Commentary to Art. 23, para. 77.
577 Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 196.
not by application of a lower than normal tax rate, but by application of favourable rules for depreciation etc. In such situations it may be unclear whether this shall be regarded as a form of tax incentive or as a component of the regular tax system of N. To some extent that difficulty can be mitigated by including references to specific legislation in the tax sparing credit or matching credit provision.\(^{578}\)

Furthermore, where it is not just a matter of applying two different rates to the same tax base, it may also be difficult to determine the hypothetical ordinary tax for the purpose of computing the creditable tax under tax sparing credit. In practice, the taxpayer may have to provide substantial documentation regarding the tax that would have been payable without the tax concession.\(^{579}\)

In these respects matching credit is easier to apply, since a credit based on the fictitious rate is given regardless of whether a tax incentive has been granted and regardless of a “hypothetical” tax in N. In particular, it is easier to apply where the matching credit provision provides that the fictitious rate shall be applied to the tax base according to R’s tax law, i.e. where the creditable tax can be determined independently of the taxable income according to N’s internal law.

6. Time Limits
The economic development of a state may remove the reasons for having tax sparing or matching credit provisions in a DTT. Further, a contracting state may alter its tax law after the conclusion of a DTT that includes tax sparing credit or matching credit provisions so as to increase the number of situations in which these provisions become applicable to an extent which is unacceptable to the other state. Thus, it is important for the state that provides double tax relief by means of tax sparing credit or matching credit that the obligation to do so is not permanent.\(^{580}\) Since the removal or modification of existing tax sparing credit or matching credit clauses may take a long time, the validity of such clauses is therefore typically time limited. For instance, provisions on tax sparing credit or matching credit in Swedish DTTs usually apply for a period of ten years from the entry into force of the DTT.\(^{581}\)


\(^{581}\) Such a time-limit is sometimes referred to as a “sunset clause”.

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7. Tax Sparing Credit and Matching Credit in Swedish DTTs

Many DTTs concluded by Sweden include some form of tax sparing credit or matching credit clause. As pointed out above, such clauses typically apply for a period of ten years, unless an agreement on extension is reached. In 1989, the Swedish Parliament clarified that the extension of the validity period of a matching credit or tax sparing credit provision in accordance with the Swedish Instrument of Government is to be made in the form of an Act of Parliament.582 Historically, Sweden frequently agreed on extensions, but in recent years Sweden seems to have become much more reluctant to do so. Although a significant number of Sweden’s DTTs contain tax sparing credit or matching credit clauses, only the clauses of the DTTs with Greece,583 Indonesia,584 Israel,585 Italy, Jamaica, Malaysia, Nigeria, Spain, Thailand, Tunisia, and Zambia are still applicable and with regard to some of these DTTs, although formally applicable, the clauses have played out their role. The tax sparing credit clause of the DTT with Malaysia runs out in 2015 and the tax sparing credit and matching credit clauses of the DTT with Nigeria apply for a period of ten years from the entry into force.586 The tax sparing credit clauses of the other DTTs are not time limited.587

In some cases the reluctance to extend the validity period may be due to the introduction by the other contracting state of new forms of tax incentives which are considered by Sweden as harmful.588 In other cases, the economic development of the state in question may, from Sweden’s point of view, have removed the legitimate need of the other state to promote inflow of capital by offering tax incentives. The main reason for the reluctance is probably that Sweden has been influenced by the scepticism towards tax sparing credit and matching credit as an appropriate means of promoting investment and economic development in developing countries which was expressed in the

583 Applicable to dividends, interest, and royalty.
584 According to prop. 1988/89:145, p. 39, the tax sparing credit clause of the DTT with Indonesia is of very little practical significance as the Indonesian legislation to which the clause refers was abolished on 1 January 1984 and therefore applies only to contracts entered into before that date and since the tax incentives under Indonesian law reduce the tax on dividends paid by an Indonesian company, which would normally be exempt from tax in Sweden under Swedish internal law regardless of the tax sparing credit clause.
585 Applicable to dividends and interest.
586 The DTT with Nigeria has not yet entered into force.
587 Cf. the Appendix to this study and Paulin & Bexelius, ‘Fasta driftställen och undantagande av internationell dubbelbeskattning’, ScSkT, 2009, No. 6-7, p. 685.
1998 OECD report on tax sparing and later also in the Commentaries of the OECD Model. However, in spite of this reluctance to extend the tax sparing credit and matching credit clauses of DTTs that are already in place, Sweden has concluded a couple of new DTTs containing tax sparing credit and matching credit clauses subsequent to the 1998 report.\textsuperscript{589}

Where the other contracting state is a developing country, an addition in line with the following has usually been made in Swedish DTTs, combining tax sparing credit and matching exemption:\textsuperscript{590}

\begin{itemize}
\item[(d)] For the purposes of sub-paragraph (a) of this paragraph the term “[N] tax paid” shall be deemed to include the [N] tax which would have been paid but for any exemption or reduction of tax granted under incentive provisions contained in the [N] law designed to promote economic development to the extent that such exemption or reduction is granted for profits from industrial or manufacturing activities or from agriculture, fishing or tourism (including restaurants and hotels) provided that the activities have been carried out within [N]. For the purpose of sub-paragraph (c) [i.e. for the purpose of determining whether dividends paid by a company which is a resident of [N] to a company which is a resident of Sweden shall be exempt from Swedish tax according to Swedish internal law] a tax of 15 per cent calculated on a Swedish tax base shall be considered to have been paid for such activities under those conditions mentioned in the previous sentence.

The competent authorities may agree to extend the application of this provision also to other activities.

\item[(e)] The provisions of paragraph (d) shall apply only for the first ten years during which the DTT is effective. This period may be extended by a mutual agreement between the competent authorities.
\end{itemize}

The purpose of including tax sparing credit provisions and similar provisions in DTTs entered into by Sweden is, according to the Swedish Government, to promote Swedish investment aimed at creating work opportunity and expansion of economic activities carried out in the other contracting state.\textsuperscript{591}

As a consequence, such provisions are typically limited to activities which require presence in the other state, as is illustrated by the above DTT provision on tax sparing credit and matching exemption. As regards the imple-

\textsuperscript{589} For instance the DTTs with Malaysia and Nigeria.

\textsuperscript{590} The text is taken from the DTT with India. Several other DTTs contain provisions that are more or less similar, for example the DTTs with Albania, Argentina, Macedonia, Malaysia, Malta, and Vietnam.

\textsuperscript{591} Prop. 1991/92:45, p. 47.
mentation of a tax sparing credit or matching credit, it follows from the Swedish Foreign Tax Credit Act that an amount which is creditable under a tax sparing credit or matching credit clause in a DTT shall be considered as foreign tax for the purpose of computing the foreign tax credit.\textsuperscript{592}

Insofar as tax incentives are granted in another contracting state for investments made through a company in that state, a Swedish investor can normally benefit from such incentives regardless of whether Sweden applies tax sparing credit or matching credit in its DTT with that state, as taxation of the profits in Sweden is generally deferred until the profits of the company are repatriated and is permanently avoided if the profits can be repatriated without taxation in Sweden or the other state.\textsuperscript{593}

5.4.7 Reverse Credit

The DTT obligation under the double tax relief article to eliminate remaining double taxation by allowing a credit for foreign tax practically always lies with R. However, reverse credit (Sw. omvänd avräkning) is conceptually different as it obliges N to eliminate double taxation by crediting tax paid in R from the N tax.

In Swedish DTT practice, reverse credit has been applied where Sweden has reserved its right to tax former residents who have moved abroad in spite of the fact that there is no such connection between Sweden and an activity or property that has generated income as would normally be required for allocating the taxing right to N. In such cases R does not normally agree to provide double tax relief, which means that double taxation can only be eliminated by Sweden in its capacity as N. As the purpose of reserving Sweden's taxing right in such situations is typically to reduce tax incentives for moving abroad, the principle of credit can be regarded as an appropriate means of eliminating double taxation, as it ensures that the aggregate tax on the income is equal to or higher than the Swedish tax on such income.

For instance, according to the DTT with Switzerland, Sweden's right in its capacity as N to tax Swedish citizens who have moved to Switzerland is reserved in certain situations in order to reduce tax incentives for moving to Switzerland, but the taxing right so reserved is limited by an obligation to credit tax paid in Switzerland on the income in question.\textsuperscript{594}

\textsuperscript{592} Ch. 1 sec. 3 para. 2 and ch. 2 sec. 8 item 2 AvrL.
\textsuperscript{594} Cf. Art. 25.2-4 of the DTT with Switzerland.
Although this means that Sweden may have to refrain from levying tax, a reserved taxing right in combination with a reverse credit provision has the effect of making sure that the item of income in question is not subject to double non-taxation as it is taxed in Sweden to the extent that the tax burden in the other state falls below the tax that would have applied if the taxpayer had remained a resident of Sweden. In this sense a reserved taxing right in combination with reverse credit works in a way which is similar to a subject-to-tax provision.595

Under Sweden's DTT with Switzerland, reverse credit applies to individuals who (i) are resident in Sweden for tax purposes under Swedish internal law, (ii) have moved from Sweden in the last three years, and (iii) are not Swiss citizens, but it is not limited to certain categories of income. Furthermore, it applies to pensions paid under the Swedish social security legislation, regardless of the above conditions.

Under the DTT with Tunisia, Sweden reserves its right to tax individuals who are resident in Tunisia for the purpose of the DTT but resident in Sweden according to Swedish internal law, but undertakes to provide double tax relief by crediting tax paid in R. Otherwise, reverse credit is applied by Sweden in a couple of DTTs with regard mainly to two specific types of income, capital gains on shares derived by former residents of Sweden and to certain pensions that under the DTT may be taxed in Sweden.

Under Swedish internal law, capital gains on shares derived by an individual are taxable in Sweden during a ten year period after emigration from Sweden.596 This taxing right is usually reserved to some extent in Sweden's DTTs, for instance by reserving Sweden's right under internal law to tax capital gains on shares in its capacity as N during a five year period following the taxpayers change of residence. In some DTTs, reverse credit is applied to avoid double taxation that cannot be solved under the DTT, i.e. the taxing right so reserved is subject to an obligation by Sweden to provide double tax relief by allowing a credit for tax paid in R.597

596 Ch. 3 sec. 19 IL.
597 See the DTTs with France and the United States (Sweden reserves its taxing right and consequently applies reverse credit in respect of capital gains on any property, but the reserved taxing right is in practice mainly relevant for capital gains on shares) and the DTTs with Italy and Spain (Sweden reserves its taxing right and consequently applies reverse credit in respect of capital gains on shares in real estate companies).
Furthermore, in many of its DTTs, Sweden reserves its right to tax pensions paid under the Swedish social security legislation. Occasionally, Sweden also reserves its right to tax pensions paid on the basis of contributions to a pension insurance institution established in Sweden.\(^{598}\) Since pensions, with the exception of pensions paid in respect of services rendered to a contracting state, are typically taxable only in R,\(^{599}\) it may be difficult to persuade the other contracting state to provide double tax relief when Sweden levies tax in its capacity as N. Where Sweden has reserved its right to tax certain pensions which are paid to a resident of the other contracting state, Sweden is therefore, according to some of its DTTs, obligated to eliminate double taxation by means of reverse credit.\(^{600}\)

Provided that the DTT provides for elimination of double taxation by R by means of the principle of exemption, no tax is payable in R and, as a consequence, no credit is allowed under a reverse credit provision. The same applies if no tax is payable under R’s internal law. However, where tax is payable under the internal law of R and R is obligated under the DTT to eliminate double taxation by means of the principle of credit, R’s obligation to provide double tax relief must be coordinated with N’s obligation to eliminate double taxation.

The DTT does not always, at least not expressly, lay down rules for how the obligations of the contracting states to eliminate double taxation shall be coordinated. For instance, Sweden’s DTT with Spain provides that R shall credit tax which has been paid in accordance with the DTT in respect of certain types of income which may be taxed in N, it also provides that N shall credit tax that has been paid in R in respect of such income. The DTT provision does not say how the obligation of N to provide double tax relief relates to the obligation of R to do the same.

Insofar as it would be the intention of the contracting states to allocate to N the tax revenue relating to a type of income that would normally be tax-

\(^{598}\) The Swedish versions of the DTTs with Italy and Spain use the phrases “belopp som utbetalas på grund av pensionsförsäkring meddelad i en avtalsslutande stat” and “utbetalningar på grund av pensionsförsäkring, som meddelats i en avtalsslutande stat” respectively, which as far as I have been able to determine have in view payments on the basis of contributions to a pension institution established in a contracting state. If that is correct, the taxing right so reserved does not cover pensions paid on the basis of contributions to pension insurance institutions which are not established in Sweden in spite of the fact that such contributions may nowadays be deductible, cf. Ewalds, *Internationell beskattning av pensionsförsäkringar* (2008), pp. 371–374.

\(^{599}\) Cf. Art. 18 of the OECD Model.

\(^{600}\) See the DTTs with Italy, Spain, and Switzerland.
able only in R, there would be reason to include a provision which reserves N’s right to tax such income, but there would be no reason to include a reverse credit clause. Including such a clause only makes sense where the purpose is not to allocate tax revenue to N but to make sure that the income in question is taxed at a sufficient level (in either of the states), thereby reducing the tax incentives for moving from N to the other state and protecting N’s tax base on a more general level. In other words, it would be logical for R to retain its primary taxing right, although a secondary taxing right for N is accepted, which may be used to the extent that R does not levy tax at a level corresponding to the tax that would have applied if the taxpayer had remained a resident of N. Thus, there are strong arguments in favour of an interpretation which obliges N under the reverse credit clause to credit the tax payable under R’s internal law but does not require R to credit any N tax on the income in question.

Reverse credit, just as ordinary credit, is in general subject to a foreign tax credit limitation. For instance, the credit of R tax granted by N may be limited to that part of the pre-credit income tax in N which is attributable to the item of income that may be taxed in R.

5.4.8 Tax Paid in Respect of Exempted Income

Where exemption is applied by R under the DTT as the main principle for elimination of double taxation, it is generally made clear that the principle of credit is an exception which applies only to situations where the principle of exemption does not apply. For instance, Article 23 A.1 of the OECD Model provides that the principle of exemption shall apply, subject to the provisions of paragraph 2, and this paragraph provides for the application of the principle of credit in respect of income which may be taxed in accordance with Articles 10 (dividends) and 11 (interest). However, where the principle of credit is applied by R under the DTT as the main principle for elimination of double taxation, the double tax relief article typically does not state expressly that R shall apply the principle of credit except where the principle of exemption applies under the distributive rules. This raises the question whether the principle of credit can apply to income which has been exempted under the distributive rules.

Insofar as the taxpayer has not derived any other taxable income in R than the income in respect of which the principle of exemption shall be applied, the question is of no practical significance, as there will be no tax in R to credit the N tax from. Where tax has been imposed in R on other income it would, on the other hand, be possible for R to credit the N tax on the income in question.
from the tax on such other income. However, it would be inconsistent to do so, as double tax relief is already provided in accordance with the principle of exemption. Allowing a credit would in effect constitute a subsidy to investments in N. Thus, it would be logical to interpret the double tax relief article as not requiring R to provide a credit for N tax on income in respect of which R is obligated under the distributive rules of the DTT to eliminate double taxation by means of the principle of exemption.

Furthermore, tax on income which has been exempted under a DTT will typically not entitle the taxpayer to unilateral credit. According to the Swedish Foreign Tax Credit Act, a condition for credit from Swedish tax is that the item of income in question has been declared as taxable in accordance with IL (“har tagits upp enligt inkomstskattelagen”). Furthermore, the Act provides that a credit against Swedish tax shall be allowed in the year in which the foreign income has been included in the tax base for the purpose of determining the Swedish tax. Although it might be possible to claim that income which is exempt under a DTT has been declared as taxable according to IL (in spite of the fact that it is exempt under the DTT), it is clear that such income is excluded from the tax base.

Accordingly, in RÅ85 1:49 HFD denied a Swedish company a credit of foreign tax paid in respect of income attributable to a PE in Egypt and in respect of dividends paid by a Danish subsidiary, as both items of income had been exempted from tax in Sweden under the applicable DTTs. In the ruling, reference was made to the internal law credit provisions applicable prior to the entry into force of the Foreign Tax Credit Act of 1986. The provisions stated that credit was only to be given for tax paid in respect of “income which is taxable in Sweden”. This was interpreted as meaning that the foreign income must have been included in the Swedish tax base.

Where Sweden eliminates double taxation by means of modified exemption, the income is not excluded from the Swedish tax assessment, which means that the above provisions do not rule out the use of the principle of credit in respect of such income, in spite of the fact that in effect modified exemption is similar to the principle of exemption since the obligation to provide double tax relief applies regardless of the amount of tax imposed by N on the income in question. Therefore, the Foreign Tax Credit Act contains a provision aimed at modified exemption, which states that neither the Swedish
tax on the income in question nor the foreign income shall be included for the purpose of computing the foreign tax credit limitation. \textsuperscript{604} This means that the foreign tax credit limitation computed on the basis of the income covered by modified exemption is zero. Unless the taxpayer has derived other foreign income, the provision has the same effect as if income covered by modified exemption would have been precluded from credit altogether. However, it seems that the provision does not rule out cross-crediting of N tax on income covered by modified exemption against R tax on other income.

As follows from the above, it can be concluded that tax paid in N on income which is exempted from tax in R under the distributive rules of a DTT does not entitle a taxpayer to a credit under the DTT. Where a taxpayer has derived income in respect of which R shall apply the principle of credit as well as income in respect of which R shall apply the principle of exemption it is therefore necessary to allocate the N tax paid between these two categories of income, so as to ensure that a credit is not given for N tax paid in respect of income which is covered by exemption. Similarly, where the taxpayer has derived income in respect of which R shall apply the principle of credit and has also derived income which under the DTT may not be taxed in N (for instance income from a third state) or has paid N tax in excess of a DTT tax rate limitation applicable to the income in question, it is necessary to distinguish between N tax which is covered by the principle of credit and N tax which is not. The N tax is of course a product of the N tax rate (or set of rates) applied to the income as determined under N’s internal law. Consequently, the amount of N tax which is covered by the principle of credit has to be determined on the basis of N’s internal law.\textsuperscript{605}

An interesting question is whether foreign tax paid in respect of an item of income which is exempted from tax in R under the internal laws of R may be credited where the applicable DTT provides for the application of the principle of credit. Of course, this question is only relevant where the taxpayer has also derived income which is not exempted in R, so that there is R tax to credit the N tax against.

This issue is illustrated by the following example.

\textsuperscript{604} Ch. 2 sec. 14 AvrL. See prop. 1985/1986:131, pp. 21–22 (regarding the commentary on sec. 8 AvrL, in which the provision was originally included).

The company A has a subsidiary in N called B. B owes A money and pays interest of 100 on the loan. In the same fiscal year, B pays dividends of 100 to A. A has not derived any other income. Both the interest and the dividends are subject to withholding tax in N, but the tax rates are limited under the DTT to ten per cent and five per cent respectively. A is subject to tax in R on the interest at a rate of 25%. The dividends are covered by R’s internal rules on participation exemption and are therefore exempt from tax in R. According to the DTT, R shall allow as a credit from the tax on the income of A an amount equal to the income tax paid in N on interest and dividends. This raises the question as to whether the N tax on the dividends is creditable against the R tax on the interest.

DTT credit provisions typically do not make any exceptions for income which is exempted under the internal law of R. As a consequence, it can be argued that the DTT obligation to allow a credit applies regardless of whether an item of income is exempted under R’s internal law. It is another matter that the tax exemption under internal law may result in a lower foreign tax credit limitation than if tax would have been imposed, which may set a ceiling on the foreign tax credit (see sub-chapter 5.4.13).

As regards Sweden, the Foreign Tax Credit Act provides that a credit against Swedish tax shall be allowed in the year in which the foreign income has been included in the tax base for the purpose of determining the Swedish tax.\(^{606}\) Prior to 1 January 2012, the provision instead required that the income had been included in the tax assessment.\(^{607}\) At that time it might have been argued that income which was exempt from tax in Sweden under an internal law provision could be considered included in the tax assessment in the sense that it had been examined by the Swedish Tax Agency in connection with the tax assessment. However, such a wide definition would have diluted the significance of the expression “included in the tax assessment” and would also have embraced for instance income which is exempt under a DTT, which as pointed out above would not make sense. Furthermore, in my opinion it is clearly not possible to consider income which is exempt under internal law as included in the tax base, as is required according to the current legislation. On the contrary, such income is by definition excluded from the tax base. As a consequence, foreign tax on income which is exempt under internal law, such

\(^{606}\) Ch. 2 sec. 7 para. 2 AvrL.

\(^{607}\) Cf. prop. 1985/86:131, pp. 20–21. The expression “included in the tax assessment” was replaced by the expression “included in the tax base” as an adaptation to the terminology of the Swedish Tax Procedure Act which entered into force on 1 January 2012, see prop. 2010/11:166, p. 229.
as the N tax on the dividends referred to in the above example, would not be creditable under the Swedish Foreign Tax Credit Act.

It can be argued that the internal rule in question is, potentially, contrary to the DTT obligation of crediting foreign tax on income which under the DTT may be taxed in N. However, the argument that R may be obligated under a DTT to credit N tax on income which is exempted under the internal law of R can be rebutted. A foreign tax credit limitation in accordance with the per-item limitation would always result in no credit being eligible, since the R tax on the particular item which is exempted from tax under R’s internal law is zero. If it is accepted that DTTs typically do not require that any limitation technique other than per-item limitation is applied (see sub-chapter 5.4.13.2), there would normally be no grounds for claiming that a credit must be allowed.

A question related to this issue is whether foreign tax on items of income which are exempt under internal law in respect of a certain portion may be credited. For instance, Swedish law provides for taxation of five sixths of dividends on unlisted shares. According to the Swedish Tax Agency, the entire foreign tax on such income is creditable, subject to the foreign tax credit limitation, since the purpose of the Swedish legislation is not to exempt income, but to achieve a lower effective rate.608

5.4.9 The Types of Taxes that are Creditable

The credit provisions of the double tax relief article typically do not provide much information as regards what types of taxes are creditable. For instance, Article 23 A.2 of the OECD Model provides that R shall allow as a credit “an amount equal to the tax paid in the other State” and Article 23 B.1 of the OECD Model provides that R shall allow as a credit “an amount equal to the income tax paid in that other State”, without defining the meaning of the terms “tax” and “income tax”. However, these terms (or very similar terms) are normally defined elsewhere in the DTT, namely in the DTT article on the scope of the DTT with regard to taxes covered.609 The taxes covered article typically provides that the DTT shall apply to taxes on income imposed on behalf of a contracting state or of its political subdivisions or local authorities,610 irrespective of the manner in which they are levied. Occasion-

609 Cf. Art. 2 of the OECD Model.
610 In Sweden, tax imposed on behalf of municipalities is covered.
ally, the taxes covered article includes an exhaustive list of the types of taxes covered. However, more often the DTT includes a general definition that covers all taxes that have the predominant character of an income tax, including tax on gains from the alienation of property. A list of existing taxes covered by the DTT may be included just the same, but is in such case merely declaratory. The taxes covered article may also declare that the DTT shall apply to any taxes that are identical or substantially similar to those listed and which are introduced after the date of signature of the DTT. In addition to income taxes, the DTT may also cover other taxes such as taxes on capital.

There is no indication that terms such as “tax” and “income tax” contained in DTT credit provisions should cover any other taxes than the DTT as a whole. Thus, the taxes covered article provides a limit to the type of taxes that are creditable under the DTT. Since no other types of taxes are creditable than those which are covered by the DTT, internal law is normally of no relevance for the purpose of determining what types of taxes are creditable under the DTT. It is another matter that other taxes may be covered by a unilateral credit.

Where the credit provisions do not expressly state that only income tax is creditable, it would be possible to argue that other taxes which are covered by the DTT are creditable from the income tax in R as well (for example taxes on capital). However, a phrase such as “allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State” can be seen as an implicit reference to the tax paid in N on the item of income in question. Consequently, regardless of whether the DTT also covers other types of taxes than taxes on income, they would not normally be creditable under the DTT from the R tax on income, but only from similar taxes imposed by R.

As the meaning of income tax is typically explained in the taxes covered article there is normally no need to fall back on the internal laws of the contracting states to determine what types of taxes are creditable. However, in most cases DTTs do not make clear whether expenses related to the payment of an income tax shall be considered as income taxes and, consequently, whether

611 Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 132. See also Art. 23.2 sub-para. 2 of the US Model, which makes an express reference to the taxes covered article.
612 Cf. Art 23 A.2 of the OECD Model.
613 Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 132.
such expenses are covered by the DTT. Many different kinds of expenses are conceivable, for example interest costs due to late payment, penalties for tax fraud and other tax surcharges, penalties for late filing of a tax return, and so on. States may take different views as to whether such expenses shall be covered by the DTT and be creditable.\textsuperscript{614} Swedish DTTs do not normally specify whether such expenses are creditable. A notable exception is the DTT with Pakistan. Article 23.2 a) of that DTT provides that “no deduction shall be allowed from the Swedish tax on such income in respect of any additional tax payable in Pakistan for not depositing tax within time or in respect of any penalty, fee or charge payable in Pakistan on account of a tax offence”. The Government Bill relating to the Incorporation Act\textsuperscript{615} does not provide any clues as to why this clarification was made in this particular DTT.

Another interesting question is whether tax which is imposed on a notional yield is creditable. For instance, according to Swedish law tax is imposed on pension capital and life insurance capital based on a notional yield.\textsuperscript{616} The yield is computed as the government loan interest rate applied to the relevant net assets at the beginning of the financial year. Thus, the yield is independent of the business profits, capital gains, etc. made by the taxpayer. In a Government Bill dealing with pension savings by individuals, the Swedish Government has expressed the view that the Swedish yield tax should be treated as a tax on actual yield and therefore be covered by the DTTs entered into by Sweden, despite the fact that the yield tax is not expressly referred to in the taxes covered article of these DTTs, since the yield tax replaces tax on actual interest, dividends, and capital gains. However, the Government admitted that it would also be possible to consider it as a tax on capital. Since tax on capital paid in N (if covered by the DTT in question) is typically only creditable against tax on capital paid in R, that would render it difficult for non-residents to credit the Swedish yield tax, unless they have been subject to tax on capital in their state of residence. The outcome of the discussion in the Government Bill was that non-resident individuals were exempted from the liability to pay yield tax.\textsuperscript{617} However, for foreign pension insurance and life insurance companies, the question whether the Swedish yield tax is covered by the applicable DTT may still be relevant.

\textsuperscript{614} The OECD Model, Commentary to Art. 2, para. 4.
\textsuperscript{615} Prop. 1985/86:172.
\textsuperscript{616} Lagen (1990:661) om avkastningsskatt på pensionsmedel (Eng. the Act on Yield Tax on Pension Capital).
5.4.10 Exchange Rate

Naturally, the contracting states impose tax denominated in their own currencies. Consequently, unless the contracting states apply the same currency, R must determine the amount of N tax in its own currency in order to give a credit from the R tax. DTTs do not generally deal expressly with how this conversion is to be made. It can therefore be argued that the contracting states are free to determine the principles for the conversion in their internal laws. Alternative dates for the conversion are conceivable, for instance when the income is earned, when the income is received, when the amount of N tax is determined by the tax authority of N, when the N tax becomes due or when the payment of N tax is actually made.

On the other hand, it can be argued that the wording of a credit provision which provides for a credit in “an amount equal to the income tax paid” in N, together with the purpose of the credit provision to eliminate double taxation by means of neutralising the cost incurred by the N tax to the extent that it does not exceed the R tax, imply that the conversion is to be made on the basis of the exchange rate on the day of payment of the tax.

In that regard, it can be noted that US internal law contains special currency translation rules which apply for the purpose of determining the dollar amount of the credit. However, regardless of whether the US currency translation rules would use a rate that differs from the rate on the day of payment of the tax, there would hardly be any room for arguing that the conversion is contrary to the DTT as the US credit provisions provide that the credit shall be allowed subject to the limitations of the law of the US.

As regards Sweden, no express DTT or internal law provisions determine principles for the conversion of foreign tax for the purpose of computing the SEK amount of credit. However, as far as I have been able to determine, Sweden seems to apply the rate on the day of the payment, at least as a main principle.

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618 Cf. the OECD Model, Commentary to Art. 23, para. 61.
619 Cf. Arts. 23 A.2 and 23 B.1 of the OECD Model.
620 Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para 131, and, as regards Austria, Tumpel, ‘Die fiktive Anrechnung (matching credit, tax sparing credit)’ in Gassner, Lang & Lechner (eds.), Die Methoden zur Vermeidung der Doppelbesteuerung (1995), p. 86.
621 The Technical Explanations of the US Model refer to these rules at p. 74.
622 Cf. Art. 23.2 of the US Model.
5.4.11 When Are the Taxes Creditable

As regards the question whether DTT credit provisions determine principles for when a credit shall be allowed, different positions may be taken. On the one hand, it is possible to take the view that DTT credit provisions typically leave this issue to be determined by the contracting states under their internal laws. On the other hand, it is possible to argue that such DTT provisions require that a credit is allowed in a certain fiscal period.

This question is particularly important where there is a timing mismatch, i.e. where R and N according to their internal laws tax an item of income in different periods. Unless the N tax is considered creditable in the period in which R taxes the item of income in question, the credit may be limited, not by the R tax which is appropriate to the foreign income derived from N, but by the R tax (if any) which is appropriate to foreign income derived in a different period.

Articles 23 A.2 and 23 B.1 of the OECD Model provide that, where a taxpayer derives income which may be taxed in N, R shall allow a credit “from the tax on the income of that resident”. The definite article in front of the term “income” indicates that it refers to specific income, namely the income which according to the distributive rules of the DTT may be taxed in N. Thus, where the DTT credit provisions follow the OECD Model, the first sentences of these provisions can be interpreted as indicating that the credit shall be allowed from the R tax on the same income (as defined by the DTT).\(^{624}\) If so, that would imply that the credit shall be given in the year in which the item of income in question is taxed by R. However, it would also be possible to interpret the term “income” in these provisions as simply referring to the income derived in the year in which the credit is allowed. If so, the first sentences of these provisions would not require that the credit is given in a particular year.\(^{625}\)

According to the Commentaries of the OECD Model, R must provide relief through the principle of credit even though N taxes the item of income in question in an earlier or later year.\(^{626}\) It can be argued that it is implicit in this statement that the credit shall be allowed in the period in which R taxes the item of income in question.


\(^{625}\) Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 141.

\(^{626}\) The OECD Model, Commentary to Art. 23, para. 32.8.
Furthermore, credit provisions generally provide that the credit shall not exceed that part of the R tax which is attributable to the income which may be taxed in N. In other words, the R tax on the same income (as defined by the DTT) and not the tax (if any) on an item of income derived in a different period shall be taken into account for the purpose of determining the foreign tax credit limitation. To determine the foreign tax credit limitation in respect of one item of income on the basis of the R tax on a different item of income would be inconsistent with the purpose of eliminating double taxation. Although it may be possible to take into account the R tax on the same income by allowing a carry forward and a carry back of unused credits (see sub-chapter 5.4.13.6.), the simplest way of meeting this requirement is to allow the credit in the period in which R taxes the income in question.

If the taxpayer has paid tax in N both in respect of income which is covered by the principle of credit and income which is not, it is necessary to first determine the amount of income under N’s internal law which is covered by the principle of credit before calculating the amount of N tax which is creditable. As pointed out in sub-chapter 5.4.13.2, the amount of income under N’s internal law is not necessarily the same as the amount of income under R’s internal law relating to the same item. Furthermore, the income according to N’s internal law is not necessarily taxable in the same period as the corresponding income in R. Determining the income according to N’s internal law which relate to the item of income which is taxable in R in a specific period may be particularly difficult where the contracting states apply partly overlapping fiscal periods. For instance, in one state the fiscal period may coincide with the calendar year whereas in the other state it does not. Thus, even where the contracting states use identical principles for determining when income arises, finding out the N tax which is creditable in a given year may require substantial investigation.627

According to the Swedish Foreign Tax Credit Act, a credit against Swedish tax shall be allowed when the income which is taxable in a foreign state is included in the Swedish tax base for the purpose of determining the Swedish tax.628 Thus, the credit is allowed in the same period as Sweden taxes the income. An exception applies to taxes which are comparable to the Swedish

628 Ch. 2 sec. 7 para. 2 AvrL.
real estate tax and to yield tax and similar taxes. These are creditable from Swedish tax relating to the same year as the foreign taxes are determined.

A practical problem arises where the N tax has not been paid or even determined when the tax assessment in R is made, so that it is not creditable when the tax assessment in R is made. This may for instance be the case where the income is taxed in N in a later fiscal period than in R due to differences in the principles applied for determining when income arises. It may also be the case where the fiscal year in N ends on a later date than the fiscal year in R or where N simply applies a later due date for payment of tax. A similar situation may arise where the income of the taxpayer which is taxable in N is increased by reassessment, for instance following a tax audit.

If the N tax has not been paid when the tax assessment in R is made and is therefore not creditable at that time, a credit can be achieved by means of a review of the assessment in R. Furthermore, if the R tax has already been paid, a refund in an amount that corresponds to the N tax which has become creditable may be required. Unless the internal law of R allows for such a retroactive credit, the taxpayer may in practice be precluded from double tax relief. Thus, it can be argued that in order to fulfil its DTT obligation of eliminating double taxation by means of the principle of credit, R must provide the option of retroactive credit. In some cases, for example when N tax is imposed as a result of reassessment in N (possibly involving lengthy litigation), the N tax may only become creditable several years after the item of income in question is taxed by R. This raises the question whether a retroactive credit has to be offered without a time limit to comply with R’s obligations under the DTT or whether it may be subject to a time limit. On the one hand, it can be argued that unless the DTT credit provision in question provides for an express time limit (which credit provisions normally do not), the obligation to provide double tax relief applies permanently. On the other hand, it can be argued that since procedural requirements such as rules regarding evidence, time limits, etc. are generally left to the contracting states to decide, a contracting state would be free to impose time limits, at least as long as they do not render excessively difficult the exercise of the

629 Ibid.
630 Where the internal law of the state that provides double tax relief provides for a carry forward of unused credits, this may provide an alternative means of crediting the foreign tax without reassessment by enabling a credit of foreign tax in a later period, see sub-ch. 5.4.13.6.
631 Cf. the OECD Model, Commentary to Art. 23, para. 32.8, which says that R must provide relief of double taxation through the credit or exemption method even though N taxes it in an earlier or later year.
taxpayer’s rights under the DTT. In this respect a distinction could be made between situations where N tax is paid in a later period due to differences in the internal laws of the contracting states and situations where the N tax is paid in a later period as a result of reassessment in N. It could be argued that R is obliged under the DTT to provide double tax relief regardless of when taxation occurs in N under N’s regular tax laws, but that there is no obligation for R to adapt to the procedural time limits of N for reassessment.

Under Swedish law, the Swedish income tax is computed in accordance with the Swedish Income Tax Act, which refers to the Swedish Foreign Tax Credit Act. The tax assessment under the Swedish Income Tax Act is made in accordance with the procedural rules of the Swedish Tax Procedure Act (“SFL”). According to chapter 66 section 7 SFL, a request for a review of the assessment must be submitted no later than six years after the end of the calendar year in which the fiscal year of the taxpayer ended. Thus, a taxpayer would not be entitled to an increased foreign tax credit on the basis of an increase in N tax paid which occurs after that period. However, according to chapter 66 section 19 SFL, no time limit applies to a reassessment by the Swedish Tax Agency in favour of the taxpayer on the initiative of the Tax Agency, for instance as a result of a reassessment by a foreign tax authority or a judgment by a foreign court. Consequently, the Swedish Tax Agency may decide to change the tax assessment after the six years period, although there is no express requirement under the law to do so. The fact that the taxpayer may have to rely on the good will of the authorities to achieve a foreign tax credit is in my opinion unsatisfactory.

A correction would normally be required under the internal law of R if a credit has been allowed on the basis of N tax paid and such tax is subsequently refunded by N, for instance as a result of an appeal by the taxpayer against a decision by the tax authorities of N. As regards Sweden, chapter

632 Ch. 65 IL regulates the computation of the Swedish income tax. Ch. 65 sec. 12 IL notes that the Swedish Foreign Tax Credit Act contains rules on credit of foreign tax, which implies that a credit for foreign tax according to that Act shall be taken into account for the purpose of computing the Swedish income tax liability.
633 Prior to the entry into force of SFL on 1 January 2012, the provision was found in ch. 4 sec. 9 para. 1 TL.
634 Prior to the entry into force of SFL on 1 January 2012, ch. 4 sec. 13 para. 1 TL provided a general time limit of five years following the end of the assessment year in respect of decisions in favour of the taxpayer on the initiative of the Swedish Tax Agency. However, in respect of some decisions, for instance a decision taken as a consequence of a decision on foreign tax (by a foreign tax authority or a foreign court), ch. 4 sec. 13 para. 2 TL provided no time limit.
33 sections 9 and 11 SFL provide that a taxpayer is obligated to report a reduction of the foreign tax in respect of which a credit has been allowed within three months of being informed of the decision to reduce the tax, so that the Swedish Tax Agency can make a reassessment. The obligation to inform the Swedish Tax Agency of the reduction of foreign tax applies indefinitely. Chapter 66 sections 21 and 27 SFL provide as a main rule that a reassessment which leads to an increased tax liability must be made no later than six years after the end of the calendar year in which the fiscal year of the taxpayer ended if the taxpayer has provided the Swedish Tax Agency with incorrect or insufficient information or otherwise no later than two years after the end of the calendar year in which the fiscal year of the taxpayer ended. However, there are some exceptions to this procedural time limit. For instance, according to chapter 66 section 30 paragraph 1 SFL, the Swedish Tax Agency may make a reassessment to the detriment of a taxpayer after the six years period where that reassessment is a consequence of such decisions as are referred to in chapter 66 section 27 item 4 provided that the reassessment is made within six months of the decision that resulted in the reassessment. Among other things, chapter 66 section 27 item 4 SFL refers to decisions on foreign tax, i.e. decisions by foreign tax authorities or foreign courts on a refund of tax. This means that the Swedish Tax Agency may make a reassessment as a result of a reduction of N tax even after the six years period, provided that the reassessment is made within six months of the decision to reduce the N tax.

5.4.12 The Meaning of “Tax Paid”
Credit provisions typically require that R shall allow as a credit an amount equal to the tax paid in N on the income in question. Thus, there is no obligation under the DTT to eliminate double taxation by means of the principle of credit unless the foreign tax has been paid. Consequently, the internal law of a state which applies the principle of credit normally requires

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636 Prior to the entry into force of SFL on 1 January 2012, essentially similar provisions could be found in ch. 15 sec. 8 LSK.
637 Prior to 1 January 2012, this was regulated in ch. 4 sec. 15 TL.
638 Prior to 1 January 2012, this was regulated in ch. 4 sec. 17 item 3 TL and ch. 4 sec. 20 para. 1 TL.
639 Prior to 1 January 2012, this was regulated in ch. 4 sec. 13 para. 2 item 3 TL.
640 Cf. Arts. 23 A.2 and 23 B.1 of the OECD Model.
641 The Swedish version of Swedish DTTs uses the phrases “den skatt som erlagts” or “den skatt som betalats” to denote “tax paid”. In my view, no difference in meaning can be discerned between the Swedish and the English expressions.

249
that the taxpayer presents proof that the tax has been paid. As this study does not deal with procedural issues, the question as to what kind of proof is or should be accepted in this respect is not analysed.

The term “paid” in the credit provision implies that a transfer of funds to the tax authorities has taken place. Thus, the withholding by the payer of an amount corresponding to the tax liability of the recipient cannot in itself be regarded as a payment of tax in the sense of the credit provision, meaning that the taxpayer (i.e. the recipient) would not be able to credit the withheld amount unless the amount withheld has been transferred to the tax authorities. It is another matter that the amount withheld by the payer might not be regarded as taxable income in the recipient’s state of residence and that the recipient might therefore only be taxed on the net amount.642

Furthermore, a transfer of funds to the tax authorities can hardly be regarded as a payment of tax unless the payment settles a tax liability. As far as withholding tax is concerned, the tax liability in N normally arises well before the tax assessment in R takes place. When the tax assessment in R is made, a transfer of funds to the tax authorities made in connection with such payment will therefore typically have settled a tax liability and be creditable insofar as it corresponds to the tax payable under N’s internal law, subject to any DTT tax rate limitations. Where tax is imposed in N by assessment, the situation is more complicated. A payment to the tax authorities of N made prior to the tax assessment in N (such as a payment of “preliminary tax”) can hardly be considered to settle a tax liability and therefore probably cannot be regarded as “tax paid” in the sense of the credit provisions. Consequently, such a payment would not be creditable until the final tax has been determined and then not in excess of the amount of final tax. However, it would also be possible to argue that a payment to the tax authorities which corresponds to a future tax liability should be regarded as “tax paid” in the sense of the credit provisions.

As regards Sweden, Swedish internal law states with respect to income tax that a credit shall not be given unless the payment relates to “final” tax.643

642 Vogel and others, *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Art. 23, para. 130.
643 Ch. 1 sec. 3 para. 1 item 1 AvrL (see also ch. 1 sec. 3 para. 3 AvrL, which implies that preliminary tax may be deducted, but not credited). Similarly, German internal law provides for a credit in respect of payments which relate to final tax (Ger. festgesetzte Steuer), see Vogel and others, *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Art. 23, para. 130, and Rindler, ‘Die anrechenbare ausländische Steuer’ in Sutter & Wimpissinger (eds.), *Freistellungs- und Anrechnungsmethode in den Doppelbesteuerungsabkommen* (2002), p. 205.
Thus, Swedish internal law expressly makes clear that a payment of preliminary tax is not creditable until the amount of tax has been determined in a decision by the foreign tax authority.\textsuperscript{644}

5.4.13 The Foreign Tax Credit Limitation

5.4.13.1 Introduction

The credit for foreign tax is practically always limited by the amount of R tax which is appropriate to the foreign income. The general idea is that foreign tax shall not reduce the tax payable on the taxpayer's domestic income as that would effectively result in a subsidy to investments in states that impose higher tax than the investor's state of residence. Accordingly, the obligation for R to eliminate double taxation provided for in DTT credit provisions by allowing as a credit an amount equal to the tax paid in N is almost always limited to that part of the pre-credit income tax in R which is attributable to the income (or item of income) that under the DTT may be taxed in N.\textsuperscript{645}

In order to determine the amount of R tax which is attributable to the foreign income, a calculation would normally be made according to the following. The ratio of the foreign income over the worldwide income is multiplied by the pre-credit tax due in R on the worldwide income. As the pre-credit tax in R divided by the worldwide income equals the tax rate in R applied to the worldwide income, the amount of R tax attributable to the foreign income can also be expressed as the tax rate in R applicable to the worldwide income multiplied by the foreign income.

Thus, any of the following two formulas can be used for computing the foreign tax credit limitation.

\begin{align*}
(i) & \quad \frac{\text{foreign income} \times \text{pre-credit tax due in R}}{\text{worldwide income}} = \text{foreign tax credit limitation} \\
(ii) & \quad \frac{\text{tax rate in R}}{\text{applicable to the worldwide income}} \times \text{foreign income} = \text{foreign tax credit limitation}
\end{align*}

\textsuperscript{644} Cf. prop. 2008/09:63, p. 37.
\textsuperscript{645} Cf. Arts. 23 A.2 and 23 B.1 of the OECD Model.
These formulas determine the foreign tax credit limitation by applying the R tax rate on the worldwide income (in the first formula expressed as the pre-credit tax in R over the worldwide income) to the foreign income, which presupposes that it is the average tax rate in R that shall be applied to the foreign income for the purpose of attributing R tax to that income. That is surely the most common solution. However, other options are conceivable. For instance, it would be possible to treat the foreign income as the top slice of income, so that the limit would be determined using the taxpayer’s highest available rate, as is the case in the UK, or the bottom slice of income.

If the foreign tax credit limitation is computed on the basis of the average tax rate in R and income in R is taxed at progressive rates, the additional tax imposed by R as a result of an increase in foreign income will not be reflected by a corresponding increase in the foreign tax credit limitation. Mössner finds this “problematic”. However, in my opinion, there is no convincing argument for regarding the foreign income as either the top or bottom slice of income for the purpose of computing the tax in R which is attributable to the foreign income. The calculation of tax under a progressive system is not based on the assumption that a particular item of income (foreign or domestic) can be attributed to a particular bracket. The use of different tax rates within different brackets is merely a method for calculating the tax to be levied on the aggregate income.

The foreign tax credit limitation can be computed collectively for all foreign income or it can be computed separately for specific groups of income, such as for income derived from any one country, for each class of income, or for each item of income. A wider basis for determining the foreign tax credit limitation increases the chances of crediting N tax on one item of income in excess of the R tax which is attributable to that item of income by

648 Philipp, Befreiungssystem mit Progressionsvorbehalt und Anrechnungsverfahren (1971), pp. 53–56, who regrets that all states seem to have rejected considering the foreign income as the bottom slice of income without presenting any arguments to support their choice, and Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 151.
allowing a credit against R tax on other items of income which are subject to a lower foreign tax. This is referred to below as “cross-crediting”.

In accordance with the above formulas, R tax is generally attributed to foreign income on the basis of the average R tax rate. However, where the foreign tax credit limitation is computed separately for specific groups of income, it is possible to attribute R tax to these groups of income on the basis of a more precise approach. For instance, under a per-item limitation, R tax can be attributed to a specific item of income on the basis of the R tax which under the internal law of R applies to that particular item of income (which, insofar as the income is taxed at progressive rates, may require that an average rate is determined). Similarly, the R tax on foreign income of a specific class can be attributed to that income on the basis of the average R tax rate applicable to all income belonging to the same class.

5.4.13.2 Different Forms of Limitation

1. Introduction

The fact that the foreign tax credit limitation can be computed separately for different groups of income and that R tax can be attributed to foreign income in different ways means that, in practice, the computation of the foreign tax credit limitation may take many different forms.

Where the foreign tax credit limitation is computed separately for each item of income, meaning that it is not possible to credit N tax in excess of the R tax attributable to that item of income against R tax on other items of income that have been subject to a lower foreign tax, this is usually referred to as a “per-item limitation”. Where the foreign tax credit limitation is computed separately for all income derived from any one state, this is usually referred to as a “per-country limitation”. Furthermore, foreign income can be grouped on the basis of the category it belongs to, resulting for instance in separate calculations being made for active business income and passive investment income. Another option is to make an aggregate calculation for all income derived from abroad, usually referred to as an “overall limitation”. Many other variations on the foreign tax credit limitation are conceivable, such as the grouping of certain classes of income into “baskets”, which form the basis for separate calculations. It is also possible to combine different techniques so that one technique is used in respect of certain forms of income whereas another is used in respect of other forms of income.
2. Cross-crediting

Generally, the chances of cross-crediting will be increased when the foreign tax credit limitation is computed on a wider basis. The following example illustrates the benefits to the taxpayer of being able to cross-credit tax where N imposes tax on different items of income at different rates.

\( X \) has derived dividends from a company in \( N \) of 100 and has also derived income attributable to a PE in \( N \) of 100. The average tax rate in \( R \) is 30 %, meaning that R tax attributable to the foreign income is 60 \((30 \% \times (100 + 100))\). The N tax on the dividends is subject to a DTT tax rate limitation and is therefore relatively low, 15. The N tax on the income attributable to the PE in \( N \) is imposed by assessment and amounts to 40.

Without cross-crediting (as would be the case if R applies a per-item limitation), the credit relating to the income from the PE would be limited by the average R tax rate applied to that item of income, resulting in a foreign tax credit limitation of 30, and the total amount of credit would therefore be 45 \((30 + 15)\). Provided that cross-crediting is allowed (as would be the case under a per-country limitation or an overall limitation), the entire N tax levied by assessment would be creditable even though it exceeds the R tax on the income attributable to the PE, as the N tax on the income that according to the DTT may be taxed in \( N \), 55 \((15 + 40)\), is lower than the R tax which is attributable to that income, 60.

Similarly, a wider basis for attributing R tax to foreign income increases the chances of crediting foreign tax on an item of income in excess of the R tax which is imposed on that item of income under R's internal law. This is illustrated by the following example.

\( X \) is an individual who has derived income of 100 from employment in \( N \). In addition, \( X \) has derived interest from a bank in \( N \) of 100. R taxes income from employment and investment income, such as interest, at different rates. The R tax on the employment income is 40 and the tax on the interest is 20. N levies tax at a rate of 30 %, both in respect of the employment income and the interest income. R applies a per-item limitation.

If R tax would be attributed to the interest income on the basis of the R tax which under the internal law of R is imposed on that item of income, 20, \( X \) would not be able to credit the entire N tax on that item of income. However, if R attributes R tax to the interest income on the basis of the average tax
rate on the worldwide income, the R tax which is attributable to the interest income would be 30 (100 × (40 + 20) / 200), assuming that X has not derived any other income which is taxed at a lower or higher rate, and would equal the N tax on that item of income. Consequently, the N tax on the interest income would be creditable in its entirety.

On the other hand, the attribution of R tax to an item of income on the basis of the average tax rate on the worldwide income can also lead to a lower foreign tax credit limitation. For instance, if R in the above example would attribute R tax to the employment income on the basis of the average tax rate on the worldwide income, the foreign tax credit limitation on the employment income would be 30 (100 × (40 + 20) / 200), whereas it would be 40 if R tax is attributed to the employment income on the basis of the tax rate which is applied to that particular item of income.

A per-item limitation requires that “item of income” is defined. For instance, each separate payment to the taxpayer could be regarded as a separate item of income. However, that would render problems in particular where R taxes income on an accrual basis and not on a cash basis. It would also be possible to define an “item of income” as all income which belongs to a certain category. The classification of the income for this purpose could follow that of the distributive rules of the DTT or, alternatively, that of the internal law of the state which provides double tax relief. However, the limitation would then be computed on a per-category basis instead of a per-item basis and it might therefore be more appropriate to speak of a “per-category limitation”.

3. Determining the R tax base and the foreign income
The credit is allowed from the R tax, which is computed by applying the R tax rate to the tax base determined in accordance with the internal law of R. As the purpose of the foreign tax credit limitation is to prevent foreign taxes from being credited against tax on domestic income, the foreign income must also be determined according to R’s internal law for the purpose of attributing R tax to it. If the foreign income would be determined according to N’s internal law, which of course is theoretically possible, differences in the principles for determining income could result in a credit in excess of the R tax which under the internal law of R is attributable to the foreign income and, consequently, a reduction of the R tax on domestic income.

Since each state has its own rules and practice for determining the tax base of a taxpayer, the tax base that is used in N for determining the N tax, and the tax base that is used in R for computing the foreign tax credit limitation, may differ. As a consequence, R may deny the taxpayer a credit of the entire tax paid in N even though the tax rate applicable in N is lower than the tax rate in R. On the other hand, R may grant the taxpayer a credit which is higher than R’s tax rate applied to the tax base determined according to the internal law of N. This is illustrated by the following example.

A is an individual who is resident in R. A has been temporarily employed by an employer in N and has worked there for two months before returning to R. According to the tax laws of R, his entire taxable income in the fiscal year amounts to 100, out of which 20 are attributable to A’s work in N, including both remuneration in cash and benefits in kind. The tax rate in R is 50%, resulting in a tax in R of 50. Thus, the foreign tax credit limitation is 10 (20 / 100 × 50). The tax rate in N is 60%. However, since the benefits in kind are exempt from tax in N, the tax base applied in N is only 15 and the tax paid in N is thus 9.

As the foreign tax credit limitation exceeds the N tax on the income from the employment in N, R grants a credit of the entire tax paid in N, even though the tax rate applied in N is higher than the tax rate in R.

If, on the other hand, the tax base in N would have been, say, 40, due to the fact that N determines the tax base according to other principles than are applied in R, the foreign tax credit limitation applied by R would still be 10, since the foreign tax credit limitation is determined on the basis of the foreign income determined in accordance with the laws and practice of R, without consideration of how the tax base is determined in N. Thus, the foreign tax credit limitation would correspond to only 25% of the tax base determined according to N’s internal law, regardless of the fact that the tax rate in R is 50%.

2006, No. 3, p. 757, which states that the use of the US tax base for measuring the credit limitation is necessary to ensure that the credit for foreign tax is applied to reduce US tax on an apples-to-apples basis and that the use of a foreign tax base would be incoherent. See also Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern vom Einkommen Und Vermögen (2008), Art. 23, paras. 127 and 146. However, for practical reasons, the income determined under the internal law of N may be accepted as evidence of the amount of foreign income, cf. Berglund & Bexelius, ‘Sweden’ in Blanluet & Durand (general reporters), Key Practical Issues to Eliminate Double Taxation of Business Income (2011), p. 641.
The process of determining the R tax base and the foreign income comprises the quantification of income as well as the attribution of income and allocation of costs to R or N. A higher amount of foreign income results in a higher foreign tax credit limitation. Conversely, a lower amount of foreign income results in a lower foreign tax credit limitation. Although the R tax base and the foreign income are determined according to the internal law of R and not the internal law of N, this does not mean that they are determined without regard to DTT provisions. The attribution of income and allocation of costs are to a significant extent matters of DTT interpretation (see sub-chapter 4.3.4). DTT provisions may also provide limits to the quantification of income in certain cases (see sub-chapter 4.3.5). Insofar as DTT provisions increase the amount of foreign income as determined under R’s internal law and, consequently, the income in respect of which R must provide double tax relief, it would be consistent to also adjust the computation of the foreign tax credit limitation accordingly.

4. The choice of form of limitation
The logic of a tax credit system does not itself dictat what the proper form of limitation should be. Whether R is to allow more credit by using an overall limitation or less credit by for instance using a per-country limitation or per-item limitation depends upon other considerations.652 Restricting cross-crediting, for instance by using a per-country limitation or a per-item limitation as opposed to an overall limitation, seeks to treat investment in a high-tax country no better than it would be under an exemption system, while preserving the benefit of worldwide taxation with a foreign tax credit for investment in lower-taxed countries.653 In other words, restricting cross-crediting ensures that the aggregate taxation of the income corresponds to the higher of the R or N tax, meaning that double tax relief is provided with a minimum loss of tax revenue. The rationale for permitting cross-crediting is not as clear-cut, but at least there are administrative advantages. Under a per-item limitation, the appropriate R tax would have to be determined in relation to each item of income in order to determine whether the N tax on that item of income can be credited, whereas the need to attribute R tax to each item of income is removed if R tax is instead attributed to foreign income for several items of income collectively.654 Furthermore, the foreign tax on each item of income

654 Viherkenntä, *Tax Incentives in Developing Countries and International Taxation* (1991),
would have to be determined. Under an overall limitation only one calculation would need to be made. In addition to the administrative advantages of grouping different items of income together for the purpose of determining the foreign tax and attributing R tax to them, increased chances of cross-crediting in many situations means a reduction of the tax burden and can therefore be regarded as a component of a policy for promoting cross border activities.

As the overall limitation allows unrestricted cross-crediting of foreign taxes on foreign income, there is a greater chance that the entire foreign tax can be credited. Insofar as the foreign credit system is applied as a means of achieving tax neutrality between those taxpayers who engage in foreign activities and those who do not, it may therefore be appropriate to choose overall limitation. The overall limitation can be seen as a compromise between stricter tax credit limitations, which are intended to relieve double taxation at minimum cost, i.e. without giving up more tax revenue than is strictly necessary to achieve the objective of double tax relief, and full credit (comprising a refund for N tax in excess of the R tax), which would be capable of achieving CEN regardless of whether the N tax exceeds the R tax.655

The choice of form of limitation is of practical consequence only for countries with a relatively high tax rate in comparison to that of many other countries. Regardless of the form of limitation, it is not possible for a taxpayer to cross-credit excess foreign taxes against R tax on other income unless the taxpayer has also derived income which has been subject to a lower tax than the R tax.656

Historically, Sweden applied a per-item limitation.657 Swedish tax was attributed to the item of foreign income on the basis of the average tax rate on the worldwide income.658 However, since 1982 Sweden has applied an overall limitation. In connection with the proposal to introduce overall limitation, the Government referred to the competitiveness of the Swedish export industry.659 Thus, the reason for the change of policy seems to have been a desire to strengthen Swedish business rather than to achieve administrative simplicity.

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656 Ibid, p. 298. In some cases, the taxpayer may be able to generate low taxed income in order to increase the foreign tax credit limitation, cf. Viherkenttä, *Tax Incentives in Developing Countries and International Taxation* (1991), p. 113.
658 Ibid. p. 61.
5. The form of limitation provided for under DTTs

The credit provisions of DTTs which conform to the OECD Model provide that the credit shall not exceed that part of the pre-credit income tax “which is attributable, as the case may be, to the income which may be taxed in that other State”.\(^{660}\)

In my opinion, the term “the income” can be seen as either a reference to the specific item of income in question or to all items of income which according to the DTT may be taxed in N. The former interpretation would mean that the DTT provides for a computation of the foreign tax credit limitation on the basis of a per-item approach.\(^{661}\) The later interpretation would provide for a per-country approach.\(^{662}\)

Similarly, where the principle of exemption is used as the main method for elimination of double taxation and the principle of credit is applied only in relation to certain categories of income, DTTs which conform to the OECD Model state that the credit shall not exceed that part of the pre-credit tax “which is attributable to such items of income derived from that other State”.\(^{663}\)

In this case as well, the credit provision can be interpreted as either providing for a separate calculation for each item of income or an aggregate calculation for all such items of income as may be taxed in N and in respect of which the principle of credit applies. Thus, it is submitted that in general both the per-item and the per-country limitations are within the interpretational frames of the DTT text.

As pointed out above, a wider basis for computing the foreign tax credit limitation is generally more favourable to the taxpayer as it increases the chances of crediting foreign tax on an item of income in excess of the R tax.

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\(^{660}\) Cf. Art. 23 B.1 of the OECD Model.


\(^{662}\) The view that DTTs in general provide for the per-country approach has been expressed by Vogel and others, *Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen* (2008), Art. 23, paras. 152–153, and Schuch, ‘Der Anrechnungshöchstbetrag’ in Gassner, Lang & Lechner (eds.), *Die Methoden zur Vermeidung der Doppelbesteuerung* (1995), p. 32. According to Austrian administrative practice on the credit for foreign tax, which is based entirely on the DTT credit provisions as there are no internal law provisions for the implementation of the credit, a per-country approach is applied, see Schuch, ‘Der Anrechnungshöchstbetrag’ in Gassner, Lang & Lechner (eds.), *Die Methoden zur Vermeidung der Doppelbesteuerung* (1995), p. 30.

\(^{663}\) Cf. Art. 23 A.2 of the OECD Model.
on that item of income through cross-crediting. Thus, insofar as internal law provides for a narrower basis for computing the foreign tax credit limitation than the DTT credit provision in question does, it can be argued that R would be obliged under the DTT to apply the wider definition when computing the foreign tax credit limitation in situations where this would lead to a higher credit.

However, where the DTT credit provisions in question expressly refer to the internal law of R it becomes more difficult to claim that the DTT credit provisions require the application of a different form of limitation than that which is provided for under internal law (see sub-chapter 5.4.2). Furthermore, as DTTs in accordance with the above do not normally state which of the per-item or per-country limitations that shall be applied, but leaves the choice up to each contracting state, there are normally no grounds for requiring that a different form of limitation is applied than that which applies under internal law, as long as internal law provides for either of the two forms of limitations.

6. The Swedish Foreign Tax Credit Limitation

According to the Swedish Foreign Tax Credit Act, the overall limitation under Swedish law comprises foreign income in respect of which a unilateral credit applies as well as foreign income covered by DTT credit provisions, i.e. no separate foreign tax credit limitation is computed for tax on income that is covered by DTTs.664

Although Sweden, for individuals as well as for legal entities, applies overall limitation and allows cross-crediting between income from different countries and between different types of income, as far as individuals are concerned it does not attribute Swedish tax to foreign income on the basis of one computation that covers all foreign income. Income derived by individuals is taxed at different rates depending on the class of income to which the income in question belongs. The Swedish Foreign Tax Credit Act differentiates between (i) income from employment and business, which for individuals is taxed at progressive rates, and (ii) income from capital, which for individuals is taxed at a flat rate. The overall limitation is computed as the sum of (i) the average tax rate on income from business and employment multiplied by the foreign income from business and employment, and (ii) the proportional tax rate on income from capital applied to the foreign income from capital.665

664 Ch. 2 secs. 8–9 AvrL.
665 Ch. 2 sec. 10 para. 1 AvrL.
In general, Sweden applies overall limitation and, with the above exception, attributes Swedish tax to foreign income by applying the average Swedish tax rate on the worldwide income to the foreign income. However, there are a few exceptions. For instance, where Sweden in its capacity as N allows a credit for tax paid in R (so-called reverse credit), the foreign tax credit limitation provided for in some of its DTTs seems to be in the form of a per-item limitation.\footnote{See for instance the DTT with Spain, Art. XXIV.5, and the DTT with Switzerland as regards pensions, Art. 25.4. However, as ch. 2 para. 2 second sentence AvrL states that AvrL shall apply where the Swedish tax, the foreign tax and the foreign income is covered by a DTT there seems to be grounds for claiming that AvrL shall apply to the reverse credit and that, consequently, the credit may be computed according to the overall limitation in spite of the per-item approach of the DTT credit provisions.} Furthermore, the foreign tax credit limitation in regard to Swedish yield tax is computed separately, i.e. independently of the attribution of regular Swedish income tax to foreign income.\footnote{Ch. 3 sec. 3 AvrL.}

7. Disadvantages for a taxpayer when foreign income is determined on a wider basis

When looking at a particular item of income, a wider basis for computing the foreign tax credit limitation may very well reduce the credit on that item. If tax is imposed by R on other items of income at a lower rate, the average R tax rate on the foreign income will fall when such other items of income are taken into account, leading to a reduction of the R tax which is considered attributable to that first-mentioned item of income.

This is illustrated by the following example.

The worldwide income of X is 100, which is taxed at a rate of 25 % in R. X has derived interest from state N1 in an amount of 10 and dividends from state N2, also in an amount of 10. The tax rate in N1 applied in respect of the interest is 40 % and the tax rate in N2 applied in respect of the dividends is 20 %, meaning that foreign tax is imposed in an amount of 6 (40 % × 10 + 20 % x 10). The foreign tax credit limitation according to the overall limitation is 5 (20 / 100 x 25), meaning that foreign tax in an amount of 1 remains uncredited.

Looking at the dividends in isolation, a per-item or per-country limitation would be more favourable to the taxpayer than the overall limitation as the tax in N2 falls below the R tax on the dividends derived from N2 and since the N2 tax on the dividends would thus be creditable in its entirety if a per-item or per country limitation is applied.

\footnote{See for instance the DTT with Spain, Art. XXIV.5, and the DTT with Switzerland as regards pensions, Art. 25.4. However, as ch. 2 para. 2 second sentence AvrL states that AvrL shall apply where the Swedish tax, the foreign tax and the foreign income is covered by a DTT there seems to be grounds for claiming that AvrL shall apply to the reverse credit and that, consequently, the credit may be computed according to the overall limitation in spite of the per-item approach of the DTT credit provisions.} Ch. 3 sec. 3 AvrL.
It could be argued that R is obliged under a DTT to apply a narrower definition of foreign income for computing the foreign tax credit limitation when this leads to a higher credit for the taxpayer. However, normally the taxpayer would be compensated for the reduction of R tax attributable to that particular item of income by a corresponding increase of the R tax which is considered attributable to other items of income included in the basis for the computation. This raises the question as to whether the taxpayer may require that a narrower basis for computing the foreign tax credit limitation provided for under the DTT shall be applied in respect of certain items of income while a wider basis provided for under internal law shall be applied in respect of other items of income.668

If X in the above example would be able to apply the per-item or per-country limitation in respect of the dividends (by referring to the DTT with N2) and the overall limitation in respect of the interest (in accordance with the internal law of R), the following result would be achieved. The entire foreign tax paid on the dividends would be creditable as the tax in N2 falls below the R tax on that item of income. Further, according to the overall limitation, five sixths of the foreign tax would be creditable, meaning that N1 tax on the interest, of 3 1/3 (5 / 6 × 4) would be creditable. Thus, the aggregate amount of creditable tax would be 5 1/3 (2 + 3 1/3), which is more than the credit that is given if the overall limitation is applied in respect of the aggregate amount of foreign income.

Furthermore, insofar as any other technique than the per-item limitation is applied, the foreign tax credit limitation may be lowered by items of negative foreign income, so that less R tax is considered attributable to the foreign income. This also raises the question as to whether a taxpayer can require that a narrower basis for computing the foreign tax credit limitation than is provided for under internal law shall be applied on the basis of a DTT.669

As the wording of DTTs conforming to the OECD Model does not unambiguously provide for either of a per-item or a per-country limitation,

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668 According to Schuch, a credit limitation which is based on the average tax rate in R and therefore lower or higher than the tax imposed on the item of income in respect of which a credit shall be given is contrary to the wording of Art. 23 B of the OECD Model, see Schuch, ‘Der Anrechnungshöchstbetrag’ in Gassner, Lang & Lechner (eds.), Die Methoden zur Vermeidung der Doppelbesteuerung (1995), pp. 35–36.

in my view there are no grounds for claiming that such DTT provisions require that one of the techniques shall be applied in a situation where internal law provides for the other. However, where the foreign tax credit limitation according to internal law shall be computed on a wider basis than on a per-country basis there may be grounds for claiming that the narrower definition of the DTT shall be applied when this is more favourable to the taxpayer. This issue is also dealt with in sub-chapter 5.4.13.5 below.

5.4.13.3 Income Exempted under a DTT

As, in respect of different items of income, the principle of exemption and the principle of credit are used in parallel in DTTs, it is important to understand how income covered by the principle of exemption is to be dealt with for the purpose of computing the foreign tax credit limitation.

For income in respect of which the DTT provides for the application of the principle of exemption by R, there is no obligation to relieve double taxation by means of the principle of credit (see sub-chapter 5.4.8). Furthermore, the general idea behind the ordinary credit method is to provide double tax relief by means of allowing a credit for foreign tax but not to such an extent that the credit reduces the tax payable on the taxpayer’s domestic income. It would therefore be inconsistent to include foreign income which is exempted from tax in R under a DTT in the computation of the foreign tax credit limitation. Thus, income which in accordance with the DTT shall be taxable only in N shall not be included in the foreign income for the purpose of computing the foreign tax credit limitation.670

The following example illustrates this line of reasoning.

X has derived income of 400. Out of this amount, 100 relate to work exercised in N and 100 consist of interest income relating to money deposited in a bank in N. The R tax rate is 20%. The N tax rate on both items of income is 30%. According to the applicable DTT, R shall provide double tax relief in respect of the employment income by means of the principle of exemption and in respect of the interest by means of the ordinary credit method. The internal law of R provides for a per-country-limitation.

670 See the OECD Model, Commentary to Art. 23, para. 15, which does not present any arguments to support the conclusion, probably because it is considered self-evident. See also Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 146.
As described in sub-chapter 5.4.8, the N tax on the employment income is not creditable, as double tax relief is provided by means of the principle of exemption. The R tax on the worldwide income is 60 (20% × 300). Provided that R does not take into account the employment income for the purpose of computing the foreign tax credit limitation, the ceiling on the credit amounts to 20 (100 / 300 × 60). In other words, only 20 of the tax paid in N on the interest can be credited. If the exempted income would be taken into account, so that the foreign income for the purpose of the computation would be 200 and the worldwide income 400, the ceiling on the credit would be 30 (200 / 400 × 60), covering the entire N tax of 30, in spite of the fact that R either subjects foreign income to tax at a lower rate than N or exempts it altogether. In other words, the foreign tax credit limitation would exceed the R tax on the income to which the principle of credit shall be applied and would therefore reduce the tax on domestic income, contrary to the general idea of the principle of credit described above.

As regards income that has been exempted under the distributive rules, it can be argued that it follows expressly from the wording of the OECD Model that income which according to a DTT is exempted from taxation in R shall not influence the foreign tax credit limitation. Articles 23 A.2 and 23 B.1 state that the credit shall not exceed that part of the income tax in R which is attributable to the income which may be taxed in N. It does not refer to income which shall be taxable only in N. Furthermore, paragraph 62 of the OECD Commentary to Article 23 states that the foreign tax credit limitation may be computed either by “apportioning the total tax on total income according to the ratio between the income for which credit is to be given and the total income, or by applying the tax rate for total income to the income for which credit is to be given” [emphasis added], i.e. excluding income in respect of which the principle of exemption is applied.

In the court case RÅ85 1:49, HFD denied a Swedish company a credit of foreign tax paid in respect of income attributable to a PE in Egypt and in respect of dividends paid by a Danish subsidiary, as both items of income had been exempted from tax in Sweden under the applicable DTTs. In the ruling, reference was made to the internal law credit provisions applicable prior to the entry into force of the Swedish Foreign Tax Credit Act, which stated that credit was only to be given for tax paid in respect of “income which is taxable in Sweden”. This was interpreted as meaning that the foreign income must have been included in the Swedish tax base. The court also held that only foreign income which is included in the tax assessment should be taken into account for the purpose of computing the foreign tax credit limitation.
Prior to the introduction of the Swedish Foreign Tax Credit Act, Swedish internal law provided expressly that the Swedish tax, “which is attributable to income derived from abroad and which has not been exempted from taxation in Sweden by an agreement with a foreign state” [author’s translation] was relevant for the purpose of determining the foreign tax credit limitation. The phrase was omitted in the Foreign Tax Credit Act without any explanation. No change seems to have been intended. Thus, since the introduction of the Foreign Tax Credit Act, the exclusion of income exempted under a DTT for the purpose of the foreign tax credit limitation does not follow directly from the wording of the Act, but the above reasoning speaks in favour of such an interpretation.

A related question is whether income which is exempted from taxation in N under a DTT shall be taken into account for the purpose of computing the foreign tax credit limitation. The first question is whether the exempted income shall be included in the foreign income. As there is no obligation under the DTT to provide a credit in respect of foreign income which is exempted from taxation in N under a DTT, it would not make sense to include it in the foreign income and to thus allow it to increase the foreign tax credit limitation. In spite of this, the Swedish Foreign Tax Credit Act seems to allow some forms of income to be included in the foreign income for the purpose of computing the foreign tax credit limitation regardless of whether N imposes tax on the income in question. According to chapter 2 section 9 paragraph 1 of the Foreign Tax Credit Act, the credit is limited to that part of the tax which is attributable to the aggregate amount of (i) income in respect of which foreign tax has been levied and (ii) other income that has been included in the tax base for the purpose of determining the R tax and is attributable to a PE or immovable property abroad or constitute interest, royalty, or dividends paid by a foreign state, a non-resident individual or a foreign legal entity. There is no requirement that tax is imposed by the other state in respect of the items of income mentioned under (ii). The preparatory works relating to the Swedish Foreign Tax Credit Act merely point out that such items of income are considered to have arisen in the other country and are typically taxed there. This indicates that the reason for regarding them as foreign income, irrespective of whether in a given case they have actually been taxed abroad, is to remove the need of investigating whether tax has in fact been imposed in the other country in order to achieve administrative simplicity. Since there is no requirement that tax has actually been imposed

on such items of income, it seems that even income which is exempt from
tax in N under the provisions of a DTT may be taken into account for the
purpose of computing the foreign tax credit limitation in Sweden. In most
cases DTTs do not exempt such items of income as are referred to in (ii)
above from tax in N, and the question lacks practical relevance. However,
there are exceptions, for instance where a DTT provides for exemption in N
in respect of dividends paid by a company in N.

Another question is whether income which is exempted under a DTT
from taxation in N shall be taken into account for the purpose of deter-
mining the average tax rate in R on the worldwide income. Insofar as such
income is taxed by R at a rate below the average tax rate in R on other
income, this would lead to a decrease of the R tax which would otherwise
be considered attributable to the foreign income. Correspondingly, if such
income is taxed by R at a rate which exceeds the average tax rate in R on
other income, the inclusion of such income and related tax in the computa-
tion would lead to a higher foreign tax credit limitation.

As regards the OECD Model the exclusion of income and tax on income
that has been exempted from tax in N presupposes that the DTT phrases
“that part of the tax” and “that part of the income tax” can be inter-
preted as referring to that part of the tax on the income in respect of which
the principle of credit applies rather than that part of the tax on the entire
income which is taxable in R. In my view, the wording of the relevant provi-
sions is not conclusive for determining which interpretation is correct. How-
ever, as there is no obligation for R to relieve double taxation of an item of
income by means of the principle of credit where the DTT obligates N to
apply the principle of exemption, it seems reasonable to argue that it does
not make sense to allow such items of income to have an influence on the
foreign tax credit limitation which is applicable in respect of other items of
income. Thus, it is submitted that income which is exempted under a DTT
from tax in N and any tax on such income shall not be included in the com-
putation of the foreign tax credit limitation.

5.4.13.4 Income Exempted under Internal Law
As pointed out above, R may be obliged under a DTT to provide double
tax relief by means of the principle of credit in respect of income which
is exempted under the internal law of R (see sub-chapter 5.4.8). Howev-

672 Art. 23 A.2 of the OECD Model.
673 Art. 23 B.1 of the OECD Model.
er, although creditable per se, the actual effect of such an obligation would depend on if and how the income which is exempted under the internal law of R is taken into account for the purpose of computing the foreign tax credit limitation.

Insofar as the R tax which is considered attributable to the item of income in question is determined on the basis of the tax which is imposed under R’s internal law on that specific item of income, the limitation in respect of the exempted income would be zero and, assuming that the tax paid in N cannot be cross-credited against R tax on other income, no tax would be creditable. However, where the R tax attributable to foreign income is determined on the basis of the average tax rate in R or by taking into account R tax on more than one item or category of income, R tax may be considered attributable to foreign income which is exempted from tax under R’s internal law, if such income is taken into account for the purpose of computing the foreign tax credit limitation. This is illustrated by the following example.

*The company A has derived business profits of 100, which are not attributable to a PE abroad. A has also received dividends of 100 from a subsidiary in N. A has not derived any other income. The dividends are subject to withholding tax in N. A is liable to tax in R on the business profits at a rate of 25 %. The dividends are covered by R’s internal rules on participation exemption and are therefore exempt from tax in R. Thus, the total amount of tax levied in R amounts to 25.

According to the DTT, R shall allow as a credit from the tax on the income of A an amount equal to the income tax paid in N, but limited to that part of the R tax which is attributable to the income that may be taxed in N.*

If the dividends are excluded from the computation of the foreign tax credit limitation, the foreign income will be zero and no R tax will be considered attributable to the foreign income (25 × 0 / 100). If the dividends are taken into account for the purpose of the computation, R tax of 12.5 will be considered attributable to the foreign income (25 × 100 / 200).

DTT credit provisions typically do not make any exceptions for income which is exempted under the internal law of R. For instance, Article 23 B of the OECD Model provides that R shall allow as a credit an amount equal to the income tax paid in N, but not exceeding the R tax which is attributable to the income which may be taxed in N. For income which under the DTT may be taxed in N, it makes no exception relating to income which is exempt under the internal law of R. Thus, it can be argued that such income shall be taken into account for the purpose of computing the foreign tax
credit limitation. However, if it is accepted that the DTT does not require R to apply an overall limitation or a per-country limitation rather than a per-item limitation (see sub-chapter 5.4.13.2), it follows that there is no obligation for R to attribute R tax to the dividends on the basis of the average tax on the dividends and the business profits. R would therefore be free to attribute R tax to the dividends on the basis of the tax which is imposed on the dividends, i.e. zero. Consequently, R would not be obliged under the DTT to allow a credit for income which is exempted under R’s internal law.

In the court case RÅ85 1:49, HFD denied a Swedish company a credit of foreign tax paid in respect of dividends paid by a Portuguese subsidiary, as the dividends were exempt from tax in Sweden under Swedish internal law. In the ruling, reference was made to the internal law credit provisions applicable prior to the entry into force of the Swedish Foreign Tax Credit Act, which stated that credit was only to be given for tax paid in respect of “income which is taxable in Sweden”. This was interpreted as meaning that the foreign income must have been included in the Swedish tax base in order for it to be creditable. Furthermore, the court held that only foreign income which is included in the tax assessment should be taken into account for the purpose of computing the foreign tax credit limitation. It seems that the court viewed the computation of the foreign tax limitation as a consequence of the question as to whether tax on such income was creditable under internal law. The fact that foreign income which was exempted under Swedish internal law did not entitle that taxpayer to a credit under the Act resulted in exclusion of such income from the computation, as at that time Sweden had not concluded a DTT with Portugal. However, according to the above analysis, the outcome would have been compatible with the obligation to provide double tax relief under a DTT conforming to the OECD Model.674

For certain types of investment income, reduced taxation applies under Swedish tax law. The technique for achieving the reduction is not based on the application of reduced tax rates. Instead a certain fraction of the income is exempted from taxation, i.e. only the remaining fraction of the income is regarded as taxable income. For instance, only five sixths of capital gains and dividends relating to shares in unlisted companies, twenty-two thirtieths of capital gains on private dwellings, two thirds of dividends paid in respect of certain closely held companies (subject to several conditions), and nine

674 Similarly, income exempted under Danish internal law is excluded from the computation of the foreign tax credit limitation under Danish law, see Pedersen and others, Skatteretten 3 (2006), p. 138.
tenths of capital gains on immovable property held for business purposes are taxable. This raises the question whether it is only the taxable share of the income that shall be taken into account for the purpose of the computation or if the entire income shall be included. According to the Swedish Tax Agency, the entire foreign tax on such income is creditable, subject to the foreign tax credit limitation. Furthermore, according to the Swedish Tax Agency, the foreign tax credit limitation shall be computed on the basis of the entire income (not only on the taxable fraction), since the purpose of the Swedish legislation is not to exempt income, but to achieve a lower effective rate. Thus, the entire foreign income (and not just the taxable fraction) is to be included in the worldwide income and the foreign income for the purpose of the computation.

The exemption of income under N’s internal law raises similar questions regarding the computation of the foreign tax credit limitation. Of course, the question whether such income shall be taken into account for the purpose of the foreign tax credit limitation is only of practical relevance where R applies the principle of credit in respect of other items of foreign income which have been taxed abroad, as there will otherwise not be any foreign tax to credit. Further, this question is of practical relevance only where R applies a limitation technique that could comprise other foreign income, which is taxed abroad, as well as the income which is exempted in N. If R applies a per-item limitation it is not be possible to cross-credit foreign tax on other items of income against R tax on the item of income which is exempt from tax in N under N’s internal law.

If it is accepted that DTTs generally do not require the use of any other form of limitation (see sub-chapter 5.4.13.2), it would not be contrary to R’s DTT obligation to disregard income which has been exempted from tax in N under N’s internal law. This conclusion is in line with the Commentaries of the OECD Model, which state that the foreign tax credit limitation will normally be that part of the R tax which is appropriate only to that item of income which is taxed in N, but which point out that other solutions are possible.

Schuch, on the other hand, argues that since R is obligated to provide double tax relief in respect of income which in accordance with the DTT may

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675 Ch. 42 sec. 15 a IL, ch. 45 sec. 33 IL, and ch. 57 sec. 20 IL.
677 The OECD Model, Commentary to Art. 23, para. 64.
be taxed in N, it would be inconsistent to take into account whether tax is actually imposed by N. Schuch’s opinion is a logical consequence of his view that DTTs typically provide for the use of the per-country limitation. If the DTT does not allow the foreign tax credit limitation to be computed according to the per-item approach, the argument that there is no DTT obligation to take into account income which is exempt from tax in N under N’s internal law since under a per-item approach no tax would be creditable against the R tax on that particular item of income carries no weight.

Under the Swedish Foreign Tax Credit Act, the credit is limited to that part of the tax which is attributable to the aggregate amount of (i) income in respect of which foreign tax has been levied, and (ii) other income that has been included in the tax base for the purpose of determining the R tax and is attributable to a PE or immovable property abroad or constitute interest, royalty, or dividends paid by a foreign state, a non-resident individual or a foreign legal entity. Thus, income falling under (ii) may be taken into account for the purpose of computing the foreign tax credit limitation even if it is exempt from tax in the other state under its internal laws. Income which does not fall under (ii), on the other hand, must have been subjected to taxation in order to be taken into account for the purpose of computing the foreign tax credit limitation.

5.4.13.5 Losses

A wider basis for computing the foreign tax credit limitation is favourable to the taxpayer in the sense that it increases the chances of cross-crediting. The other side of the coin is that under a wider basis items of negative foreign income may cancel items of positive foreign income so that the foreign income and, hence, the foreign tax credit limitation becomes lower than if the limitation would have been computed separately. This raises the question whether R may be obliged under a DTT to apply a narrower basis for computing the foreign tax credit limitation when this would lead to a higher foreign tax credit limitation.

A requirement for a narrower basis would have to be based on the idea that the applicable DTT requires the use of a different form of limitation than that which is generally applied by R. If it is accepted that DTTs typically do not

678 Cf. Arts. 23 A.2 and 23 B.1 of the OECD Model.
680 Ch. 2 sec. 9 para. 1 AvrL.
unambiguously require the use of any one specific form of limitation and that either of the per-item or the per-country limitations can be fitted within the wording of the DTT credit provisions in question (see sub-chapter 5.4.13.2), there would be no grounds for claiming that such DTT provisions require that one of the techniques shall be applied in a situation where internal law provides for the other.

Thus, items of negative income derived from a state may be taken into account for the purpose of computing the foreign tax credit limitation and result in a lower foreign tax credit limitation as long as the aggregate income from that state remains positive, even though under a strict per-item limitation, the foreign tax credit limitation would instead be set by the R tax on each item of income, disregarding any items of negative income.

However, where internal law provides for computation of the foreign tax credit limitation on a wider basis than on a per-country basis there may be grounds for claiming that the narrower definition of the DTT shall be applied when this is more favourable to the taxpayer. Thus, more specifically, under an overall limitation it may be argued that it would be contrary to R’s DTT obligations to take into account losses incurred in a third country when determining the foreign income for the purpose of computing the ceiling on the credit for tax paid in N.

As regards Sweden, HFD made clear in the court case RÅ 1999 ref. 65 that, although Sweden applies overall limitation, negative foreign income derived from one country shall not reduce positive foreign income from other countries for the purpose of computing the foreign tax credit limitation. This makes it less likely that the application of the overall limitation under Swedish internal law would lead to a less favourable result for the taxpayer than the limitation provided for under the DTT.681

If the worldwide income as a result of losses in R is zero or negative, normally no R tax is payable and, hence, there is no R tax to credit the foreign tax from. However, if R imposes tax on a tax base which differs from the worldwide income, R tax may be payable despite the fact that the worldwide income is negative. For instance, R’s internal law may restrict the offsetting of items of negative income against items of positive income so that tax is imposed on items of positive income despite the fact that the total income

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681 The case is commented on by Lindencrona in ‘Juridik och matematik – nyare praxis på den svenska avräkningslagen’, SN, 2007, No. 1-2, pp. 3–4, who, based on statements in the preparatory works found the conclusion so self-evident that he asked himself why the Swedish Tax Agency had brought the question to court.
is zero or negative. Further, tax may be imposed on a standardised yield, despite the fact that the actual income is zero or negative. This was the case in the Swedish court case RÅ 2001 ref. 43. The taxpayer in question derived income from Spain in the form of royalty, which was taxed in Spain. Swedish pension yield tax was levied in spite of the fact that the worldwide income was negative (as a result of losses incurred in Sweden). Under Swedish law, the foreign tax was creditable against the yield tax, subject to the foreign tax credit limitation. The question was how the foreign tax credit limitation was to be computed. Since there was no taxable income and since it is mathematically not possible to divide a number by zero, HFD held that no foreign tax was creditable. The outcome is rather strange. If the worldwide income would have been lower than the foreign income, but not zero or negative, the ratio of the foreign income over the worldwide income would have exceeded one and the limitation would therefore have exceeded the tax paid in R. As a consequence, the Spanish tax would have been creditable up to an amount corresponding to the entire Swedish tax.682 Thus, a consequence of HFD’s judgment is that the marginal effect of going from a very small amount of worldwide income, such as SEK 1, to a zero or negative income is dramatic, since all of a sudden no foreign tax is creditable. The judgment has been rightly criticised by both Lindencrona and Nylén & Aldén as follows. The foreign tax credit limitation provides a limitation to the amount of tax that would otherwise have been creditable, i.e. it is an exception to the general rule. If the foreign tax credit limitation cannot be computed, the consequence is merely that the general rule applies without being restricted by the limitation.683

5.4.13.6 Carry Forward and Carry Back of Excess Credits

If the foreign tax credit limitation for a particular period is lower than the amount of foreign tax on items of income in respect of which the principle of credit applies, the entire foreign tax, although creditable \textit{per se}, cannot be credited. This may occur for instance where N applies a higher tax rate than R or where losses in R or in a third state reduce the worldwide income and, as a consequence, the tax payable in R. The excess credits are normally forfeited. However, the internal law of R may provide for a carry forward or

682 Cf. the OECD Model, Commentary to Art. 23, para. 65.
carry back of excess tax credits, so that unused credits can reduce future or prior period taxes to the extent that the foreign tax credit limitation in these future or previous periods exceeds the creditable taxes attributable to those periods. The right to carry forward and/or carry back excess credits may apply indefinitely or be limited to a certain period.

According to the Commentaries of the OECD Model, R must provide relief through the principle of credit even though N taxes the item of income in question in an earlier or later year.\textsuperscript{684} It can be argued that it is implicit in this statement that the credit shall be allowed in the period in which R taxes the item of income in question. This is normally achieved by allowing a credit from the R tax for N tax paid, regardless of whether the N tax has been paid in a previous period, and by allowing a refund of R tax where N tax is paid subsequently to the payment of R tax. Thus, carry forward and carry back of excess credits is normally not needed to match the R tax and the N tax where R and N tax an item of income in different periods. Instead, the benefits to the taxpayer of carry forward and carry back of excess credits is that it increases the chances of cross-crediting by allowing a taxpayer to credit N tax paid in respect of one item of income in one period against R tax paid on another item of income in a different period. Thus, by allowing a carry forward or carry back of excess credits in conjunction with a wide definition of foreign income for the purpose of computing the foreign tax credit limitation, R relinquishes revenue it would otherwise collect in any period in which the average tax on the foreign income is less than the R rate.\textsuperscript{685}

If it is accepted that DTT provisions typically do not require that a different form of limitation than per-item limitation is applied (see sub-chapter 5.4.13.2), it can be concluded that R is normally not obliged under the DTT to cross-credit foreign tax paid in respect of one item of income against R tax paid on a different item of income. As a consequence, R is normally not obliged to enable cross-crediting by carrying forward or back excess credits. Thus, carry forward and carry back of excess credits are measures that typically apply on a unilateral basis under the internal law of R.\textsuperscript{686}

In Sweden, rules on carry forward of excess credits were enacted in connection with the lowering of tax rates at the beginning of the 1990s, which

\textsuperscript{684} The OECD Model, Commentary to Art. 23, para. 32.8.
\textsuperscript{686} Cf. Vogel and others, Doppelbesteuergungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 154, simply conclude that DTTs do not provide for carry forward or carry back of excess credits.
increased the risk that a taxpayer would not be able to credit foreign taxes in their entirety. 687 Swedish law does not provide for a carry back of excess credits. The introduction of rules on carry forward of excess credits had already been discussed in the 1980s, but at that time Sweden had refrained from introducing such rules mainly because they were considered to increase the administrative burden of the tax authorities. 688 The carry forward period was initially three years, but was increased in 2009 to five years in order to lower the risk that a taxpayer, for instance in connection with a recession, would not be able to credit foreign tax. 689 According to the Swedish Foreign Tax Credit Act, foreign taxes attributable to an earlier year are credited prior to taxes attributable to a later year. 690 This decreases the risk that excess credits are forfeited as a result of inability to credit them within the five-year period. Furthermore, as a carry forward of excess credits constitutes an alternative to a reassessment procedure leading to a refund of tax in cases where the foreign tax was not yet paid (or even known) when the assessment in R was made, the increased opportunities for carrying forward excess credits means that a reassessment procedure can (provided that the foreign tax credit limitation in a later year exceeds the creditable tax attributable to that year) more often be substituted by a claim in the tax return regarding a carry forward of excess credits. 691

5.5 Summary

One aim of this study is to get an overview of the many methods for elimination of double taxation that exist in DTTs. This is achieved in this chapter by grouping the variations, first into three categories (the two main principles for elimination of double taxation, namely exemption and credit, and a third category, limitation of the tax rate), and then by dividing the two main principles in turn into a number of specific methods. Furthermore, a number of issues which are connected to the specific methods are identified and analysed.

The principles of exemption and credit and the third category, limitation of the tax rate, are all conceptually different. The principle of exemption,
which may be applied on the basis of the distributive rules or on the basis of
the double tax relief article, functions by excluding certain items of income
from the tax base, thereby reducing the tax liability. Typically, the exemp-
tion method is applied regardless of the taxation (or non-taxation) in N. In
contrast, under the principle of credit, which is applied on the basis of the
double tax relief article, a pre-credit R tax is computed on the basis of the
taxpayer's worldwide income and a credit is granted from the R tax for tax
paid in N. This means that the tax revenue of R relating to the income from
N depends on the tax law of N, since the tax revenue of R decreases if the N
tax is increased. However, as in practically all cases the credit is limited to the
R tax which is attributable to the foreign income (determined on for instance
a per-item or per-country basis), no credit is allowed against R tax on domes-
tic income, meaning that the R tax on domestic income is independent of
the taxation in other countries. As an alternative to the principles of exemp-
tion and credit, double taxation can be reduced by means of DTT provisions
which put a ceiling on the tax which N may impose. The ceiling is typically
determined as a maximum percentage of a payment of interest, dividends, or
royalty, i.e. as a percentage of the gross income. Limitation of the tax rate is
used in combination with an obligation for R to eliminate remaining double
taxation by means of the principle of credit.

Since the mid-1960s, Sweden applies the principle of credit as the main
principle in its DTTs for elimination of double taxation. The reasons for
the shift from the principle of exemption to the principle of credit were not
presented clearly at the time. However, the introduction of rules on unilateral
credit of foreign tax in the 1960s seems likely to have influenced the shift and
there are statements in the preparatory works which support that conclusion.

The interaction between DTT provisions and internal law plays an impor-
tant role throughout this study. As regards the principles of exemption and
credit, it can be observed that the exclusion of income from the tax base
under the principle of exemption is normally less complicated than a credit
of foreign tax. As a result there is generally less need for internal law regula-
tion in the application of the principle of exemption than in the application
of the principle of credit. As regards Swedish internal law, there are no provi-
sions that expressly provide for exemption of income where it follows from
a DTT that income shall be exempted. Instead, the fact that the tax liability
shall be determined excluding such items of income as have been exempted
under a DTT follows from the priority over internal law normally attributed
to DTTs. However, the Swedish Income Tax Act expressly provides for non-
deductibility of expenses relating to income which has been exempted under
a DTT. In contrast, an entire Act, the Swedish Foreign Tax Credit Act, is devoted to the application of the principle of credit. The Act applies to credit under DTTs as well as unilateral credit.

It can be noted that in regard to procedure (time limits for claiming treaty relief etc.) internal law plays an important role for the elimination of double taxation under DTTs. Procedural requirements under internal law are relevant to the principles of exemption and credit as well as to limitation of the tax rate. For instance, DTTs do not in general specify whether a reduced tax rate on payments of dividends, interest, and royalty shall be achieved through a reduction of the amount deducted on remittance or through a refund of excess tax. As regards withholding tax on dividends, Sweden generally offers both alternatives for achieving a reduced rate in accordance with DTT tax rate limitations. Sweden does not impose tax at source in respect of interest and royalty, which means that there is no need for a reduction of tax deducted on remittance in these cases.

A consequence of the fact that the principle of exemption is typically applied regardless of whether tax is imposed by the other state is that the exemption of income under a DTT may result in double non-taxation if the other contracting state does not subject the item of income in question to tax. To avoid such situations, a clause may be inserted in the DTT which relieves a contracting state from the obligation to exempt income unless certain criteria relating to the taxation of that income by the other state are fulfilled, for instance a so-called subject-to-tax clause. Subject-to-tax clauses and similar provisions are discussed and analysed briefly in sub-chapter 5.2.3. It can be concluded that subject-to-tax clauses can give rise to many interpretational difficulties.

Another issue which is discussed in this chapter and which relate specifically to the principles of exemption and credit is the question whether R must allow a deduction for losses incurred in N. Most states treat losses in symmetry with income, meaning that losses are considered deductible insofar as corresponding income is taxed and non-deductible if corresponding income is tax exempt, for instance on the basis of the provisions of a DTT. In contrast, where the principle of credit is applied, the pre-credit tax in R is usually computed on the basis of the worldwide income, taking into account any losses incurred in N by a taxpayer. Thus, losses in N reduce the amount of tax to be paid in R. It is submitted that, as DTTs do not normally limit R’s right to tax income which is taxable only in R, R is free to determine such income and, consequently, free to determine whether a deduction shall be allowed for losses incurred in N.
If a taxpayer is denied deduction of losses due to the fact that a DTT provides for elimination of double taxation by means of the principle of exemption, this leaves the taxpayer worse off than if no DTT had been concluded. As a consequence, it can be argued that denying deduction of losses incurred in N is contrary to the principle that DTT provisions may not increase the tax burden provided for under internal law. However, as mentioned in subchapter 3.5, that principle is a principle under domestic law, not under international law. Therefore, no generally applicable conclusion can be drawn regarding the obligation to allow deduction of losses incurred in N. Rather, the question whether R is obliged to allow deduction of losses incurred in N in a situation where the DTT in question provides for exemption of income has to be answered on the basis of an analysis of the meaning of the principle in the state in which the DTT is applied.

In this study, the principle of exemption is divided into full exemption, exemption with progression, modified exemption, tax sparing exemption, and matching exemption. The principle of credit is divided into full credit, ordinary credit, tax sparing credit, matching credit, and reverse credit.

Many DTTs provide for exemption of income by R in accordance with the “exemption with progression” method. However, in my opinion, an interpretation of DTTs in accordance with the textual approach advocated by the VCLT leads to the conclusion that the absence of a proviso safeguarding progression does not normally preclude a contracting state (R or N) from taking into account exempted income for the purpose of determining the tax on the remaining income. This is due to the fact that DTTs do not generally contain any provisions that expressly restrict a contracting state’s right to tax the remaining income. Therefore, the inclusion of a proviso safeguarding progression is in my opinion typically merely declaratory. From a Swedish perspective, the question whether a proviso safeguarding progression is required in order to allow the taking into account of exempted income is of little relevance, as Sweden regularly refrains, on a unilateral basis, from taking into account exempted income. In other words, in most cases the application of the principle of exemption by Sweden means “full exemption”. The reasons referred to in preparatory works for this choice is to lower the work load of the Swedish Tax Agency, to avoid complicated legislation, and the fact that the loss of tax revenue is deemed to be negligible.

As an alternative to excluding income which under the DTT may be taxed in N, double tax relief may be provided by allowing as a credit an amount equal to the part of the total tax in the state providing the relief appropriate to the foreign income, so-called “modified exemption”. Although modified
exemption technically works by crediting tax, it is conceptually different to the principle of credit, as relief is provided independently of the taxing position in N. Typically, the outcome of modified exemption equals that of exemption with progression as no R tax is imposed on the income that may be taxed in N and since that income is in effect taken into account for determining the R tax on the income which is taxable in R only. However, the outcome may differ where losses are incurred. As regards the application of modified exemption in Sweden, HFD has held that income covered by modified exemption shall not reduce a loss on domestic income, i.e. the loss in R is unaffected by income from N in the same way as if full exemption or exemption with progression would have been applied. This is in line with the general idea of modified exemption, namely to achieve in principle the same result as under exemption with progression without excluding income from the tax base for the purpose of determining social benefits etc. However, it can be questioned whether HFD’s conclusion is compatible with the wording of the DTT and internal law.

Normally, exemption is provided regardless of the taxation in N. However, as mentioned above it is possible to limit the applicability of the principle of exemption to situations where certain criteria concerning the taxation in N are fulfilled, for instance by providing a minimum rate at which tax must have been levied. In such cases tax incentives granted by N may lead to the non-application of the principle of exemption. To counter this, the contracting states may agree that R shall treat the income in question as if N had imposed tax under its general tax legislation or as if tax had been levied in N at a fictitious, higher rate, disregarding the actual taxation in N. By analogy with tax sparing credit and matching credit, these kinds of provisions are in this study referred to as “tax sparing exemption” and “matching exemption” respectively. Several Swedish DTTs contain such provisions in regard to dividends, i.e. for the purpose of determining whether dividends paid by a company in N to a company in Sweden shall be exempted from tax in Sweden, tax shall be deemed to have been paid in N at the regular rate or at a fictitious rate. However, since the exemption under internal law with respect to dividends paid by a foreign company to a Swedish company has been made substantially wider than it was when these DTTs were entered into, such provisions are now of little practical importance.

A limitation of the tax rate in N on payments of dividends, interest, and royalty in combination with an obligation for R to eliminate remaining double taxation in accordance with the principle of credit can be regarded as a compromise between provisions which obligate either of R or N to eliminate
double taxation. The tax rate limitations applicable under DTTs in respect of dividends, interest, and royalty payments may seem relatively low at first glance, but the fact that N is entitled to tax both the payer and the recipient must be taken into consideration. As regards dividends, which are normally not deductible for the paying company, the profits out of which the dividends are paid may already have been subjected to taxation in N when N taxes the dividends and may therefore be subjected to economic double taxation. Interest and royalty on the other hand are normally deductible for the payer, which means that interest and royalty are normally not subjected to economic double taxation. As a consequence, tax rate limitations on dividends are incapable of completely eliminating recurrent corporate taxation, i.e. taxation once at the level of the distributing company when it is taxed on its profits and once again at the level of the corporate shareholder when it is taxed on the profit distribution. Different solutions to recurrent corporate taxation within the framework of a DTT are conceivable.

Furthermore, it should be observed that tax rate limitations are computed on the basis of the gross amount of payment, i.e. regardless of expenses incurred. A tax rate limitation on a gross amount may correspond to a substantially higher rate on the net amount where there are costs connected with generating the income.

In regard to the principle of credit, it would be consistent with the objective of CEN to allow a credit for foreign tax regardless of whether the N tax exceeds the R tax which is attributable to the foreign income. However, in practice CEN is rarely, if ever, regarded as an overriding objective, but rather as an objective which has to be weighed against other goals. A credit of foreign tax in excess of the R tax which is attributable to the foreign income would normally be considered as an unacceptable limitation of R’s sovereign right to tax its residents, as the taxation of income in R would become dependent on the taxation in N. Further, a credit against R tax on domestic income in accordance with the “full credit” credit method (or a “negative tax” where the R tax on domestic income does not suffice) would in effect constitute a subsidy by R of investments into N in an amount corresponding to the excess of the N tax over the R tax, which would in most cases be considered unacceptable.

Thus, in practically all cases, the credit for N tax is limited by the R tax which is considered attributable to the foreign income. Where the DTT provides for such a “foreign tax credit limitation”, the method applied is usually referred to as “ordinary credit”. Many of the issues that are discussed in connection with the principle of credit relate to the computation of the foreign tax credit limitation.
A consequence of the principle of credit is that a tax reduction in N is “absorbed” by R if the N tax falls below the R tax. In certain cases the contracting states may agree that such a reduced tax in N shall lead to a reduced aggregate tax burden for the taxpayer. To achieve the intended outcome, the contracting states may therefore agree that R shall allow as a credit an amount corresponding to the tax that N would have imposed under its general tax legislation (referred to as a “tax sparing credit”) or that R shall allow a credit of an amount computed on the basis of a fixed rate (in this study referred to as “matching credit”), regardless of whether N levies tax at a lower rate. There are different views as to whether the application of such methods is an appropriate means of encouraging investment into other states. For instance, the sceptical attitude of the OECD Model towards “tax sparing credit” stands in stark contrast to the positive view expressed in the UN Model. As a consequence of the objections, many states that apply tax sparing credit and matching credit limit the applicability of these methods by providing that they shall only apply to certain kinds of business activities, typically to business activities which require substantial actual presence in N, and by providing that they shall only apply for a certain period, so that a review can be made when the period has elapsed without need for a renegotiation of the DTT. For instance, tax sparing credit and matching credit clauses have been inserted in many DTTs entered into by Sweden, but they are typically time limited. Currently, there is only a handful of DTTs that contain such clauses which are still applicable.

In some DTTs, Sweden reserves its right to tax former residents of Sweden who have moved abroad in spite of the fact that there is no such connection between Sweden and an activity or property that has generated income as would normally be required for allocating the taxing right to N. In such cases R does not normally agree to provide double tax relief, which means that double taxation can only be eliminated by Sweden in its capacity as N. In this study, the application of the principle of credit by N is referred to as “reverse credit”. As the purpose of reserving Sweden’s taxing right in such situations is typically to reduce tax incentives for moving abroad, the principle of credit can be regarded as an appropriate means of eliminating double taxation, as a reserved taxing right in combination with a reverse credit provision has the effect of ensuring that the item of income in question is not subject to double non-taxation. Rather, it is taxed in Sweden to the extent that the tax burden in the other state falls below the tax that would have applied if the taxpayer had remained a resident of Sweden.

Where the principle of credit is applied by R under the DTT as the main method for elimination of double taxation, the double tax relief article typi-
cally does not state expressly that R shall apply the principle of credit except where the principle of exemption applies under the distributive rules. This raises the question whether the principle of credit can apply to income which has been exempted under the distributive rules. However, it would be inconsistent to give credit for N tax on such income, as double tax relief is already provided in accordance with the principle of exemption. Consequently, it is submitted that it would be logical to interpret the double tax relief article as not requiring R to provide a credit for N tax on income in respect of which R is obligated under the DTT to eliminate double taxation by means of the principle of exemption. This conclusion also follows from a judgment by HFD.

A related issue is whether foreign tax paid in respect of an item of income which is exempted from tax in R under the internal laws of R may be credited where the applicable DTT provides for the application of the principle of credit. As a foreign tax credit limitation in accordance with the per-item limitation would always result in no credit being eligible, since the R tax on the particular item which is exempted from tax under R's internal law is zero, and since the DTT in accordance with the analysis presented in this chapter does not require that a different form of limitation is applied, it is submitted that there would normally be no grounds for claiming, on the basis of a DTT, that a credit shall be allowed for income which is exempted under the internal law of R.

As regards the types of taxes that may be credited under a DTT, it is submitted that the taxes covered article define the type of taxes that are creditable and that internal law is normally of no relevance in this regard. However, interpretational difficulties may arise in relation to certain expenses relating to a tax. For instance, it may be difficult to determine whether interest costs due to late payment, penalties for tax fraud, penalties for late filing of a tax return, etc. are taxes in the sense of the taxes covered article.

As N tax is often paid in another currency than the R tax, it is often necessary to determine the equivalent of the N tax in the currency of R. Alternative dates for the conversion are conceivable, for instance when the income is earned, when the income is received, when the amount of tax is determined by the tax authority of N, when the N tax becomes due, or when the payment of N tax is actually made. As regards Sweden, no express DTT or internal law provisions determine principles for the conversion of foreign tax for the purpose of computing the SEK amount of credit. However, as far as I have been able to determine, Sweden seems to apply the rate on the day of the payment, at least as a main principle.
As regards the question when taxes are creditable, DTTs do not generally include any express provisions on this. However, it can be argued that in order to be able to fulfil its treaty obligation of allowing a credit of foreign tax to the extent that the foreign tax does not exceed the R tax which is attributable to the foreign income it is necessary to allow a credit in the year in which R taxes the item of income in question, implying *inter alia* that, where the N tax is paid in a later period, R must allow a retroactive credit. According to the Swedish Foreign Tax Credit Act, a credit is allowed in the same period as Sweden taxes the income. In addition, the Swedish Foreign Tax Credit Act provides for a carry forward of unused credit, which can often be used to achieve a credit of foreign tax imposed in a previous period, or which can accommodate an increase in N tax relating to a previous year that occurs after the assessment in R, without the need for a review of the assessment in Sweden.

As regards the requirement that the N tax must have been paid to be creditable, it is submitted that a payment of a “preliminary tax” cannot be considered as “tax paid” as it does not settle a tax liability. Consequently, DTT credit provisions normally do not require that a credit is granted for such payments. Accordingly, Swedish internal law requires that the payment relates to “final” tax in order for it to be creditable.

Where ordinary credit is applied, the foreign tax credit limitation, i.e. the R tax which is attributed to the foreign income, can be determined in many different ways. The foreign tax credit limitation can be computed collectively for all foreign income or it can be computed separately for specific groups of income, such as for income derived from any one country, for each class of income, or for each item of income. A wider basis for determining the foreign tax credit limitation increases the chances of cross-crediting N tax on one item of income in excess of the R tax which is attributable to that item of income against R tax on other items of income which are subject to a lower foreign tax.

The attribution of income and allocation of expense to either R or N is central to the computation of the foreign tax credit limitation as a higher amount of foreign income results in a higher foreign tax credit limitation and, conversely, a lower amount of foreign income results in a lower foreign tax credit limitation. As follows from sub-chapter 4.3.4, the distributive rules provide general principles for the attribution of income and allocation of expense, but frequently needs to be complemented by internal law. It is submitted that, insofar as DTT provisions increase the amount of foreign income as determined under R’s internal law and, consequently, the income in respect
of which R must provide double tax relief, it would be consistent to also adjust
the computation of the foreign tax credit limitation accordingly.

Restricting cross-crediting, for instance by using a per-country limitation
or a per-item limitation as opposed to an overall limitation, has the effect of
treating investment in a high-tax country no better than it would be under an
exemption system, while preserving the benefit of worldwide taxation with a
foreign tax credit for investment in lower-taxed countries. In other words, it
ensures that the aggregate taxation of the income corresponds to the higher
of the R or N tax on a specific item of income or on all income from N. The
rationale for permitting extensive cross-crediting is not as clear-cut, but at
least there are administrative advantages. However, extensive opportunities
for cross-crediting increases the chances of achieving tax neutrality between
those taxpayers who engage in foreign activities and those who do not, which
may be seen as an appropriate goal of a foreign tax credit system. Sweden
applies overall limitation, i.e. the Swedish foreign tax credit system provides
for extensive cross-crediting. Statements in preparatory works relating to the
Swedish rules on credit of foreign tax indicate that the choice of overall limi-
tation is due to a desire to strengthen Swedish business rather than to achieve
administrative simplicity.

A wider basis for computing the foreign tax credit limitation is generally
more favourable to the taxpayer as it increases the chances of crediting foreign
tax on an item of income in excess of the R tax on that item of income tax
through cross-crediting. Thus, insofar as internal law provides for a narrower
basis for computing the foreign tax credit limitation than the DTT credit
provision in question does, it can be argued that R would be obliged under
the DTT to apply the wider definition when computing the foreign tax credit
limitation in situations where this would lead to a higher credit. However,
where the DTT credit provisions in question expressly refer to the internal law
of R it becomes more difficult to claim that the DTT credit provisions require
the application of a different form of limitation than that which is provided
for under internal law. Furthermore, as DTTs according to the analysis pre-
sented in sub-chapter 5.4.13.2 do not normally state which of the per-item or
per-country limitations that shall be applied, but leaves the choice up to each
contracting state, there are normally no grounds for requiring that a different
form of limitation is applied than that which applies under internal law, as
long as internal law provides for either of the two forms of limitations.

Furthermore, an analysis is made of the question whether exempted income
shall be disregarded for the purpose of the computation of the foreign tax
credit limitation. In regard to income which under a DTT is exempted from
taxation in R, it is submitted that it would be inconsistent to include such income in the computation of the foreign tax credit limitation as it might lead to a foreign tax credit limitation which is higher than the R tax which is appropriate to the income in respect of which a credit shall be given, contrary to the general idea behind the ordinary credit method, namely to provide double tax relief by means of allowing a credit for foreign tax but not to such an extent that the credit reduces the tax payable on the taxpayer’s domestic income. This conclusion is supported by a judgment by HFD. The same applies in regard to income which under a DTT is exempted from taxation in N. However, for reasons of administrability, the Swedish Foreign Tax Credit Act provides that certain types of income shall be included in the computation of the foreign tax credit limitation regardless of whether they are subjected to tax in N. The question whether income which is exempted under the internal law of R shall be taken into account for the purpose of the foreign tax credit limitation is more complex. It can be argued that such income shall be taken into account as the principle of credit applies in respect of income which according to the DTT may be taxed in N, regardless of whether taxation takes place in R. However, if it is accepted that the DTT does not require R to apply an overall limitation or a per-country limitation rather than a per-item limitation, it follows that there is no obligation for R to attribute R tax to an item of income which is exempted from tax in R under its internal law on the basis of the tax on that item of income and other items of income. This leads to the conclusion that there is no obligation under the DTT to take into account income which is exempt from tax in R under its internal law for the purpose of computing the foreign tax credit limitation. The same conclusion applies to income which is exempted from tax in N under the internal law of N.

In some situations, the application of a wider basis for determining the foreign tax credit limitation can be a disadvantage for the taxpayer, as items of negative income may reduce the foreign income and lead to a lower ceiling on the credit. As follows from the analysis in this chapter, there may be grounds for claiming that a narrower definition of foreign income shall be applied with reference to the applicable DTT where internal law provides for computation of the foreign tax credit limitation on a wider basis than on a per-country basis and the narrower definition of the DTT is more favourable to the taxpayer. Thus, more specifically, under an overall limitation it may be argued that it would be contrary to R’s DTT obligations to take into account losses incurred in a third country when determining the foreign income for the purpose of computing the ceiling on the credit for tax paid in N. However, according to Swedish case law, negative foreign income derived from one country shall
not reduce positive foreign income from other countries for the purpose of computing the foreign tax credit limitation, which makes it less likely that the application of the overall limitation under Swedish internal law would lead to a less favourable result for the taxpayer than a limitation provided for under a DTT.

As regards the possibility of carrying forward or back excess credits, it follows from the analysis in this chapter that DTTs do not normally require that unused credits shall reduce future or prior period taxes, but merely require that R shall allow a credit in the period in which R taxes the item of income in question. Thus, the possibility of carrying forward or back excess credits are typically not introduced as a result of a DTT obligation, but on a unilateral basis.
6 Evaluation in Selected Situations of the Methods Recommended by the OECD

6.1 Introduction

The purpose of this chapter is to evaluate the two methods for elimination of double taxation recommended by the OECD in the OECD Model, namely exemption with progression and ordinary credit, in a few selected situations on the basis of tax neutrality. Thus, this chapter relates to the second aim of the study as set out in sub-chapter 1.2.2.

Some basic assumptions are made for the purpose of the following study. First, it is assumed that there is no difference between the contracting states as regards the attribution of income and allocation of expense to R or N or the quantification of income, except where expressly stated. Second, with the exception of sub-chapter 6.2 which deals with income taxed at progressive rates, it is assumed that the contracting states apply a proportional tax.

6.2 Income Taxed at Progressive Rates

6.2.1 Introduction

Income tax, in particular tax on income derived by individuals, such as income from employment, is often levied at progressive rates, meaning that the applicable tax rate rises as the income rises.

Where income is taxed at progressive rates, a taxpayer who derives income from more than one state and whose income is split between these states in accordance with the principle of exemption may achieve progressivity advantages that would not have been present if the entire income had been taxable in only one state. The taking into account of exempted income for the purpose of determining the tax on the remaining income counteracts such progressivity advantages.

As follows from sub-chapter 5.2.6, there are different views as to whether the absence of a proviso safeguarding progression precludes a contracting state from taking into account exempted income for the purpose of determining the tax on the remaining income. In my opinion, an interpretation in accordance with the textual approach advocated by the VCLT implies that
a contracting state is generally free to do so regardless of whether a proviso safeguarding progression has been inserted into the DTT in question, as DTTs do not generally contain any provisions that expressly restrict a contracting state’s right to tax the remaining income. Either way, DTTs often include an express proviso safeguarding progression which clarifies that R is not precluded from taking into account exempted income.

In this section an analysis is made of the effects of the application of exemption with progression and ordinary credit on income taxed at progressive rates and an evaluation is made on the basis of tax neutrality.

6.2.2 Examples

In order to evaluate the methods, the following two examples are considered.

Example 1: X is an individual who has derived income from her employer in R amounting to 100. She has also worked for a subsidiary of the employer in N and has been paid a salary of 100 for the work performed in N. Both R and N tax income from employment at progressive rates. In R, income in the bracket 0–100 is taxed at 20% and income in the bracket 100–200 is taxed at 40%. As regards N, income in the bracket 0–60 is taxed at 30% whereas income above 60 is taxed at 50%.

Example 2: For the purpose of the second example, one element is added. In this case, the internal law of N provides for a basic allowance of 40, meaning that income up to 40 is tax exempt. Consequently, income in the bracket 40–100 is taxed at 30% whereas income above 100 is taxed at 50%.

6.2.3 Evaluation

As set out in sub-chapter 1.2.2, for the purpose of this study tax neutrality is deemed to be achieved when the effective taxation of a transaction corresponds to the tax that would have been levied in either R or in N, had the cross border element not been present (i.e. CEN and CIN respectively). Tax neutrality is also deemed to be achieved if the effective taxation of a transaction is within the range of CEN and CIN. For the purpose of the above examples the transaction is the exercise of an employment in N. However, in order to determine whether that transaction is taxed neutrally with transactions within R or in N, it is in my opinion not sufficient to look at the taxation of the income from the exercise of an employment in N in isolation. Since in this case we deal with income which is taxed at progressive rates, it is relevant to also take into account changes to the taxation of other income which is included in the same tax base as the income from the employment in N that occur as a consequence.
of the fact that the employment is exercised abroad. Furthermore, in order to
determine whether the income from the employment is taxed neutrally with
activities within N, a comparison must in my view be made with a taxpayer
who is resident in N. In such a situation, N would take into account the
income derived in R, which is included in the same tax base, for the purpose
of determining the tax on the income from the employment in N.

If the entire amount of income would have been taxed in R, the R tax on
the entire income would have been 60 (20 % × 100 + 40 % × 100) and the
R tax on the income from the exercise of an employment in N would have
amounted to 30 (100 / 200 × 60). Thus, CEN is achieved where the aggre-
gate tax in R and in N on the income from the employment in N is 30. If,
instead, the income from the exercise of an employment in N is taxed in N
and N would take into account the income derived in R, the N tax would have
amounted to 44 (100 / 200 × (30 % × 60 + 50 % × 140)) as regards example
1 and 34 (100 / 200 × (0 % × 40 + 30 % × 60 + 50 % × 100)) as regards
example 2. Thus, CIN is achieved where the aggregate tax on the income from
the employment in N is 44 (as regards example 1) or 34 (as regards example
2). This means that for the purpose of this study, tax neutrality is deemed to be
achieved where the aggregate amount of tax in R and N on the income from
the transaction is, as regards example 1, anywhere within the range of 30–44,
and, as regards example 2, within the range of 30–34.

The income which is taxable in R is exempt from tax in N in accordance
with the distributive rules. There is typically no proviso safeguarding pro-
gression in N. Although this does not necessarily mean that N is precluded
under the DTT from taking into account the income which is exempt from
tax in N for the purpose of determining the applicable tax rate (cf. sub-
chapter 5.2.6), in most cases N would not take into account such income.
In particular, it is unlikely that N would take into account exempted income
where the taxpayer is a non-resident of N, as N would in such cases typically
only tax income on the basis of a connection between N and an activity or
property that generates the income and there is likely no such connection in
regard to the exempted income. Thus, we will assume that N does not take
into account the income which is exempt from tax in N. In example 1, the
tax imposed by N therefore amounts to 38 (30 % × 60 + 50 % × 40) and in
example 2 the tax imposed by N is 18 (0 % × 40 + 30 % × 60).

I will deal first with the effects of the application of exemption with progres-
sion.

If R were to apply full exemption, the R tax on the remaining income
would be 20 (20 % × 100) instead of 30 (100 / 200 × (20 % × 100 + 40 %

288
Thus, the exercise of an employment in N would result in a progressivity advantage in R of 10 \((30 - 20)\). Since the progressivity advantage is a consequence of the taxpayer’s choice to exercise an employment in N, it would be logical to take it into account for the purpose of determining whether tax neutrality is achieved with regard to the income from the exercise of an employment in N by deducting the progressivity advantage from the N tax. If the progressivity advantage is taken into account, the taxation of the income from the exercise of an employment in N as regards both example 1 and example 2 would be lower than if the income had been taxed in the contracting state with the lowest tax burden, 28 \((38 - 10)\) and 8 \((18 - 10)\) respectively.

However, for the purpose of the valuation, it is the taxation under exemption with progression which is relevant. If R applies exemption with progression, the remaining income is taxed at the same rate is if the entire income would have been taxed in R. In other words, no progressivity advantage is achieved in R. However, this does not rule out a progressivity advantage being achieved in N. The fact that R takes into account exempted income prevents the progressivity advantage in R, but has no effect on a progressivity advantage in N caused by the exemption of income from the tax base in N on the basis of the distributive rules or due to the absence of internal law provisions that provide for taxation of income from R derived by a non-resident taxpayer.\(^{692}\)

In this case N determines the tax on the income from the employment in N, which in example 1 is 38 and in example 2 is 18, disregarding the income in R, which means that there is a progressivity advantage in N of 6 \((44 - 38)\) as regards example 1 and of 16 \((34 - 18)\) as regards example 2. As regards example 1, the progressivity advantage is not sufficient to compensate for the higher tax burden in N as compared to R and the aggregate taxation of 38 therefore does not fall below CEN. As a result, the taxation of the income from the exercise of an employment in N in example 1 is within the range of CIN and CEN. In example 2, on the other hand, where the level of taxation in N is lower and the progressivity advantage in N (as a consequence of higher progressivity) is higher, the progressivity advantage is sufficient to bring the taxation in N down to 18, i.e. below CEN as well as CIN. Thus, as a consequence of the progressivity advantage in N, the aggregate taxation of the transaction is lower than the tax that would have been imposed if the entire income had been taxable in the contracting state with the lowest tax burden.

Thus, the evaluation of exemption with progression can be illustrated as follows.

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<th>non-neutral taxation</th>
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<td>Example 2 CEN</td>
<td>Example 1 CIN</td>
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Now, let us look instead at *ordinary credit*.

Under the ordinary credit method, the pre-credit tax in R is 60 (20% × 100 + 40% × 100). The R tax which is considered attributable to the foreign income is 30 (60 × 100 / 200). In other words, according to the foreign tax credit limitation, N tax on the foreign income in excess of 30 is not creditable.

Where a DTT obliges R to eliminate double taxation by means of the principle of credit, R takes into account the entire income of the taxpayer for the purpose of determining the pre-credit tax. In other words, the application of the principle of credit in a situation where domestic as well as foreign income is derived by a taxpayer does not give rise to any progressivity advantage in R.

As regards example 1, the post-credit R tax on the income from an employment exercised in N would be zero as the N tax exceeds the pre-credit R tax which is attributable to the income from the transaction and therefore cancels the R tax. As a consequence, the aggregate tax on the income from the transaction would correspond to the N tax, 38. The fact that N does not take into account income which is exempted under the distributive rules leads to a progressivity advantage in N. If N would have taken into account the income which is exempted under the distributive rules, the N tax would have been 44, i.e. 6 (44 – 38) higher. No further credit from the R tax would have been allowed as the N tax already exceeds the foreign tax credit limitation. Thus, it can be concluded that the application of ordinary credit by R does not rule out a progressivity advantage being achieved in N due to the exemption of income from the tax base in N. However, although the progressivity advantage in N results in lower N tax, the aggregate taxation is within the range set by CIN and CEN.

In example 2, the entire N tax of 18 is creditable as it falls below the foreign tax credit limitation. The post-credit R tax is 12 (30–18). The aggregate amount of tax is therefore 30 (12 + 18). If N would have taken into account the income which is exempted under the distributive rules, the N tax would
have been 34. Thus, the exemption of income by N results in a progressivity advantage in N of 16 (34–18). However, to the extent that the N tax falls below the foreign tax credit limitation in R, the decrease of N tax caused by the progressivity advantage is absorbed by R and does not result in lower aggregate tax. The aggregate amount of tax, 30, corresponds to the tax on the transaction that would have been imposed by R if the entire income had been taxable in R, i.e. CEN.

The evaluation of ordinary credit can be illustrated as follows.

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<th>non-neutral taxation</th>
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<tr>
<td>CEN</td>
<td>Example 1</td>
<td>CIN</td>
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<td>Example 2</td>
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Sweden generally applies the principle of credit as its main method for providing double tax relief under DTTs. However, in respect of certain items of income exemption is applied under the double tax relief article, as a complement to the principle of credit, and exemption may also apply under the distributive rules. Although many Swedish DTTs expressly give Sweden a right to take into account income which it exempts in its capacity as R for the purpose of determining the tax on the remaining income, Sweden generally refrains on a unilateral basis from doing so (see sub-chapter 5.2.6). Thus, regardless of whether Sweden acts in a capacity as R or N it normally applies full exemption rather than exemption with progression. Where Sweden acts as N, the above analysis is thus fully relevant. Furthermore, where Sweden acts as R, progressivity advantages in R may exist in addition to progressivity advantages in N. This will make non-neutral taxation even more likely.

To summarise, the following conclusions can be drawn. Although exemption with progression prevents progressivity advantages from being achieved in R, it does not prevent progressivity advantages from being achieved in N. Such progressivity advantages may lead to taxation of income from a transaction being lower than if, under similar circumstances, the income would have been taxed in the contracting state with the lowest tax burden. Similarly, the application of the principle of credit does not prevent progressivity advantages as regards the taxation in N. However, the principle of credit does not allow the aggregate taxation to fall below CEN. A reduction of N tax caused by a progressivity advantage leads, to the extent that the N tax falls below the R tax, to a corresponding increase of R tax, i.e. the progressivity advantage is
absorbed by R. To the extent that the N tax is higher than the R tax, a reduction of the N tax caused by a progressivity advantage in N results in lower aggregate taxation than if no progressivity advantage existed, but the principle of credit ensures that the aggregate taxation of the income that may be taxed in N does not fall below the tax that would have applied if the entire income would have been taxable only in R.

Thus, when it comes to income which is taxed at progressive rates, the principle of credit is better equipped to ensure that the goal of tax neutrality is reached. It can be noted that the progressivity advantage in N which may cause the taxation to become non-neutral is not due to DTT provisions per se, but a consequence of the fact that N typically does not take into account income which is exempt from tax in N under the distributive rules of a DTT for the purpose of determining the tax on the remaining income. As follows from the analysis in sub-chapter 5.2.6 above, the absence of a proviso safeguarding progression in N does not necessarily preclude N from taking into account exempted income. Thus, by amending its internal law so as to take into account exempted income for the purpose of determining the tax on the income which is taxable in N it may be possible for N to ensure that the tax relief provided according to exemption with progression is in line with the goal of tax neutrality.

6.3 The Effect of Income Derived From a Third State

6.3.1 Introduction

The obligation to provide double tax relief under a DTT is determined on a bilateral basis. Even where a DTT is multilateral, it does not provide for a coordinated means of double tax relief between all contracting states, but rather it applies to the relation between two states and functions by limiting on a mutual basis the taxing rights in respect of specific items of income. Thus, DTTs are applied without taking into account the taxation in third states. However, DTTs may be complemented by internal law provisions that do take into account the taxation in a third state. This is the case, for example, as regards the computation of the foreign tax credit limitation according to the overall limitation.

The purpose of sub-chapter 6.3 is to evaluate exemption with progression and ordinary credit from the perspective of tax neutrality in a situation where income is derived from a third state.
6.3.2 Example
Consider the following example.

The company A is resident in R. A has a sales office in N, which is deemed to constitute a PE in N. Furthermore, it has a sales office in a third state, X, which is also deemed to constitute a PE. It has derived income of 100 from each of the PEs, but zero income from its activities in R. The tax rate in R is 30 %, whereas the tax rates in N and X are 40 % and 20 % respectively.

6.3.3 Evaluation
For the purpose of the evaluation, we will look at the taxation of the sales activities in N. As the tax in R is 30 %, the R tax on the income would have amounted to 30 (30 % × 100), if the transaction would have been taxable in R only. If taxation would have taken place in N only, the tax would have been 40 (40 % × 100). Thus, tax neutrality is deemed to be achieved if the aggregate taxation of the transaction is within the range of 30–40.

If we look first at exemption with progression, that method has the effect of excluding the income from the PE in N from the tax base in R, resulting in taxation of the sales activities in N only. The N tax is 40 (40 % × 100). In other words, tax neutrality in the form of CiN is achieved.

If we look instead at ordinary credit, the evaluation is somewhat more complex.

If R applies a per country limitation, A will be able to credit N tax of 30, but it will not be able to offset the tax paid in N in its entirety, since the foreign tax credit limitation limits the credit to 30 (60 × 100 / 200), i.e. the R tax of 60 (30 % × 200) applied to the income derived from N over the worldwide income. As a consequence, the aggregate taxation of the transaction amounts to 40 (30 + 40 – 30), i.e. the pre-credit R tax of 30 plus the N tax of 40 less the credit for N tax of 30. This means that tax neutrality in the form of CiN is achieved. Thus, although the principle of credit is typically associated with CEN, this is an example of a situation where the principle of credit instead leads to CiN as a result of the fact that the N tax exceeds the R tax.

If, on the other hand, R applies the overall limitation, the income from X and the tax paid in X is taken into account for the purpose of determining the foreign tax credit limitation. As a result, the foreign tax credit limitation for all foreign income is 60 (60 × 200 / 200), i.e. the R tax of 60 (30 % × 200) applied to the foreign income (i.e. the income from N and X) over the worldwide income. As the total amount of tax paid in N and X does not exceed the tax paid in R in respect of the profits attributable to the PEs, the
The entire amount of tax paid in N can be credited. Thus, A will be allowed to offset the tax of 40 paid in N even though this amount exceeds the R tax rate applied to the profits attributable to the PE in N. As a consequence, the aggregate taxation of the income from N is 30 (30 + 40 – 40), meaning that CEN is achieved.

The principle of credit generally operates to reduce the effective over-all rate of tax to the higher of the N or the R tax. When the N rate is higher, only the N tax is paid. When the N rate is lower, the effective over-all rate of tax is the R tax. However, as the above example shows, under an overall limitation, cross-crediting of excess foreign taxes on income derived from a relatively high-taxed country against tax in R on income derived from a low-tax country concedes the residual tax in R on such low-taxed foreign income to investments in a high-tax foreign country. As a consequence, CEN may be achieved regardless of the fact that the foreign tax exceeds the R tax on the income in question in the same way as if R would have applied full credit. This means that a foreign tax credit system that allows excessive crediting of foreign taxes may be more generous to investment in high-tax countries than an exemption system. This is because under an exemption system tax exceeding the taxation in R cannot be used as credits against tax on other income.

However, although the principle of credit in combination with overall limitation may result in lower aggregate taxation of a transaction than the principle of exemption insofar as a taxpayer has derived income from a state which imposes higher tax than R as well as income from a state which imposes lower tax than R, the taxation of a transaction will not fall outside the range set by CEN and CiN, as the credit cannot exceed the tax paid in N on the income resulting from the transaction. In other words, the overall limitation is not contrary to the goal of tax neutrality.

694 Ibid, p. 772. According to Vogel and others, Doppelbesteuerungsabkommen Der Bundesrepublik Deutschland Auf Dem Gebiet Der Steuern Vom Einkommen Und Vermögen (2008), Art. 23, para. 145, the ordinary credit method never leads to lower taxation than exemption with progression. The above shows that the statement needs to be qualified by adding that, under specific circumstances, the principle of credit in combination with overall limitation may result in lower aggregate taxation.
695 Ibid, p. 671.
For the purpose of this study, tax neutrality is deemed to be achieved when the effective taxation of a transaction corresponds to the tax that would have been levied in either the state of residence or in the other state, had the cross border element not been present, i.e. CEN and CIN respectively. The logic behind delimitating the evaluation criterion in such a way is that a taxpayer’s decision to undertake a transaction is normally not affected by the decision to undertake other transactions. If the transaction is sufficiently profitable, it is undertaken, otherwise not. However, sometimes a transaction may be linked to other transactions so that it becomes relevant to evaluate the aggregate effect of more than one transaction.

For instance, as regards the above example it would normally be relevant for the taxpayer to decide whether to open a sales office in N on the basis of that transaction alone, i.e. without regard to the effects of the opening of a sales office in X. Consequently, it would be relevant to determine CEN and CIN on the basis of that transaction alone. However, there may be situations where the opening of a sales office in N presupposes the opening of a sales office in X, so that it becomes relevant to look at both transactions as an aggregate. If so, CIN would have to be determined on the basis of the tax in N and X. Thus, CIN would be achieved where the aggregate tax is 60 (40 % × 100 + 20 % × 100). CEN would be achieved where the taxation equals the R tax on both transactions, i.e. 60 (30 % × 200). In other words, unless the aggregate taxation of both transactions is 60, tax neutrality is not achieved.

If the taxation of the activities in N and X is looked at as an aggregate, the evaluation of exemption with progression and ordinary credit would produce the following result. According to exemption with progression, no taxation would take place in R and the aggregate taxation would therefore equal the sum of the N tax and the X tax, i.e. 60 (40 % × 100 + 20 % × 100). Thus, the application of exemption with progression would lead to tax neutrality. If ordinary credit is applied, the outcome would depend on the form of limitation applied. If R applies overall limitation, the entire tax paid in N and X would be creditable, so that tax is paid in N only, again leading to tax neutrality. However, under a per-country approach, only 30 of the N tax would be creditable (60 × 100 / 200). The aggregate tax would therefore be 70 (60 + 40 – 30 + 20 – 20), i.e. the pre-credit R tax of 60 plus the N tax of 40 less the credit for N tax which is limited to 30 plus the X tax less the credit for X tax. The aggregate taxation would neither equal CIN nor CEN. Thus, insofar as foreign income from more than one country is looked at as an aggregate, computation of the foreign tax credit limitation in accordance with the overall limitation would be required in order to ensure that the aggregate tax on
foreign income does not exceed the tax that would have applied if the income had been taxed only in R or abroad. In other words, the fact that ordinary credit under a per-country limitation results in taxation at the higher of CEN and CIN in relation to each foreign state means that the taxation of all foreign income looked at as an aggregate may exceed CEN as well as CIN. However, as a taxpayer normally decides whether to undertake a transaction on the basis of the merits of that transaction alone, it is submitted that it is normally appropriate to make the evaluation on the basis of each transaction.

As follows from sub-chapter 5.4.13.1, Sweden essentially applies overall limitation for computing the foreign tax credit limitation. According to the above evaluation the application of overall limitation is consistent with the goal of tax neutrality.

6.4 Timing Mismatch

6.4.1 Introduction

As tax is imposed under the internal laws of the contracting states, the amount of taxable income is determined on the basis of internal law provisions. In order to assess the taxable income of a taxpayer, it is necessary to determine when taxable income arises, i.e. when the taxable event occurs. Occasionally, differences in the principles for determining when the taxable event occurs lead to the imposition of tax in different periods by the contracting states, sometimes referred to as a “timing mismatch”. In this sub-chapter, the effects of the application of exemption with progression and ordinary credit in a situation where there is a timing mismatch are analysed and an evaluation is made from the perspective of tax neutrality.

6.4.2 Examples

In order to evaluate the methods, the following examples are applied.

Example 1: X is an individual who is resident in R. X owns immovable property situated in another state, N. In year 1, X enters into an agreement regarding sale of the property. In year 2, X receives the consideration for the property.

According to the distributive rules of the DTT between R and N, a capital gain made by a resident of R in respect of immovable property in N may be taxed in both R and N. The double tax relief article provides that R shall provide double

tax relief in respect of such income. According to the tax law of N, the capital gain is taxed when there is a binding agreement between the seller and the buyer, i.e. in year 1. In R, taxation takes place when the taxpayer receives the consideration for the property, i.e. in year 2.

Example 2: For the purpose of the second example, the circumstances are the same as in example 1, except that it is R which taxes the capital gain when there is a binding agreement between the seller and the buyer, i.e. in year 1, and N which taxes the capital gain when the taxpayer receives the consideration for the property, i.e. in year 2.

6.4.3 Evaluation

First, we look at the consequences of the timing mismatch on the application of exemption with progression.

If R applies exemption with progression, the capital gain on the immovable property is not taxable in R, regardless of when taxation in N takes place. Thus, the transaction is taxed in N only, resulting in CIN. As tax neutrality for the purpose of this study is considered to be achieved where the aggregate taxation is within the range set by CEN and CIN, it can be concluded that tax neutrality is achieved in example 1 as well as in example 2, regardless of the timing mismatch.

It can be noted that the taking into account of exempted income by R for the purpose of determining the tax on remaining income which is taxed at progressive rates is in general unaffected by a timing mismatch as R normally determines the amount of exempted income on the basis of its internal law, disregarding the amount of income which is considered taxable by N (see sub-chapter 5.2.6).

Where N taxes the income in a later period, as is the case in example 2, the application of exemption with progression by R may lead to double non-taxation in the year when the taxable event occurs under R’s internal law. Where provisions have been inserted in the DTT to counter double non-taxation, such as a subject-to-tax clause, this raises the question whether such provisions are triggered by the exemption of income by R which is not taxable in N in that period, but in a later period. However, that question falls outside the scope of the analysis undertaken in this sub-chapter.

Second, let us consider the consequences of the timing mismatch on the application of ordinary credit.

A credit is generally only allowed for foreign tax that has been paid (see sub-chapter 5.4.12). Furthermore, under ordinary credit, the credit is limited to
that portion of the tax paid in R which is appropriate to the income derived from N.

As regards example 1, there is in year 1 no R tax attributable to the foreign income and, hence, the foreign tax credit limitation in that year is zero. Furthermore, there may not even be any R tax at all to credit the N tax against, unless the taxpayer has derived other income which is taxable in R in year 1. As regards example 2, there is in year 1 no tax paid in N which can be credited against the tax liability in R. Both situations therefore raise the question as to whether the taxpayer is entitled to credit N tax on the capital gain.

If R in any of the above situations denies a credit as a result of the timing mismatch, tax will be imposed in R as well as in N, albeit in different periods. If so, the aggregate taxation of the transaction will exceed the highest of the R and the N tax. Thus, if the credit mechanism in R does not take into account N tax which is paid in a previous or later year, tax neutrality will not be achieved.

However, R may provide a credit for N tax despite the fact that it is imposed by N in a different period than the R tax. Where the N tax is paid in a previous year, as in example 1, this presupposes either that R allows a credit in year 1 for the N tax against R tax on other income, despite the fact that the R tax in year 1 attributable to the capital gain is zero, or that R allows a credit in year 2 from the tax liability in R for N tax relating to a previous period. Where N tax is imposed in a later year, as is the case in example 2, a credit can be allowed from the R tax in year 1 by means of reassessment of that year when the N tax has been paid.

It can be argued that it is an obligation rather than an option for R to allow a credit for N tax imposed in a different period, as the double tax relief article provides that R shall credit N tax on income that according to the DTT may be taxed in N, without restricting that obligation to N tax imposed in the same year as R imposes tax (see sub-chapter 4.3.3.2).

If R, in example 1, allows a credit in year 2 when the income in question is taxable in R for N tax imposed in year 1, the credit in year 1 is zero. Thus, looking at year 1 in isolation, the income is taxed in N only and tax neutrality in the form of CIN is achieved. When, in year 2, the income is taxable in R, the N tax is credited to the extent that it does not exceed the R tax which is appropriate to the foreign income. Thus, if the R tax is higher than the N tax so that the entire amount of N tax can be credited, the aggregate amount of tax will correspond to the R tax, i.e. CEN. If instead the N tax is higher than the R tax, the N tax will cancel the tax liability in R so that no tax is payable in R. As a consequence, the aggregate taxation will consist of the tax imposed
by N in year 1, i.e. CIN. In either case, the application of the ordinary credit method results in taxation within the range set by CIN and CEN.

If N imposes tax in a later year, as in example 2, no N tax will have been paid when R imposes tax and, hence, the aggregate taxation in that year will consist of the R tax, i.e. CEN. If R allows a credit for the N tax when it is imposed, it will be creditable to the extent that it does not exceed the R tax which is attributable to that income. Insofar as the R tax has already been paid, the credit will have to be implemented through repayment of previously paid R tax or through a reduction of R tax on other income attributable to a later year. Either way, the outcome will amount to CEN if the R tax exceeds the N tax and CIN if the N tax exceeds the R tax.

Thus, insofar as R credits N tax imposed in a previous or later year, it can be concluded that tax neutrality is achieved regardless of the timing mismatch. If R does not allow a credit for N tax imposed in a different period, taxation will take place in both states, meaning, of course, that the aggregate taxation of the transaction will exceed the highest of the R and the N tax and that, as a result of the timing mismatch, tax neutrality is not achieved.

In regard to Sweden, it can be observed that Sweden applies ordinary credit as its main method for providing double tax relief, under DTTs as well as on a unilateral basis. As follows from sub-chapter 5.4.11, Swedish law provides for a credit of foreign tax against Swedish tax when the income which is taxable in a foreign state is included in the tax base for the purpose of determining the Swedish tax. Thus, Swedish law provides for a credit regardless of whether foreign tax is paid in a previous or a later period. Thus, it seems that the Swedish tax credit system has adequate tools for dealing with timing mismatches and that it, insofar as timing mismatches are concerned, is designed in a way which is in accordance with the goal of tax neutrality.

6.5 Differing Attribution of Income and Allocation of Expense to R or N

6.5.1 Introduction

In this section the effects of exemption with progression and ordinary credit in a situation where the contracting states apply differing attribution of income and/or allocation of expense to R or N are analysed and the methods are evaluated from the perspective of tax neutrality.

The attribution of income and allocation of expense to R or N are matters that are dealt with by DTTs. Thus, to some extent differences in the attribu-
tion of income and allocation of expense according to the internal laws of the contracting states are taken care of by the DTT. For instance, the internal law of N may attribute income of an enterprise to N on the basis that the enterprise sells products to customers in N, whereas the DTT provides that such income shall be attributed to R as there is no PE in N and, consequently, preclude N from taxing the income. However, DTT provisions merely provide general principles for attribution of income and allocation of expense and therefore frequently needs to be complemented by internal law. This means that differences in the attribution of income and allocation of expense may occur on the basis of differences in the internal laws of the contracting states, which cannot be overcome through application of the DTT in question (see sub-chapter 4.3.4).

6.5.2 Example
The following example provides a starting point for the evaluation.

A is a wine-producing company which is resident in R. A has set up an office in N in order to handle marketing and sales there. According to the tax laws of both R and N, the office in N is deemed to constitute a PE. A raises a loan and transfers money to the office in N to cover expenses connected with the setting up of the office in N. The yearly interest costs relating to the loan amount to 40. A's income in R before deduction of interest costs is 400. Out of these, 100 are considered attributable to the PE in N. The corporate tax rate in R is 25 % and the corporate tax rate in N is 30 %.

As regards the interest costs, three different approaches can be discerned.
1. The interest costs in their entirety are considered attributable to the PE in N.
2. The interest costs are considered as an overhead cost for the business of A and therefore attributable to the operations in N on a pro rata basis, meaning that interest costs of 10 (40 × 100 / 400) are attributed to the operations in N.
3. The interest costs in their entirety are considered attributable to the operations in R, meaning that no part of the interest costs is considered attributable to the PE in N.

6.5.3 Evaluation
As long as R and N adopt the same approach as regards the allocation of interest costs, the application of exemption with progression by R results in taxation of the income from the PE in N only, meaning that CIN is achieved, regardless of the choice of approach. A part of the interest costs may be taken into account by both contracting states according to their internal laws, but
since R exempts the income from the PE in N and, as a consequence, also
exempts any interest costs allocated to the PE, the application of the prin-
ciple of exemption has the effect of ensuring that the interest costs are taken
into account only once.

If R and N adopt the same approach as regards the allocation of interest
costs and R applies ordinary credit, the N tax will be credited from the R tax
on the income from the PE insofar as it does not exceed the R tax. If the N
tax is lower than the R tax on the income from the PE, the entire N tax can
be credited and the aggregate taxation of the operations of the PE will cor-
respond to the tax that would have applied in R if the income from the PE
would have been taxable in R only, meaning that CEN is achieved. The part
of the interest costs which are allocated to the PE are taken into account by
both R and N according to their internal laws, leading to a reduction of tax
under the internal laws of R as well as N. However, the part of the interest
costs which is allocated to the PE causes a reduction of N tax, which, as long
as the R tax exceeds the N tax, is compensated by a corresponding increase
of R tax by means of a reduction of the credit of foreign tax. The application
of ordinary credit in this case therefore means that the interest costs are, in
the end, taken into account only once. If the N tax exceeds the R tax on
the income from the PE, the tax liability in R is cancelled. Taxation of the
income from the PE will therefore take place in N only, meaning that CIN
is achieved. Since taxation takes place in N only, the interest costs allocated
to the PE are taken into account only once.

Thus, although a part of the interest costs may be taken into account
according to the internal laws of both R and N, the application of either
exemption with progression or ordinary credit ensures that the interest costs
are, in the end, taken into account only once, provided that the contracting
states adopt the same approach as regards the allocation of interest costs. The
taxation is therefore within the range set by CEN and CIN.

However, it may very well happen that the contracting states adopt dif-
ferent approaches as regards the allocation of the interest costs to R or N.
The difference in attribution of income or allocation of costs may be due to
a disagreement between the contracting states on the facts of a case or on the
interpretation of the DTT. Where the disagreement relates to the facts of a
case or the interpretation of the DTT, it may be possible to find a solution
under the DTT based on a mutual agreement procedure. However, differ-
ences in the attribution of income or allocation of expense may also be due
to differences in the principles of the internal laws of the contracting states
for attributing income and allocating costs. If the attribution of income or
allocation of expense under the internal laws of the contracting state is not contrary to the DTT, the difference cannot be resolved under the DTT.

As regards the examples referred to above, two situations can be distinguished; R may either allocate less interest costs to the PE in N than N does or it may allocate more interest costs to the PE.

As regards the first-mentioned situation, we assume for the purpose of determining whether tax neutrality is achieved that R considers the interest costs as an overhead cost and therefore allocates interest costs of only 10 to the PE in N, whereas N considers the interest costs in their entirety as attributable to the PE and therefore allocates interest costs of 40 to the PE in N. Thus, the tax imposed by N on the income from the PE is 18 (30 % × (100–60)) and the tax imposed according to the internal law of R on the income from the PE is 22.5 (25 % (100–10)).

For the purpose of this study, tax neutrality is defined as a situation where the effective taxation of a transaction corresponds to the tax that would have been levied in either of R or N, had the cross border element not been present (CEN and CIN respectively), or where the aggregate taxation is within the range set by CEN and CIN. In this case the interest costs are taken into account according to the internal laws of both R and N, meaning that a corresponding amount of income is subject to double non-taxation. Unless the application of the methods for elimination of double taxation removes the double non-taxation, the effect of the double non-taxation that occurs as a result of the cross border element would have to be taken into account in order to be able to make a relevant comparison with a situation where taxation would have taken place in R or N only.

Thus, for the purpose of determining whether CIN or CEN is achieved, it would be relevant to take into account the reduction of tax that occurs as a result of the fact that the interest costs according to the internal laws of R and N are taken into account twice, since the interest costs would have been taken into account only once in a domestic situation. As follows from the above, double non-taxation that occurs as a result of the fact that interest costs are taken into account twice is eliminated by the application of the methods for elimination of double taxation where the contracting states adopt the same approach as regards the allocation of interest costs. However, where different approaches are taken, the outcome is more complex.

Furthermore, a problem in this context is that it would be possible to take into account the reduction of tax that occurs as a result of the fact that interest costs are taken into account twice either from the standpoint of R, by compensating for the “incorrect” deduction of interest costs in N, or
from the standpoint of N, by compensating for the “incorrect” deduction of interest costs in R.

Thus, if we start by looking at exemption with progression, we can note that the amount of tax imposed by N is 18 and that R does not tax the income from the PE. If we take the view that the allocation of interest costs made by R is correct and that N incorrectly allocates interest costs of 30 to the PE, we can conclude that the R tax on the remaining income is correct but that the N tax on the income from the PE should have been 27 (30 % (100 – 10)) and that the N tax is therefore 9 (27 – 18) lower than what would correctly reflect CIN. Further, as CEN is achieved if the aggregate taxation is 22.5, the taxation is 4.5 (22.5 – 18) lower than what would correspond to CEN. If, instead, we take the view that the allocation of interest costs made by N is correct and that R incorrectly allocates interest costs of 30 to the remaining income, we can conclude that the N tax of 18 on the income from the PE correctly reflects CIN, but that the R tax on the remaining income should have been 7.5 (25 % × 30) higher and that the aggregate tax imposed is therefore 7.5 too low to correctly reflect CIN. Further, aggregate taxation of 15 (25 % × (100 – 40)) would have reflected CEN. In this case, N imposes tax of 18, but since R incorrectly allocates interest costs of 30 to the remaining income, the aggregate taxation is in effect only 10.5 (18 – 7.5). Thus, as a result of the differing allocation of interest costs, the aggregate taxation of the transaction falls below CEN as well as CIN.

As regards ordinary credit, an initial question is whether the N tax of 18 can be credited from the R tax. As the credit of foreign tax is limited by the amount of R tax which R considers to be attributable to the PE, it follows that the foreign tax credit limitation is 22.5 (90 × (100 – 10) / 360), i.e. the pre-credit R tax (computed as the R tax rate applied to the worldwide income) applied to the foreign income over the worldwide income. This means that the entire N tax is creditable in spite of the fact that the N tax rate exceeds the R tax rate. The post-credit R tax on the income from the PE is 4.5 (22.5 – 18) and the aggregate tax on the income from the PE is 22.5. If we take the view that the allocation of interest costs made by R is correct and that N incorrectly allocates interest costs of 30 to the income from the PE, it follows that the N tax should have been 27 (30 % × (100 – 10)). Thus, the aggregate tax falls below CIN. However, since we take the view that the allocation of interest costs made by R is correct and since the aggregate taxation of the income from the PE corresponds to the tax that would have applied if the income from the PE would have been taxable in R only, it can be concluded that CEN is achieved. In other words, the reduction of N tax caused by the incorrect
allocation of interest costs by N is partly compensated by an increase in R tax which causes the aggregate taxation to equal CEN. If, instead, we take the view that the allocation of interest costs made by N is correct and that R has incorrectly allocated interest costs of 30 to the remaining income, it follows that the R tax on the income from the PE should have been 15 (25 % (100 – 40)). If so, the entire R tax liability should have been cancelled by the N tax of 18 and tax on the income from the PE should only have been payable in N. Instead, the aggregate taxation of the income from the PE is 22.5. However, as R determines the pre-credit tax liability on the basis of the worldwide income, the incorrect allocation of interest costs of 30 by R leads to a corresponding reduction of the income which is taxable in R only and, as a consequence, a decrease of the R tax on that income by 7.5 (25 % × 30). If the reduction of tax on the income which is taxable in R only is taken into account, it can be concluded that the aggregate taxation of the transaction amounts to 15 (22.5 – 7.5). In other words, the increase in tax on the income from the PE caused by the incorrect allocation of interest costs is compensated by an equally high decrease in tax on the income which is taxable in R only. Thus, as long as the entire N tax can be credited, the incorrect allocation by R has no effect on the overall taxation of the transaction and CEN is therefore achieved.

We now turn to the last-mentioned situation referred to above, namely a situation where R allocates more interest costs to the PE in N than N does. We assume for the purpose of determining whether tax neutrality is achieved that R considers the entire interest costs attributable to the PE and therefore allocates interest costs of 40 to the PE in N, whereas N considers the interest costs as an overhead cost and therefore allocates interest costs of only 10 to the PE in N.

In this situation, the problem is not that double non-taxation may occur as a result of the fact that both contracting states take into account the interest costs and that such double non-taxation may not be removed by the application of the methods for elimination of double taxation. Rather, the problem is that a part of the interest costs may not be taken into account at all due to the different approach taken by R and N with regard to the allocation of interest costs in combination with the application of the methods for elimination of double taxation, resulting in unresolved double taxation.

Thus, in order to evaluate whether the aggregate taxation of the transaction is within the range set by CEN or CiN, it would be relevant to take into account the increase in the overall taxation that occurs as a result of the fact that the contracting states allocate interest costs differently.

The tax imposed under the internal law of N on the income from the PE
is 27 (30% × (100 – 10)) and the tax imposed under the internal law of R is 15 (25% × (100 – 40)). If R applies exemption with progression, taxation of the income from the PE will take place in N only. If we take the view that the allocation of interest costs made by R is correct and that N incorrectly allocates interest costs of only 10 to the PE, we can conclude that the R tax on the remaining income is correct but that the N tax on the income from the PE should have been 18 (30% × (100 – 40)). The taxation of the transaction is therefore 9 (27 – 18) too high to correspond to CIN and 12 (27 – 15) too high to correspond to CEN. If, instead, we take the view that N has correctly allocated interest costs of only 10 to the PE, the taxation in N of the income from the PE of 27 correctly reflects CIN. However, as R has not allocated any interest costs to the remaining income but should have allocated 30, the R tax on the remaining income is 7.5 (25% × 30) higher than under a correct allocation. Taking into account the increase in R tax caused by the incorrect allocation of interest costs, the overall taxation of the transaction is 34.5 (27 + 7.5), exceeding CIN by 7.5 (34.5 – 27). Furthermore, under a correct allocation, the tax in R on the income from the PE should have been 22.5 (25% × (100 – 10)). Thus, the taxation is 12 (34.5 – 22.5) higher than CEN. In other words, the unresolved double taxation caused by the difference in allocation of interest costs leads to non-neutral taxation.

If R applies ordinary credit, the N tax is creditable insofar as it does not exceed the R tax which is attributable to the foreign income, i.e. the foreign tax credit limitation, which in this case is 15 (25% × 360 × (100 – 40) / 360). As the N tax exceeds the foreign tax credit limitation, the entire R tax liability is cancelled by the N tax, meaning that taxation takes place in N only. The outcome is therefore the same as under exemption with progression. If we take the view that the allocation of interest costs made by R is correct and that N incorrectly allocates interest costs of only 10 to the PE, we can conclude that the R tax on the income which is taxable in R only is correct but that the N tax on the income from the PE should have been 18 (30% × (100 – 40)). The taxation of the transaction is therefore 9 (27 – 18) too high to correspond to CIN and 12 (27 – 15) too high to correspond to CEN. If, instead, we take the view that N has correctly allocated interest costs of only 10 to the PE, the taxation in N of the income from the PE of 27 correctly reflects CIN. However, as R has not allocated any interest costs to the income which is taxable in R only but should have allocated 30 to that income, the R tax on the income which is taxable in R only is 7.5 (25% × 30) higher than under a correct allocation. Taking into account the increase in R tax caused by the incorrect allocation of interest costs, the overall taxation of the transaction is 34.5 (27
+ 7.5), exceeding CIN by 7.5 (34.5 – 27). Furthermore, under a correct allocation, the pre-credit tax in R on the income from the PE should have been 22.5 (25 % × (100 – 10)). Thus, the taxation is 12 (34.5 – 22.5) higher than CEN. In other words, the unresolved double taxation caused by the difference in allocation of interest costs leads to non-neutral taxation.

To sum up, differences in the attribution of income and allocation of expense to R or N may result in double non-taxation that is not removed by the application of the methods for elimination of double taxation, leading to aggregate taxation which falls below CEN as well as CIN. Furthermore, differences in attribution of income and allocation of expense to R or N in combination with the application of the methods for elimination of double taxation may result in unresolved double taxation, i.e. taxation in excess of CEN as well as CIN.

As follows from the above, it seems that ordinary credit stands a greater chance than exemption with progression of achieving an outcome which is consistent with the goal of tax neutrality as defined for the purpose of this study, as an incorrect attribution of income or allocation of expense resulting in an increase or decrease in tax under the ordinary credit method may be compensated by an equally high decrease or increase in tax. For instance, an unjustified decrease in N tax may result in a lower credit and, hence, may be compensated by an equally high increase in R tax. Furthermore, an unjustified decrease in R tax on the foreign income may be compensated by an equally high increase in R tax on the income which is taxable in R only (if the N tax is within the foreign tax credit limitation). Similarly, an unjustified increase in N tax may result in an equally high increase of the foreign tax credit (if the N tax, taking into account the increase, is within the foreign tax credit limitation) and, hence, be compensated by a decrease in R tax. Moreover, an unjustified increase in R tax on the foreign income may be compensated by an equally high decrease in R tax on the income which is taxable in R only.

The tax laws of Sweden, just like the tax laws of any other state, contains rules and principles for determining whether an item of income or expense shall be considered as domestic or foreign. Consequently, differences in the attribution of income and allocation of expense between R and N by Sweden and another contracting state may cause double taxation or double non-taxation and result in taxation which is not in accordance with the goal of tax neutrality. In this regard it seems appropriate that Sweden applies ordinary credit as its main method for providing double tax relief, under DTTs as well as on a unilateral basis, as the ordinary credit appears to be better equipped to achieve a result which is consistent with the goal of tax neutrality.
6.6 Losses

6.6.1 Introduction
Most states treat losses in symmetry with income. As a consequence, losses are only considered deductible if corresponding income is taxable. For instance, a state would typically not allow a taxpayer to deduct losses in a situation where corresponding income would have been exempted in accordance with the principle of exemption (see sub-chapter 5.2.4). In contrast, under the principle of credit, the pre-credit tax is typically determined on the basis of the worldwide income. Therefore, losses would in most cases be deductible as corresponding income would have been included in the worldwide income for the purpose of determining the pre-credit tax (see sub-chapter 5.4.3).

In this section the effects of the application of ordinary credit and exemption with progression on the taxation in a situation where losses have been incurred in either N or R are analysed and an evaluation of the methods is made on the basis of tax neutrality.

6.6.2 Examples
The following examples can be taken as a starting point for the evaluation.

Example 1. A is a company which manufactures and sells raincoats. A has recently set up a sales office in N, which is considered by both R and N as constituting a PE in N. During the start-up phase of the sales office, the costs attributable to the PE have exceeded the income, so that the income attributable to the PE is negative by 50. The activities in R, on the other hand, have generated income of 100. The tax rate in R is 30 %, whereas the tax rate in N is 20 %.

Example 2. For the purpose of the second example the circumstances of the above example are reversed so that the income attributable to the PE in N is 100, whereas the activities in R have resulted in negative income of 50.

6.6.3 Evaluation
For the purpose of determining whether the income from the investment in N is taxed neutrally in example 1, we can start by noting that since the income from the PE is negative, no tax is imposed on that income, neither under the internal law of R nor under the internal law of N. However, that is not sufficient to conclude that the taxation of the income from the PE is treated neutrally with transactions within R or N. As pointed out in sub-chapter 1.2.2, changes in the taxation of other income that occur as a consequence of the cross border element also have to be taken into account.
Assuming that the internal law of R provides for a deduction of losses relating to a sales office in R, the negative income of the sales office would have resulted in a reduction of the R tax by 15 (50 × 30 %) in the absence of a cross border element. Similarly, if the entire income of the taxpayer would have been taxable in N, the negative income would have resulted in a reduction of N tax by 10 (50 × 20 %), assuming that the internal law of N would have provided for a set off of the negative income against the other income of the taxpayer. Thus, CEN is achieved where the negative income of the PE in N results in a negative tax of 15 and CIN is achieved where it results in a negative tax of 10.

Now let us turn to the effects of the methods for elimination of double taxation. First, we look at the taxation of the transaction where exemption with progression is applied. As pointed out above in sub-chapter 5.2.4, most states would treat losses in symmetry with income, meaning that losses are considered deductible insofar as corresponding income is taxed and non-deductible if corresponding income is tax exempt, for instance on the basis of the provisions of a DTT. Thus, typically, R would deny the taxpayer to deduct the losses in N from the remaining income. As a consequence, R would not impose any tax on the negative income from the PE, but the R tax on remaining income, which is 30 (30 % × 100), would be unaffected by the negative income from the PE. Therefore, neither CEN nor CIN would be achieved, at least not in the year when the losses in N were incurred. However, insofar as the internal law of N provides for a carry forward or carry back of the losses to a year in which the income attributable to the PE is positive so that the losses can be deducted from taxable income in N, the losses in N will result in a negative tax of 10, meaning that CIN is achieved. If the internal law of N does not provide for such a carry forward or carry back of losses or if there is not sufficient positive income attributable to the PE to enable the taxpayer to utilise the entire amount of losses in another year, the taxation would exceed the range set by CIN and CEN.

Second, we analyse the taxation of the transaction in a situation where ordinary credit is applied. As R determines the tax liability on the basis of the worldwide income, R would, as pointed out in sub-chapter 5.4.3, typically take into account the losses for the purpose of determining the tax which

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697 The outcome may be different where the income is taxed at progressive rates. Insofar as R allows the taking into account of losses in N for the purpose of determining the tax on the remaining income, the losses in N may result in a reduction of R tax even though they are not deductible as such, see sub-ch. 5.2.6.
is payable in R, unless the internal law of R provides for limitations to the deduction of losses incurred abroad. Thus, it can be assumed that the losses attributable to the PE in N would result in a reduction of the R tax on the domestic income by 15. Looking at that fiscal year in isolation, CEN would be achieved. However, in this situation as well, the evaluation is complicated by the fact that N’s internal law may provide for a carry forward or carry back of the losses, potentially enabling the taxpayer to deduct the losses against positive income attributable to the PE in another fiscal period. Thus, in addition to the reduction of R tax by 15 in the year in which the losses incurred, the losses might lead to a reduction of N tax by 10, provided that the entire losses can be deducted from positive income derived in a different period. However, such a reduction of N tax may decrease the credit of foreign tax given by R in that other period by an equally high amount. Thus, a reduction of N tax caused by a carry forward or carry back of the losses in N may be compensated by an equally high increase in R tax. In the end, the losses would lead to a reduction of the R tax on other income by 5 (a reduction by 15 as a consequence of the deduction and an increase by 10 due to a lower credit for N tax in another period) and a reduction of N tax on income relating to a different period by 10. The aggregate reduction of tax on other income caused by the losses would be 15, i.e. equal to CEN. Thus, regardless of whether the losses in N can be deducted from income in N relating to a different period, the aggregate taxation of the transaction would correspond to CEN.

We now turn to the second example where the income from the PE is positive by 100 and the activities in R have resulted in losses of 50. If the entire income of the taxpayer would have been taxable in N, i.e. in the absence of a cross border element, the losses in R would have been deductible from the income in N. The N tax on the income from the PE would therefore have been 10 (20 % × (100 – 50)). Thus, CIN can be regarded to be achieved where the aggregate taxation of the transaction, i.e. of the income from the PE, is 10. The R tax on the income attributable to the PE is 30 (30 % × 100), but provided that the losses can be deducted from the positive income, the losses reduce the R tax by 15 (30 % × (100 – 50)), so that, in the end, R tax of 15 is payable. Thus, CEN can be considered achieved where the aggregate taxation of the income from the PE is 15.

Let us begin by analysing the aggregate taxation of the transaction where exemption with progression is applied. Under exemption with progression, R would exclude the income attributable to the PE from the tax base, so that no tax would be payable in R. In N, on the other hand, the income relating to the
cross border activities would be subject to a tax of 20 in N \( (20 \% \times 100) \). Thus, the aggregate taxation of the transaction in the year in which the income from the PE is derived would be 20, exceeding CEN as well as CIN. Provided that the internal law of R provides for a carry forward or carry back of the losses and that the taxpayer derives taxable income in a different fiscal year, which can be set off against the losses, the losses would lead to a reduction of R tax by 15 \( (30 \% \times 50) \). Taking into account the reduction of R tax caused by the losses, the aggregate taxation of the transaction would be only 5 \( (20 – 15) \), falling below CEN as well as CIN. Thus, regardless of whether the taxpayer would be able to deduct the losses in R from income which is taxable in R in another year, the application of exemption with progression would cause the aggregate taxation to fall outside the range set by CEN and CIN.

Under *ordinary credit*, it is important to determine to what extent the N tax is creditable. According to the computation of the foreign tax credit limitation, the N tax of 20 \( (20 \% \times 100) \) is creditable up to the R pre-credit tax, which is 15 \( (30 \% \times (100 – 50)) \), as the entire R tax is attributable to the foreign income. This means that the tax liability in R is cancelled by the N tax, so that tax will in the end be payable in N only. As the losses in R are deducted from the income attributable to the PE for the purpose of determining the taxable income in R, they are “consumed” and cannot be carried forward or back, regardless of whether R’s internal law provides for a carry forward or carry back of losses in general. Thus, the losses do not lead to a reduction of R tax in a different period. The aggregate taxation of the transaction is therefore equal to the N tax of 20, exceeding the tax that would have been imposed on the income attributable to the PE in the absence of a cross border element. Thus, neither CEN nor CIN is achieved.

The reason for the non-neutral taxation in the second example, i.e. where the income from the PE in N is positive and the income from the activities in R is negative, is that the N tax is determined on the basis of the tax rate applicable in N without regard to the negative income. Where exemption with progression is applied, the taxpayer may be able to offset the losses against future income in R, but the losses would in such case reduce the tax on the basis of the R tax rate, resulting in non-neutral taxation. If R applies ordinary credit, the taxpayer will not be able to utilise the losses to reduce the tax burden as the losses only reduce the pre-credit tax in R but have no effect on the post-credit tax, which is zero. The combined effect of positive income in N and negative income in R may therefore deviate from the aggregate taxation that would have taken place if the entire income of the taxpayer would have been taxable in either of R or N.
In regard to Sweden, it can be observed that the evaluation is relevant as Sweden denies deduction of losses in a situation where corresponding income is exempted under a DTT (see sub-chapter 5.2.4) and takes into account losses incurred abroad for the purpose of determining the pre-credit tax on income which in accordance with a DTT is covered by the principle of credit.

6.7 Summary

The focus of the evaluation made in this chapter is to see whether there are situations where the application of the main methods for elimination of double taxation under DTTs, ordinary credit and exemption with progression, leads to taxation which is outside the range made up by CEN and CiN.

The first situation that is analysed is the taxation of income which is taxed at progressive rates. As regards exemption with progression, it can be concluded that, although that method is aimed at preventing progressivity advantages, it is usually only progressivity advantages in R which are prevented and not progressivity advantages in N. Therefore, situations may arise where a progressivity advantage in N causes the aggregate taxation to fall below CEN as well as CiN. This outcome is avoided where ordinary credit is applied, as under ordinary credit a progressivity advantage in N would be cancelled by a corresponding increase in R tax to the extent that the progressivity advantage causes the N tax to fall below the R tax, resulting in CEN, and since the taxation would otherwise exceed CEN but not CiN. Thus, when it comes to income which is taxed at progressive rates, the principle of credit is better at achieving neutral taxation. As pointed out above, the remedy to the non-neutral taxation in this situation is not necessarily to be found in the DTT. Rather, it would be a matter for N to ensure that no progressivity advantage is achieved under N’s internal law, insofar as N would consider neutral taxation as an overriding objective.

Second, the effect of income from a third state on exemption with progression and ordinary credit is analysed. The analysis shows that a foreign tax credit system that allows extensive cross-crediting of foreign taxes may actually be more generous to investment in high-tax states than an exemption system insofar as income is also derived from a third state that imposes tax at a lower level than R does. However, extensive cross-crediting, for instance where overall limitation is applied, does not lead to a credit of foreign tax against R tax on domestic income and therefore does not result in non-neutral taxation.
Third, an analysis is made of exemption with progression and ordinary credit in a situation where the contracting states impose tax in different periods. As regards exemption with progression, such timing mismatch does not cause the taxation to fall below the range made up of CEN and CIN. As regards ordinary credit, the outcome depends on whether R allows a credit for N tax paid in a previous or later period. Insofar as it does allow a credit for N tax paid in a different period than in R, the taxation will be within the range of CEN and CIN. If it does not, double taxation will remain and the aggregate tax will exceed CEN as well as CIN.

Fourth, an evaluation of exemption with progression and ordinary credit is made as regards situations where the contracting states attribute income or allocate costs to R or N differently. It can be concluded that differences in the attribution of income and allocation of expense may result in double taxation or double non-taxation which, in some cases, is not removed by the application of the methods for elimination of double taxation, leading to aggregate taxation which falls outside the range set by CEN and CIN.

Finally, an analysis of exemption with progression and ordinary credit is made in situations where losses are incurred in either of N or R. The analysis shows that it is often difficult to achieve aggregate taxation which falls within the range made up of CEN and CIN in such situations. For instance, if the losses in R or in N as a result of the application of the principle of exemption under a DTT cannot be set off against income derived in the other state and cannot be carried forward or back to a period in which the taxpayer has derived positive income, the losses will be forfeited, despite the fact that it might have been possible to deduct them from the taxable income of the taxpayer in a purely domestic situation. This means that the aggregate taxation of the income from the cross border activities may become higher than CEN and CIN. Moreover, where losses have been incurred in R, the taxation may be non-neutral even if the losses can be carried forward or back and be set off against taxable income in R, as the taxation in N is determined on the basis of the tax rate applicable in N whereas the deduction reduces taxation in R on the basis of the R tax rate. The combined effect of the taxation of positive income in N and deduction of negative income in R may therefore deviate from the aggregate taxation that would have taken place if the taxpayer would have been taxable in either of R or N.
7 Conclusions

7.1 Conclusions Relating to the First Aim of the Study

The first aim of the study is to systematise and analyse the methods for elimination of double taxation under DTTs in order to gain a better understanding of how they work. Since DTT provisions are applied by tax authorities, courts, and taxpayers in a domestic law context, i.e. within the framework of the legal system of a particular state, the analysis focuses on the application of the methods for elimination of double taxation under DTTs in Sweden.

In this study, the methods for elimination of double taxation that exist in DTTs are grouped into three categories: the two main principles for elimination of double taxation, namely exemption and credit, and a third category, limitation of the tax rate. The two main principles are in turn divided into a number of specific methods: the principle of exemption is divided into (i) full exemption, (ii) exemption with progression, (iii) modified exemption, (iv) tax sparing exemption, and (v) matching exemption, while the principle of credit is divided into (i) full credit, (ii) ordinary credit, (iii) tax sparing credit, (iv) matching credit, and (v) reverse credit.

As shown by this study, the principles of exemption and credit and the third category, limitation of the tax rate, are conceptually different. The principle of exemption, which may be applied on the basis of the distributive rules or on the basis of the double tax relief article, functions by excluding certain items of income from the tax base, thereby reducing the tax liability. Typically, the exemption method is applied regardless of the taxation (or non-taxation) in N. In contrast, under the principle of credit, which is applied on the basis of the double tax relief article, a pre-credit R tax is computed on the basis of the taxpayer’s worldwide income and a credit is granted from the R tax for tax paid in N. This means that the tax revenue of R relating to the income from N depends on the tax law of N, since the tax revenue of R decreases if the N tax is increased and vice versa. However, because in practically all cases the credit is limited to the R tax which is attributable to the foreign income (determined for instance on a per-item or per-country basis), no credit is allowed against R tax on domestic income, meaning that the R tax on domestic income is independent of the taxation in other countries. As an alternative to the principles of exemption and credit, double taxation can be reduced by means of DTT provisions which put a limit on the tax which N may impose. The limit
is typically determined as a maximum percentage of a payment of interest, dividends, or royalty, i.e. as a percentage of the gross income. Such limitation of the tax rate is used in combination with an obligation for R to eliminate remaining double taxation by means of the principle of credit.

Prior to the 1960s, Sweden traditionally used the principle of exemption as the main principle in its DTTs for elimination of double taxation. However, since the mid-1960s, Sweden has applied the principle of credit as the main principle. The reasons for this shift were not presented clearly at the time. However, as shown by this study, the introduction of rules on unilateral credit of foreign tax in the 1960s seems likely to have influenced the shift.

The interaction between DTT provisions and internal law plays an important role throughout the study. As regards the principles of exemption and credit, it can be observed that the exclusion of income from the tax base under the principle of exemption is normally less complicated than a credit of foreign tax. As a result there is generally less need for internal law regulation in the application of the principle of exemption than in the application of the principle of credit. As regards Swedish internal law, there are no provisions that expressly provide for exemption of income where it follows from a DTT that income shall be exempted. Instead, the fact that the tax liability shall be determined excluding such items of income as have been exempted under a DTT follows from the priority over internal law which is normally attributed to DTTs. However, the Swedish Income Tax Act expressly provides for non-deductibility of expenses relating to income which has been exempted under a DTT. In contrast, an entire Act, the Swedish Foreign Tax Credit Act, is devoted to the application of the principle of credit. The Act applies to credit under DTTs as well as unilateral credit. It can be noted that in regard to procedure (time limits for claiming treaty relief etc.) internal law plays an important role for the elimination of double taxation under DTTs. Procedural requirements under internal law are relevant to the principles of exemption and credit as well as to limitation of the tax rate. For instance, DTTs do not in general specify whether a reduced tax rate on payments of dividends, interest, and royalty shall be achieved through a reduction of the amount deducted on remittance or through a refund of excess tax. As regards withholding tax on dividends, Sweden generally offers both alternatives for achieving a reduced rate in accordance with DTT tax rate limitations. Sweden does not impose tax at source in respect of interest and royalty, which means that there is no need for a reduction of tax deducted on remittance in these cases.

In general, DTTs are only effective where tax is imposed on the same taxpayer under the internal laws of both contracting states. This is sometimes
referred to as a requirement for “subject identity”. As follows from the analysis in chapter 4, DTTs do not normally contain any rules for attributing income to a person, meaning that such attribution is normally made solely on the basis of internal law. Furthermore, it follows from the analysis that a DTT may be unable to resolve double taxation where the contracting states attribute income to different persons. As regards determining whether there is subject identity, it would make sense to look at the attribution of income for tax purposes. For instance, if income is derived through a partnership which is considered by both contracting states as transparent for tax purposes, it would make sense to regard the income as attributable to the owners of the partnership. However, in Swedish case law subject identity has been determined with reference to legal entitlement to the income. Although, the Swedish Foreign Tax Credit Act has later been amended in order to entitle the owners of a partnership to unilateral credit in respect of foreign tax on income derived through the partnership, the requirement for legal entitlement may still be of relevance in other situations.

Double taxation can be eliminated either under the distributive rules or under the double tax relief article. To the extent that a distributive rule precludes one of the contracting states from taxing an item of income, double taxation is eliminated under the distributive rules without the need for application of the double tax relief article. As follows from chapter 4, there are several situations where the distributive rules allocate the taxing right exclusively to R, but only a few situations where the taxing right is allocated exclusively to N.

The distributive rules of a DTT allocate taxing rights on the basis of the existence of a connection either between a contracting state and a taxpayer or between a contracting state and an activity or property that generates income. In cases where the connection is present only for a limited period, it is necessary to determine whether income is attributable to the period in which the connection existed. As DTTs do not determine tax liability, DTTs do not contain rules for determining when income arises. In spite of this, it may sometimes be possible to refer income to a specific period in which there is or is not a connection between N and an activity or property that generates income, independently of the internal laws of the contracting states, at least in uncomplicated cases where income is earned continually and on a regular basis. However, as follows from the analysis in chapter 4, in complicated cases it may be necessary to fall back on internal law in order to refer income to a specific period. Furthermore, it follows from the analysis that where the relevant distributive rule does not allocate a taxing right to
N on the basis of the existence of a connection between N and an activity or property that generates income, but instead allocates the taxing right to R on the basis of a connection between the taxpayer and that state, it may be even more difficult to refer income to a specific period, independently of the rules and principles under internal law for determining when income arises. As a consequence, income may have to be referred to the period in which the connection existed on the basis of internal law. In other words, the taxable event under internal law becomes decisive for referring income to a specific period. Where a taxpayer changes his residence and the contracting states refer the income to different periods, double taxation which cannot be solved under the DTT or double non-taxation may therefore occur.

In many cases, the distributive rules do not preclude either of the states from taxing an item of income. In such cases, remaining double taxation may be eliminated under the double tax relief article. As regards the term “income”, which is typically applied in the double tax relief article, it is submitted that a meaning of the term can be derived from the DTT and that no narrower meaning shall be given to the term on the basis of internal law. In other words, the DTT as a whole can be regarded as “context” in the sense of the interpretational rule of the DTT and, since the meaning of the term can be derived from the DTT, there is in my view reason to consider the context referred to in the interpretational rule of the DTT as requiring that the meaning that can be derived from the DTT shall prevail over the meaning of the term under internal law, in spite of the fact that there are cases from HFD that point in the opposite direction.

As regards the requirement of the double tax relief article of some DTTs that double tax relief shall only be provided in respect of income from “sources” in N, which is inserted in many DTTs entered into by states that adhere to the British legal tradition, the situation is different. Generally, no definition of the term “source” is made in DTTs and it is therefore necessary to fall back on internal law to determine the meaning of the term. If R does not have source rules in its internal law, it is submitted that the inclusion of the term “source” shall normally be disregarded, i.e. it shall be interpreted as not implying a change of meaning, unless there is evidence in the DTT text of an intention to give the term a specific meaning. Thus, double tax relief shall be provided by R in respect of income which in accordance with the DTT may be taxed in N, regardless of whether N considers the income to be sourced in N. From a Swedish point of view, the solution presented finds support in a ruling by HFD.

An important limitation to the obligation to provide double tax relief under the double tax relief article is that double tax relief shall be provid-
ed only to the extent that the foreign income is taxed by N *in accordance with* the DTT. Thus, R is not obliged to provide double tax relief where N imposes tax in excess of the taxing right that is reserved to N under the DTT. For instance, tax levied by N in excess of a tax rate limitation provided by a DTT would not qualify for a credit of foreign tax. As shown by the analysis in chapter 4, the same principle applies according to the Swedish Foreign Tax Credit Act in regard to the Swedish unilateral credit. Where the contracting states classify an item of income differently for the purpose of the DTT and, as a result, apply different DTT provisions on the same item of income, N may consider that it imposes tax in accordance with the DTT, while R considers that N imposes tax in excess of the taxing right reserved to it under the distributive rule which R considers to be applicable. In such a situation, it is likely that R will deny double tax relief to the extent that the N tax exceeds the taxing right which R considers to have been reserved to N. However, if the DTT allows the classification to be made on the basis of internal law and the classification of income by N has been made with reference to N’s internal law, it seems reasonable to argue that the taxation in N is in accordance with the DTT regardless of whether R considers another distributive rule to be applicable. Consequently, it can be argued that R would be obliged to provide double tax relief. In my view, it is reasonable to consider N as taxing an item of income in accordance with the DTT if, on the basis of internal law, it considers a different distributive rule than R to be applicable, insofar as the DTT allows classification on the basis of internal law, as this does not presuppose that R accedes to the classification made by N for the purpose of the double tax relief article, but merely means that R accepts the N taxation as being within the interpretative limits set by the DTT provisions.

A consequence of the fact that the principle of exemption is typically applied regardless of whether tax is imposed by the other state is that the exemption of income under a DTT may result in double non-taxation if the other contracting state does not subject the item of income in question to tax. To avoid such situations, a clause may be inserted in the DTT which relieves a contracting state from the obligation to exempt income unless certain criteria relating to the taxation of that income by the other state are fulfilled, for instance a so-called subject-to-tax clause. Subject-to-tax clauses and similar provisions are discussed and analysed briefly in sub-chapter 5.2.3. It is concluded that subject-to-tax clauses can give rise to many interpretational difficulties.

The quantification of income is largely dealt with by internal law without interference from DTT provisions. Only to a very limited extent, in relation to
business profits, do DTTs provide principles for the quantification of income. To the extent that a quantification of the income, taking into account these principles, falls below a quantification of the taxable income under internal law, the DTT limits the amount of income that may be subjected to tax in N. Similarly, where there is an obligation under the DTT to eliminate double taxation and the quantification of foreign income, taking into account the principles provided for in the DTT in regard to business profits, exceeds the amount of foreign income computed under internal law, double tax relief shall be provided by R in respect of the higher amount.

Many DTTs provide for exemption of income by R in accordance with the “exemption with progression” method. However, in my opinion, an interpretation of DTTs in accordance with the textual approach advocated by the VCLT leads to the conclusion that the absence of a proviso safeguarding progression does not normally preclude a contracting state (R or N) from taking into account exempted income for the purpose of determining the tax on the remaining income. This is due to the fact that DTTs do not generally contain any provisions that expressly restrict a contracting state’s right to tax the remaining income. Therefore, the inclusion of a proviso safeguarding progression is in my opinion typically merely declaratory. From a Swedish perspective, the question whether a proviso safeguarding progression is required in order to allow the taking into account of exempted income is of little relevance, as Sweden regularly refrains, on a unilateral basis, from taking into account exempted income. In other words, in most cases the application of the principle of exemption by Sweden means “full exemption”. The reasons referred to in preparatory works for this choice are threefold: to lower the work load of the Swedish Tax Agency, to avoid complicated legislation, and the fact that the loss of tax revenue is deemed to be negligible.

As an alternative to excluding income which under the DTT may be taxed in N, double tax relief may be provided by allowing as a credit an amount equal to the part of the total tax in the state providing the relief appropriate to the foreign income, so-called “modified exemption”. Although modified exemption technically works by crediting tax, it is conceptually different to the principle of credit, as relief is provided independently of the taxing position in N. Typically, the outcome of modified exemption equals that of exemption with progression as no R tax is imposed on the income that may be taxed in N and since that income is in effect taken into account for determining the R tax on the income which is taxable in R only. However, the outcome may differ where losses are incurred. As regards the application of modified exemption in Sweden, HFD has held that income covered by
modified exemption shall not reduce a loss on domestic income, i.e. a loss in R is unaffected by income from N in the same way as if full exemption or exemption with progression would have been applied. This is in line with the general idea of modified exemption, namely to achieve in principle the same result as under exemption with progression without excluding income from the tax base for the purpose of determining social benefits etc. However, it can be questioned whether HFD’s conclusion is compatible with the wording of the DTT and internal law.

Normally, exemption is provided regardless of the taxation in N. However, as mentioned above it is possible to limit the applicability of the principle of exemption to situations where certain criteria concerning the taxation in N are fulfilled, for instance by providing a minimum rate at which tax must have been levied. In such cases tax incentives granted by N may lead to the non-application of the principle of exemption. To counter this, the contracting states may agree that R shall treat the income in question as if N had imposed tax under its general tax legislation or as if tax had been levied in N at a fictitious, higher rate, disregarding the actual taxation in N. By analogy with tax sparing credit and matching credit, these kinds of provisions are in this study referred to as “tax sparing exemption” and “matching exemption” respectively. Several Swedish DTTs contain such provisions in regard to dividends, i.e. for the purpose of determining whether dividends paid by a company in N to a company in Sweden shall be exempted from tax in Sweden, tax shall be deemed to have been paid in N at the regular rate or at a fictitious rate. However, since the exemption under internal law with respect to dividends paid by a foreign company to a Swedish company is now substantially wider than it was when these DTTs were entered into, such provisions are of little practical importance.

DTT provisions on limitation of the tax rate in N on payments of dividends, interest, and royalty in combination with the application of the principle of credit by R can be regarded as a compromise between provisions which obligate either of R or N to eliminate double taxation. Although the tax rate limitations applicable under DTTs in respect of dividends, interest, and royalty payments may seem relatively low at first glance, the fact that N is entitled to tax both the payer and the recipient must be taken into consideration. As regards dividends, which are normally not deductible for the paying company, the profits out of which the dividends are paid may already have been subjected to taxation in N when N taxes the dividends and may therefore be subject to economic double taxation. Interest and royalty on the other hand are normally deductible for the payer, which means that interest and royalty
are normally not subject to economic double taxation. As a consequence, tax rate limitations on dividends are incapable of completely eliminating recurrent corporate taxation, i.e. taxation once at the level of the distributing company when it is taxed on its profits and once again at the level of the corporate shareholder when it is taxed on the profit distribution. Different solutions to recurrent corporate taxation within the framework of a DTT are conceivable. Furthermore, it should be observed that tax rate limitations are computed on the basis of the gross amount of payment, i.e. regardless of expenses incurred. A tax rate limitation on the gross amount may correspond to a substantially higher rate on the net amount where there are costs connected with generating the income.

A consequence of the principle of credit is that a tax reduction in N is “absorbed” by R if the N tax falls below the R tax. In certain cases the contracting states may agree that such a reduced tax in N shall lead to a reduced aggregate tax burden for the taxpayer. To achieve the intended outcome, the contracting states may therefore agree that R shall allow as a credit an amount corresponding to the tax that N would have imposed under its general tax legislation (referred to as a “tax sparing credit”) or that R shall allow a credit of an amount computed on the basis of a fixed rate (in this study referred to as “matching credit”), regardless of whether N levies tax at a lower rate. There are different views as to whether the application of such methods is an appropriate means of encouraging investment into other states. For instance, the sceptical attitude of the OECD Model towards “tax sparing credit” stands in stark contrast to the positive view expressed in the UN Model. As a consequence of the objections, many states that apply tax sparing credit and matching credit limit the applicability of these methods by providing that they shall only apply to certain kinds of business activities, typically to business activities which require substantial actual presence in N, and by providing that they shall only apply for a certain period, so that a review can be made when the period has elapsed without need for a renegotiation of the relevant DTT. For instance, time-limited tax sparing and matching credit clauses have been inserted in many DTTs entered into by Sweden. Currently, there is only a handful of DTTs that contain such clauses which are still applicable.

In some DTTs, Sweden reserves its right to tax former residents of Sweden who have moved abroad in spite of the fact that there is no such connection between Sweden and an activity or property that has generated the income as would normally be required for allocating the taxing right to N. In such cases R does not normally agree to provide double tax relief, which means that double taxation can only be eliminated by Sweden in its capacity.
as N. As the purpose of reserving Sweden’s taxing right in such situations is typically to reduce tax incentives for moving abroad, the application of the principle of credit by N (in this study referred to as “reverse credit”) can be regarded as an appropriate means of eliminating double taxation, as a reserved taxing right in combination with a reverse credit provision has the effect of ensuring that the item of income in question is not subject to double non-taxation. Rather, it is taxed in Sweden to the extent that the tax burden in the other state falls below the tax that would have applied if the taxpayer had remained a resident of Sweden.

In regard to the principle of credit, it would be consistent with the objective of CEN to allow a credit of foreign tax regardless of whether the N tax exceeds the R tax which is attributable to the foreign income. However, in practice CEN is rarely, if ever, regarded as an overriding objective, but rather as an objective which has to be weighed against other goals. A credit of foreign tax in excess of the R tax which is attributable to the foreign income would normally be considered as an unacceptable limitation of R’s sovereign right to tax its residents, as the taxation of income in R would become dependent on the taxation in N. Further, a credit against R tax on domestic income in accordance with the “full credit” credit method (or a “negative tax” where the R tax on domestic income does not suffice) would in effect constitute a subsidy by R of investments into N in an amount corresponding to the excess of the N tax over the R tax, which would in most cases be considered unacceptable. Thus, in practically all cases, the credit for N tax is limited by the R tax which is considered attributable to the foreign income. Where the DTT provides for such a “foreign tax credit limitation”, the method applied is usually referred to as “ordinary credit”. Many of the issues that are discussed in connection with the principle of credit relate to the attribution of R tax to the foreign income.

Where the principle of credit is applied by R under the DTT as the main method for elimination of double taxation, the double tax relief article typically does not state expressly that R shall apply the principle of credit except where the principle of exemption applies under the distributive rules. This raises the question whether the principle of credit can apply to income which has been exempted under the distributive rules. However, it would be inconsistent to give credit for N tax on such income, as double tax relief is already provided in accordance with the principle of exemption. Consequently, it is submitted that it would be logical to interpret the double tax relief article as not requiring R to provide a credit for N tax on income in respect of which R is obligated under the DTT to eliminate double taxation by means of the principle of exemption. This conclusion also follows from a judgment
by HFD. A related issue is whether foreign tax paid in respect of an item of income which is exempted from tax in R under the internal laws of R may be credited where the applicable DTT provides for the application of the principle of credit. As a foreign tax credit limitation in accordance with the per-item limitation would always result in no credit being eligible, since the R tax on the particular item which is exempted from tax under R’s internal law is zero, and since in general DTTs do not require that a different form of limitation is applied (according to the analysis presented in sub-chapter 5.4.13.2), it is submitted that there would normally be no grounds for claiming, on the basis of a DTT, that a credit shall be allowed for income which is exempted under R’s internal law.

As regards the types of taxes that may be credited under a DTT, it follows from the analysis in sub-chapter 5.4.9 that the taxes covered article defines the type of taxes that are creditable and that internal law is normally of no relevance in this regard. However, interpretational difficulties may arise in relation to certain taxes or costs relating to a tax. For instance, it may be difficult to determine whether interest costs due to late payment, penalties for tax fraud, penalties for late filing of a tax return, etc. are taxes in the sense of the taxes covered article.

As N tax is often paid in another currency than the R tax, in many cases it is necessary to determine the equivalent of the N tax in the currency of R. Various options for the conversion date are conceivable, for instance when the income is earned, when the income is received, when the amount of tax is determined by the tax authority of N, when the tax becomes due, or when the payment of tax is actually made. As regards Sweden, no express DTT or internal law provisions determine principles for the conversion of foreign tax for the purpose of computing the SEK amount of credit. However, as far as I have been able to determine, Sweden seems to apply the rate on the day of the payment, at least as a main principle.

As regards the question when taxes are creditable, DTTs do not generally include any express provisions on this. However, as follows from the analysis in chapter 5, it can be argued that in order to be able to fulfil its treaty obligation of allowing a credit of foreign tax to the extent that the foreign tax does not exceed the R tax which is attributable to the foreign income it is necessary to allow a credit in the year in which R taxes the item of income in question. Furthermore, where the N tax is paid in a later period, R must allow a retroactive credit. According to the Swedish Foreign Tax Credit Act, a credit is allowed in the same period as Sweden taxes the income. In addition, the Swedish Foreign Tax Credit Act provides for a carry forward of unused credit, which can often
be used to achieve a credit of foreign tax where the foreign tax was not yet paid (or even known) when the assessment in R was made, without need for a reassessment procedure (provided that the foreign tax credit limitation in a later year exceeds the creditable tax attributable to that year).

As regards the requirement that the N tax must have been paid in order to be creditable, it is submitted that a payment of a “preliminary tax” cannot be considered as “tax paid” as it does not settle a tax liability. Consequently, DTT credit provisions normally do not require that a credit is granted for such payments. Accordingly, Swedish internal law requires that the payment relates to “final” tax in order for it to be creditable.

Where ordinary credit is applied, the foreign tax credit limitation, i.e. the R tax which is attributed to the foreign income, can be determined in many different ways. The foreign tax credit limitation can be computed collectively for all foreign income or it can be computed separately for specific groups of income, such as for income derived from any one country, for each class of income, or for each item of income. A wider basis for determining the foreign tax credit limitation increases the chances of cross-crediting N tax on one item of income in excess of the R tax which is attributable to that item of income against R tax on other items of income which are subject to a lower foreign tax.

The application of the distributive rules requires that income is attributed and expense is allocated to either R or N. As follows from the analysis in chapter 4, the distributive rules provide general principles for attributing income and allocating expense to R or N, which are complemented by internal law. Differences in the contracting states in regard to the attribution of income and allocation of expense may result in double taxation that cannot be solved under the DTT or double non-taxation, as shown by the evaluation in subchapter 6.5. The attribution of income and allocation of expense to either R or N is also central to the computation of the foreign tax credit limitation as a higher amount of foreign income results in a higher foreign tax credit limitation and, conversely, a lower amount of foreign income results in a lower foreign tax credit limitation. It is submitted that, insofar as DTT provisions increase the amount of foreign income as determined under R’s internal law and, consequently, the income in respect of which R must provide double tax relief, it would be consistent to also adjust the computation of the foreign tax credit limitation accordingly.

Restricting cross-crediting, for instance by using a per-country limitation or a per-item limitation as opposed to an overall limitation, has the effect of treating investment in a high-tax country no better than it would be under
an exemption system, while preserving the benefit of worldwide taxation with a foreign tax credit for investment in lower-taxed countries. In other words, it ensures that the aggregate taxation of the income corresponds to the higher of the R or N tax on a specific item of income or on all income from N. The rationale for permitting extensive cross-crediting is not as clear-cut, but at least there are administrative advantages. Extensive opportunities for cross-crediting also increases the chances of achieving tax neutrality between those taxpayers who engage in foreign activities and those who do not, which may be seen as an appropriate goal of a foreign tax credit system. Sweden applies overall limitation, i.e. the Swedish foreign tax credit system provides for extensive cross-crediting. Statements in preparatory works relating to the Swedish rules on credit of foreign tax indicate that the choice of overall limitation is due to a desire to strengthen Swedish business rather than to achieve administrative simplicity.

A wider basis for computing the foreign tax credit limitation is generally more favourable to the taxpayer as it increases the chances of crediting foreign tax on an item of income in excess of the R tax on that item of income through cross-crediting. Thus, insofar as internal law provides for a narrower basis for computing the foreign tax credit limitation than the DTT credit provision in question does, it can be argued that R would be obliged under the DTT to apply the wider definition when computing the foreign tax credit limitation in situations where this would lead to a higher credit. However, where the DTT credit provisions in question expressly refer to the internal law of R it becomes more difficult to claim that the DTT credit provisions require the application of a different form of limitation than that which is provided for under internal law. Furthermore, as DTTS according to the analysis presented in sub-chapter 5.4.13.2 do not normally state which of the per-item or per-country limitations shall be applied, but leaves the choice up to each contracting state, there are normally not grounds for requiring that a different form of limitation is applied than that which applies under internal law, as long as internal law provides for either of the two forms of limitations.

With regard to the question as to whether exempted income shall be disregarded for the purpose of the computation of the foreign tax credit limitation the following can be said. In regard to income which under a DTT is exempted from taxation in R, it is submitted that it would be inconsistent to include such income in the computation of the foreign tax credit limitation as it might lead to a foreign tax credit limitation which is higher than the R tax which is appropriate to the income in respect of which a credit shall be given. This would be contrary to the general idea behind the ordinary
credit method, namely to provide double tax relief by means of allowing a credit for foreign tax but not to such an extent that the credit reduces the tax payable on the taxpayer's domestic income. This conclusion is supported by a judgment by HFD. The same applies in regard to income which under a DTT is exempted from taxation in N. However, for reasons of administrability, the Swedish Foreign Tax Credit Act provides that certain types of income shall be included in the computation of the foreign tax credit limitation regardless of whether they are subjected to tax in N. The question whether income in respect of which the principle of credit applies under a DTT, but which is exempted under the internal law of R, shall be taken into account for the purpose of the foreign tax credit limitation is more complex. It can be argued that such income shall be taken into account as the principle of credit applies in respect of income which according to the DTT may be taxed in N, regardless of whether taxation takes place in R. However, if it is accepted that the DTT does not require R to apply an overall limitation or a per-country limitation rather than a per-item limitation, it follows that there is no obligation for R to attribute R tax to an item of income (which is exempted from tax in R under its internal law) on the basis of the tax on that item of income and other items of income. This leads to the conclusion that there is no obligation under the DTT to take into account income which is exempt from tax in R under its internal law for the purpose of computing the foreign tax credit limitation. The same conclusion applies to income which is exempted from tax in N under the internal law of N.

Another issue which is analysed in this study is the question as to whether R must allow a deduction for losses incurred in N. Most states treat losses in symmetry with income, meaning that losses are considered deductible insofar as corresponding income is taxed and non-deductible if corresponding income is tax exempt, for instance on the basis of the provisions of a DTT. In contrast, where the principle of credit is applied, the pre-credit tax in R is usually computed on the basis of the worldwide income, taking into account any losses incurred in N by a taxpayer. Thus, losses in N reduce the amount of tax to be paid in R. It is submitted that, as DTTs do not normally limit R's right to tax income which is taxable only in R, R is free to determine such income and, consequently, free to determine whether a deduction shall be allowed for losses incurred in N. If a taxpayer is denied deduction of losses due to the fact that a DTT provides for elimination of double taxation by means of the principle of exemption, this leaves the taxpayer worse off than if no DTT had been concluded. As a consequence, it can be argued that denying deduction of losses incurred in N is contrary to the principle that DTT provisions may
not increase the tax burden provided for under internal law. However, as that principle is a principle under domestic law, not under international law (cf. sub-chapter 3.5), no generally applicable conclusion can be drawn regarding the obligation to allow deduction of losses incurred in N. Rather, the question whether R is obliged to allow deduction of losses incurred in N in a situation where the DTT in question provides for exemption of income has to be answered on the basis of an analysis of the meaning of the principle in the state in which the DTT is applied.

In some situations, the application of a wider basis for determining the foreign tax credit limitation can be a disadvantage for the taxpayer, as items of negative income may reduce the foreign income and lead to a lower ceiling on the credit. As follows from the analysis in chapter 5, there may be grounds for claiming that a narrower definition of foreign income shall be applied with reference to the applicable DTT where internal law provides for computation of the foreign tax credit limitation on a wider basis than on a per-country basis and the narrower definition of the DTT is more favourable to the taxpayer. Thus, more specifically, under an overall limitation it may be argued that it would be contrary to R’s DTT obligations to take into account losses incurred in a third country when determining the foreign income for the purpose of computing the ceiling on the credit for tax paid in N. However, according to Swedish case law negative foreign income derived from one country shall not reduce positive foreign income from other countries for the purpose of computing the foreign tax credit limitation, which makes it less likely that the application of the overall limitation under Swedish internal law would lead to a less favourable result for the taxpayer than a limitation provided for under a DTT.

As regards the possibility of carrying forward or back excess credits, it follows from the analysis in this chapter that DTTs do not normally require that unused credits shall reduce future or prior period taxes, but merely require that R shall allow a credit in the period in which R taxes the item of income in question. Thus, the possibility of carrying forward or back excess credits are typically not introduced as a result of a DTT obligation, but on a unilateral basis.

It is hoped that the systematisation and analysis relating to the first aim of the study will contribute to the understanding of the methods for elimination of double taxation under DTTs and how they interact with internal law. If nothing else, the analysis demonstrates the multitude and complexity of the issues that arise in connection with application of the methods for elimination of double taxation.
7.2 Conclusions Relating to the Second Aim of the Study

The second aim of the study is to evaluate in a few selected situations the two main methods for elimination of double taxation recommended by the OECD, namely exemption with progression and ordinary credit, on the basis of tax neutrality. Tax neutrality is considered to be achieved if the aggregate taxation of income relating to a cross border transaction (taking into account changes in the taxation of other income caused by the transaction) corresponds to CEN or CiN. Tax neutrality is also deemed to be achieved if the effective taxation of income relating to the cross border transaction is within the range set by CEN and CiN.

Generally, the principle of exemption is associated with CiN whereas the principle of credit is associated with CEN, although in reality that is an oversimplification. A rather obvious example is the fact that a credit of foreign tax is practically always limited by the amount of R tax attributable to the foreign income and therefore does not result in CEN where the taxation in N exceeds the tax in R which is attributable to the income derived from N. However, as is shown by this study, there are also other situations that contradict the general view of the implications of the methods.

The first situation that is analysed is the taxation of income which is taxed at progressive rates. As regards exemption with progression, it can be concluded that, although that method is aimed at preventing progressivity advantages, it is usually only progressivity advantages in R which are prevented and not progressivity advantages in N. Therefore, situations may arise where a progressivity advantage in N causes the aggregate taxation to fall below CEN as well as CiN. This outcome is avoided where ordinary credit is applied. As long as the taxation in N, in spite of any progressivity advantages in N, is higher than the taxation in R, the taxation will exceed CEN but not CiN. To the extent that a progressivity advantage in N causes the N tax to fall below the R tax, the progressivity advantage in N is cancelled by a corresponding increase in R tax. The R tax will equal the excess of the R tax over the N tax and the aggregate taxation of income relating to the cross border transaction will correspond to the tax burden on transactions within R, resulting in CEN. Thus, when it comes to income which is taxed at progressive rates, the principle of credit is better at achieving neutral taxation. As pointed out above, the remedy to the non-neutral taxation in this situation is not necessarily to be found in the DTT. Rather, it would be a matter for N to ensure that no progressivity advantage is achieved under N’s internal law, insofar as N would consider neutral taxation as an overriding objective.
Second, the effect of income from a third state on exemption with progression and ordinary credit is analysed. The analysis shows that a foreign tax credit system that allows extensive cross-crediting of foreign taxes may actually be more generous to investment in high-tax states than an exemption system insofar as income is also derived from a third state that imposes tax at a lower level than R does. However, extensive cross-crediting, for instance where overall limitation is applied, does not lead to a credit of foreign tax against R tax on domestic income and therefore does not result in non-neutral taxation.

Third, an analysis is made of exemption with progression and ordinary credit in a situation where the contracting states impose tax in different periods. As regards exemption with progression, such timing mismatch does not cause the taxation to fall below the range made up of CEN and CEN. As regards ordinary credit, the outcome depends on whether R allows a credit for N tax paid in a previous or later period. Insofar as it does allow a credit for N tax paid in a different period than in R, and it can be argued that this obligation follows from the DTT, the taxation will be within the range of CEN and CIN. If it does not, double taxation will remain and the aggregate tax will exceed CEN as well as CIN.

Fourth, an evaluation of exemption with progression and ordinary credit is made as regards situations where the contracting states attribute income or allocate costs to R or N differently. It can be concluded that differences in the attribution of income and allocation of expense may result in double taxation or double non-taxation which, in some cases, is not removed by the application of the methods for elimination of double taxation, leading to aggregate taxation which falls outside the range set by CEN and CIN.

As follows from the evaluation, it seems that ordinary credit is better than exemption with progression in this situation at achieving an outcome which is consistent with the goal of tax neutrality as defined for the purpose of this study, as an incorrect attribution of income or allocation of expense resulting in an increase or decrease in tax under the ordinary credit method may be compensated by an equally high decrease or increase in tax. For instance, an unjustified decrease in N tax may result in a lower credit and, hence, may be compensated by an equivalent increase in R tax. Furthermore, an unjustified decrease in R tax on the foreign income may be compensated by an equally high increase in R tax on the income which is taxable in R only (if the N tax is within the foreign tax credit limitation). Similarly, an unjustified increase in N tax may result in an equivalent increase of the foreign tax credit (if the N tax, taking into account the increase, is within the foreign tax credit limi-
tation) and hence may be compensated by a decrease in R tax. Moreover, an unjustified increase in R tax on the foreign income may be compensated by an equally high decrease in R tax on the income which is taxable in R only. The tax laws of Sweden, just like the tax laws of any other state, contains rules and principles for determining whether an item of income or expense shall be considered as domestic or foreign. Consequently, differences in the attribution of income and allocation of expense in Sweden and in another contracting state may cause double taxation or double non-taxation and result in taxation which is not in accordance with the goal of tax neutrality.

In this regard it seems appropriate that Sweden applies ordinary credit as its main method for providing double tax relief, under DTTS as well as on a unilateral basis, as the ordinary credit method appears to be better equipped to achieve a result which is consistent with the goal of tax neutrality.

Finally, an analysis of exemption with progression and ordinary credit is made in situations where losses are incurred in either of N or R. The analysis shows that it is often difficult to achieve aggregate taxation which falls within the range set by CEN and CIN in such situations. For instance, if the losses in R or in N as a result of the application of the principle of exemption under a DTT cannot be set off against income derived in the other state and if the losses in R or in N cannot be carried forward or back to a period in which the taxpayer has derived positive income, the losses will be forfeited, despite the fact that it might have been possible to deduct them from the taxable income of the taxpayer in a purely domestic situation. This means that the aggregate taxation of income relating to cross border activities may become higher than CEN and CIN. Moreover, where losses have been incurred in R, the taxation may be non-neutral even if the losses can be carried forward or back and be offset against taxable income in R, as the taxation in N is determined on the basis of the tax rate applicable in N whereas the deduction reduces taxation in R on the basis of the R tax rate. The combined effect of the taxation of positive income in N and deduction of negative income in R may therefore deviate from the aggregate taxation that would have taken place if the entire income of the taxpayer would have been solely taxable in either of R or N.

A comparison of the outcome as regards exemption with progression and ordinary credit reveals that ordinary credit stands a greater chance than exemption with progression of achieving an outcome which is consistent with the goal of tax neutrality. For instance, where a progressivity advantage is achieved in N, ordinary credit, in contrast with exemption with progressions, ensures that the aggregate tax does not fall below CEN. Furthermore,
an incorrect attribution of income or allocation of expense to R or N made by N is, insofar as the entire N tax can be credited, corrected by a corresponding increase or decrease of the R tax. Moreover, as R determines the pre-credit tax liability on the basis of the worldwide income, an incorrect attribution of income or allocation of expense by R may be compensated by a corresponding increase or decrease of the domestic income insofar as the entire N tax can be credited.

In one particular situation, namely where there is a timing mismatch, can the application of exemption with progression lead to taxation within the range set by CEN and CEN, whereas ordinary credit risks resulting in non-neutral taxation. However, provided that R allows a credit for N tax relating to a different period than the period in which R taxes the income under its internal law, and it can be argued that R is obliged under the DTT to do so, the taxation would come within the range set by CEN and CEN.

As pointed out in sub-chapter 1.2.2, it is not the purpose of this study to rank the two main methods. An extensive, multi-disciplinary study would be needed to cover all factors of relevance for evaluating the merits and disadvantages of the methods. Furthermore, different weight may be attributed to these merits and disadvantages depending on for instance political preferences or the design of the tax system in the jurisdiction in which the methods are to be applied. However, the evaluation provides insights into the effects of the methods and it is hoped that the study can thus contribute to the understanding of how the two methods work.
# Appendix – The Double Tax Relief

## Article of Swedish DTTs

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<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method/s applied by Sweden</th>
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<tr>
<td>Albania</td>
<td>1998</td>
<td>Ordinary credit Art. 23.2 (a)</td>
<td>Exemption with progression Art. 23.2 (b) Applies to income which in accordance with the DTT shall be taxable only in Albania</td>
<td>Matching exemption Art. 23.2 d) and e) Applies to dividends paid by an Albanian company if the profits are derived from certain listed business activities In effect for a period of ten years, no extension enacted</td>
<td>Tax sparing credit Art. 23.2 d) and e) In effect for a period of ten years, no extension enacted</td>
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<tr>
<td>Argentina</td>
<td>1995</td>
<td>Ordinary credit Art. 22.2 (a)</td>
<td>Exemption with progression Art. 22.2 (b) Applies to income which in accordance with the DTT shall be taxable only in the Argentina</td>
<td>Matching exemption Art. 22.2 e) and g) Applies to dividends paid by an Argentinian company if the profits are derived from certain listed business activities In effect for a period of ten years, no extension enacted</td>
<td>Tax sparing credit Art. 22.2 e) and g) In effect for a period of ten years, no extension enacted</td>
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<tr>
<td>Australia</td>
<td>1981</td>
<td>Ordinary credit Art. 24.3</td>
<td>Modified exemption Art. 24.4 Applies to income which in accordance with the distributive rules shall be taxable only in Australia</td>
<td>Full exemption Art. 24.5 Applies to dividends*, subject to certain additional conditions</td>
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698 DTTs in force as of 1 January 2012. DTTs that are limited to certain categories of income, for instance income from international air transport, have been excluded.
<table>
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<tr>
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<td>Austria</td>
<td>1959</td>
<td>Ordinary credit Art. 20.1</td>
<td>Exemption with progression Art. 20.2 Applies to income which in accordance with Art. 7 (operation of ships and aircraft in international traffic) or Art. 16.1 (government service) shall be taxable only in Austria</td>
<td>N/A</td>
<td>N/A</td>
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<td>Bangladesh</td>
<td>1982</td>
<td>Ordinary credit Art. 23.2</td>
<td>Modified exemption Art. 23.3 Applies to income which in accordance with the DTT shall be taxable only in Bangladesh</td>
<td>Tax sparing credit Art. 23.4 In effect for a period of ten years, no extension enacted</td>
<td>N/A</td>
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<td>Barbados</td>
<td>1991</td>
<td>Ordinary credit Art. 23.1 (a)</td>
<td>Exemption with progression Art. 23.1 (b) Applies to income which in accordance with Art. 20 (government service) shall be taxable only in Barbados</td>
<td>Tax sparing credit Art. 23.1 c), e) and f) In effect for a period of ten years, no extension enacted</td>
<td>Tax sparing exemption Art. 23.1 d), e) and f) Applies to dividends In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Belarus</td>
<td>1994</td>
<td>Ordinary credit Art. 22.2 (a)</td>
<td>Exemption with progression Art. 22.2 (b) Applies to income which in accordance with Art. 19 (government service) shall be taxable only in Belarus</td>
<td>Tax sparing credit Art. 22.2 e) and f) Applies to income derived from certain listed business activities In effect for a period of five years, no extension enacted</td>
<td>Matching exemption Art. 22.2 e) and f) Applies to dividends paid by a Belarusian company if the profits are derived from certain listed business activities In effect for a period of five years, no extension enacted</td>
</tr>
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<td>Treaty partner</td>
<td>Year of signature</td>
<td>Main method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
<td>Additional method/s/ applied by Sweden</td>
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</tr>
<tr>
<td>Belgium</td>
<td>1991</td>
<td>Ordinary credit</td>
<td>Exemption with progression</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
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<td>Art. 23.2 (a)</td>
<td>Art. 23.2 (e)</td>
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<tr>
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<td>Applies to income which has been</td>
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<td></td>
<td>exempted in accordance with the DTT</td>
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</tr>
<tr>
<td>Bolivia</td>
<td>1994</td>
<td>Ordinary credit</td>
<td>Exemption with progression</td>
<td>Matching exemption</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
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<td>Art. 22.2 (a)</td>
<td>Art. 22.2 (b)</td>
<td>Art. 22.2 c), d) and e)</td>
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</tr>
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<td>Applies to income which in accordance with the DTT shall be taxable only in Bolivia</td>
<td>Applies to dividends paid by a Bolivian company if the profits are derived from certain listed business activities</td>
<td>In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Botswana</td>
<td>1992</td>
<td>Ordinary credit</td>
<td>Exemption with progression</td>
<td>Full exemption</td>
<td>Tax sparing credit</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Art. 23.2 (a)</td>
<td>Art. 23.2 (b)</td>
<td>Art. 23.1 (d) and c)</td>
<td>Art. 23.1 d) and c)</td>
</tr>
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<td></td>
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<td></td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Botswana</td>
<td>Applies to dividends*, subject to certain additional conditions</td>
<td>Applies to dividends</td>
</tr>
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<tr>
<td>Brazil</td>
<td>1975</td>
<td>Ordinary credit</td>
<td>Exemption with progression</td>
<td>Full exemption</td>
<td>Matching credit</td>
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<tr>
<td></td>
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<td>Art. 23.1</td>
<td>Art. 23.2</td>
<td>Art. 23.2</td>
<td>Art. 23.3</td>
</tr>
</tbody>
</table>
|               |                   |                              | Applies to income which has been exempted in accordance with the DTT | Applies to dividends*, subject to certain additional conditions | Applies to dividends, royalty and interest | In effect for a period of five years, extended until 1997

<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method/s applied by Sweden</th>
</tr>
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<tbody>
<tr>
<td>Bulgaria</td>
<td>1988</td>
<td>Ordinary credit</td>
<td>Exemption with progression</td>
<td>Full exemption Art. 21.2 (c)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Art. 21.2 (a)</td>
<td>Art. 21.2 (b) and (d)</td>
<td>Applies to dividends*</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with Art. 6 (business profits), Art. 11.2 (alienation of movable property) or Art. 12 (liberal profession) may be taxed in Bulgaria** and to income which in accordance with Art. 16.2 (disbursements under the social security legislation of a contracting state and annuities) and Art 17 (governmental functions) shall be taxable only in Bulgaria</td>
<td></td>
</tr>
</tbody>
</table>

| Canada        | 1996            | Ordinary credit             | Exemption with progression        | N/A                                  |
|               |                 | Art. 22.2 (a)               | Art. 22.2 (b)                     | N/A                                  |
|               |                 |                             | Applies to income which in accordance with the DTT shall be taxable only in Canada |

<p>| Chile         | 2004            | Ordinary credit             | Exemption with progression        | N/A                                  |
|               |                 | Art. 23.2 (a)               | Art. 23.2 (b)                     | N/A                                  |
|               |                 |                             | Applies to income which in accordance with the DTT shall be taxable only in Chile |</p>
<table>
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<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method/s applied by Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>1986</td>
<td>Ordinary credit Art. 23.2 (a)</td>
<td>Exemption with progression Art. 23.2 (c) Applies to income which in accordance with the DTT shall be taxable only in China</td>
<td>Full exemption Art. 23.2 (b) Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>Tax sparing credit Art. 23.3-4 Applies to income derived from a PE in China provided that the income is derived from certain listed activities and to interest and royalties Matching exemption Art. 23.3 Applies to dividends In effect for a period of ten years, extended until 2006700</td>
</tr>
<tr>
<td>Cyprus</td>
<td>1988</td>
<td>Ordinary credit Art. 21.2 (a)</td>
<td>Exemption with progression Art. 21.2 (c) Applies to income which in accordance with Art. 7 (business profits) or Art. 14 (independent personal services) may be taxed in Cyprus and to income which in accordance with the DTT shall be taxable only in Cyprus</td>
<td>Matching credit Art. 21.2 (d) Applies to dividends and interest In effect for a period of seven years, no extension enacted</td>
</tr>
<tr>
<td>Czechoslovakia</td>
<td>1979</td>
<td>Ordinary credit Art. 23.2 (a)</td>
<td>Modified exemption Art. 23.2 (b) Applies to income which in accordance with the DTT shall be taxable only in Czechoslovakia</td>
<td>N/A</td>
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</table>

700 SFS 2000:211.
<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method/s/ applied by Sweden</th>
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<tbody>
<tr>
<td>Egypt</td>
<td>1994</td>
<td>Ordinary credit Art. 23.1 (a)</td>
<td>Exemption with progression Art. 23.1 (b) Applies to income which in accordance with Art. 18 (pensions and annuities) or Art. 19 (government service) shall be taxable only in Egypt</td>
<td>Tax sparing credit Art. 23.1 c) and e) In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Estonia</td>
<td>1993</td>
<td>Ordinary credit Art. 23.1 (a)</td>
<td>Exemption with progression Art. 23.1 (b) Applies to income which in accordance with Art. 19 (government service) shall be taxable only in Estonia</td>
<td>Full exemption Art. 23.1 (c) Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td>France</td>
<td>1990</td>
<td>Ordinary credit Art. 23.1 (a)</td>
<td>Exemption with progression Art. 23.1 (g) Applies to income which in accordance with Arts. 8.1 (shipping and air transport), 13.5 (alienation of ships and aircraft) or 19 (government service) shall be taxable only in France</td>
<td>Full exemption Art. 23.1 (c), (d) and (e) Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td></td>
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<td>Reverse credit Art. 23.1 (b) Applies to income which in accordance with Art. 13.7 (gains from the disposition of any property derived by an individual who is a citizen of Sweden but not of France and who is a resident of France and has been a resident of Sweden for at least five of the previous seven years) may be taxed in Sweden</td>
<td></td>
</tr>
<tr>
<td>Treaty partner</td>
<td>Year of signature</td>
<td>Main method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
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<tr>
<td>The Gambia</td>
<td>1993</td>
<td>Ordinary credit Art. 22.2</td>
<td>Exemption with progression Art. 22.2 (a)</td>
<td>Matching exemption Art. 22.2 c), d) and e)</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>Applies to income which in accordance with the DTT shall be taxable only in the Gambia</td>
<td>Applies to dividends paid by a Gambian company if the profits are derived from certain listed business activities In effect for a period of five years, not extended</td>
</tr>
<tr>
<td>Germany</td>
<td>1992</td>
<td>Ordinary credit Art. 23.2</td>
<td>Exemption with progression Art. 23.2 (a)</td>
<td>Full exemption Art. 23.3</td>
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<td></td>
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<td></td>
<td>Applies to income which in accordance with Arts. 18 (pensions and similar payments) and 19 (government service) shall be taxable only in Germany</td>
<td>Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td>Greece</td>
<td>1961</td>
<td>Exemption with progression Arts. XXIII.2 and XXIII.4</td>
<td>Ordinary credit Art XXIII.2 (a)</td>
<td>Tax sparing credit Art XXIII.2 (b)</td>
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<tr>
<td></td>
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<td>Applies to dividends that have not been exempted under Art. VII.3, interest and royalty</td>
<td>Applies to dividends, interest and royalty No time limit</td>
</tr>
<tr>
<td>Hungary</td>
<td>1981</td>
<td>Ordinary credit Art. 23.2</td>
<td>Modified exemption Art. 23.2 (b)</td>
<td>N/A</td>
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<td></td>
<td></td>
<td>(a)</td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Hungary</td>
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<tr>
<td>Treaty partner</td>
<td>Year of signature</td>
<td>Main method applied by Sweden</td>
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<td>Additional method/s applied by Sweden</td>
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<tr>
<td>India</td>
<td>1997</td>
<td>Ordinary credit Art. 24.3 (a)</td>
<td>Exemption with progressions Art. 24.3 (b) and (c) Applies to income which in accordance with the DTT shall be taxable only in India</td>
<td>Matching exemption Art. 24.3 c), d) and e) Applies to dividends paid by an Indian company if the profits are derived from certain listed business activities In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1989</td>
<td>Ordinary Credit Art. 23.1 (a)</td>
<td>Exemption with progressions Art. 23.1 (b) and (c) Applies to income which in accordance with Arts. 7 (business profits), 13.2 (gains from the alienation of movable property attributable to a PE in Indonesia) or 14 (independent personal services) may be taxed in Indonesia** and have been subjected to the normal tax in Indonesia or a tax comparable thereto and to income which in accordance with Art. 19.1-2 (government service) shall be taxable only in Indonesia</td>
<td>Tax sparing credit Art. 23.2 No time limit</td>
</tr>
<tr>
<td>Treaty partner</td>
<td>Year of signature</td>
<td>Main method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
<td>Additional method/s applied by Sweden</td>
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<tr>
<td>Ireland</td>
<td>1986</td>
<td>Ordinary credit Art. 24.2 and 24.7</td>
<td>Exemption with progression Art. 24.3 Applies to dividends*, subject to certain additional conditions</td>
<td>Matching credit Art. 24.8 (a) 1 and 3, Art. 24.8 (b) and Art. 24.8 (c) Applies to income which in accordance with Art. 8 (business profits) may be taxed in Ireland (income from financial activities are excluded) Tax sparing exemption Art. 24.8 (a) 2, Art. 24.8 (b) and Art. 24.8 (c) (income from financial activities are generally excluded) In effect until 31 December 2000, no extension enacted</td>
</tr>
<tr>
<td>Israel</td>
<td>1959</td>
<td>Exemption with progression Art. XVII.2 a) Applies to dividends that are not exempted and interest</td>
<td>Ordinary credit Art. XVII.2 a) Applies to dividends and interest</td>
<td>Tax sparing credit Art. XVII.2 a) Applies to dividends and interest No time limit</td>
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<tr>
<td>Treaty partner</td>
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<td>Main method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
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<tr>
<td>Italy</td>
<td>1980</td>
<td>Ordinary credit</td>
<td>Modified exemption, Art. 24.5</td>
<td>Full exemption, Arts. 24.3</td>
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<td>Applies to income which in accordance with the DTT shall be taxable only in Italy</td>
<td>Applies to dividends*, subject to certain additional conditions</td>
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<td></td>
<td>Tax sparing credit and tax sparing exemption, Art. 24.7</td>
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<td>No time limit</td>
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<td>Reverse credit, Art. 24.6</td>
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<td>Applies to income which in accordance with Art. 13.5 (capital gains on shares in real estate companies derived by a former resident of Sweden, subject to certain requirements) or Art. 18.2 (pensions paid to a Swedish citizen under the Swedish social security legislation or on the basis of contributions to a pension insurance institution established in Sweden) may be taxed in Sweden</td>
</tr>
<tr>
<td>Jamaica</td>
<td>1985</td>
<td>Ordinary credit</td>
<td>Modified exemption, Art. 23.2 (b)</td>
<td>Tax sparing credit, Art. 23.3</td>
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<td>Applies to income which in accordance with the DTT shall be taxable only in Jamaica</td>
<td>Applies to income derived from a PE or a fixed base in Jamaica and to dividends, interest and royalties received from a company which is a resident of Jamaica</td>
</tr>
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<td>No time limit</td>
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<tr>
<td>Japan</td>
<td>1983</td>
<td>Ordinary credit, Art. 22.2</td>
<td>Exemption with progression, Art. 22.2 (b)</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(a)</td>
<td>Applies to income which in accordance with Art. 18 (government service) shall be taxable only in Japan</td>
<td>N/A</td>
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<tr>
<td>Treaty partner</td>
<td>Year of signature</td>
<td>Main method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
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<tr>
<td>Kazakhstan</td>
<td>1997</td>
<td>Ordinary credit Art. 22.2 (a)</td>
<td>Exemption with progression Art. 22.2 (b) Applies to income which in accordance with the DTT shall be taxable only in Kazakhstan</td>
<td>N/A</td>
</tr>
<tr>
<td>Kenya</td>
<td>1973</td>
<td>Ordinary credit Art. XXII.2</td>
<td>Exemption with progression Art. XXII.3 Applies to income which has been exempted under the DTT</td>
<td>Tax sparing credit Art. XXII.4 In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Latvia</td>
<td>1993</td>
<td>Ordinary credit Art. 23.1 (a)</td>
<td>Exemption with progression Art. 23.1 (b) Applies to income which in accordance with Art. 19 (government service) shall be taxable only in Latvia</td>
<td>Full exemption Art. 23.1 (c) Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td>Lithuania</td>
<td>1993</td>
<td>Ordinary credit Art. 24.1 (a)</td>
<td>Exemption with progression Art. 24.1 (b) Applies to income which in accordance with Art. 19 (government service) shall be taxable only in Lithuania</td>
<td>Full exemption Art. 24.1 (c) Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td>Treaty partner</td>
<td>Year of signature</td>
<td>Main method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
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</tr>
<tr>
<td>Luxembourg</td>
<td>1996</td>
<td>Ordinary credit Art. 23.2</td>
<td>Exemption with progression Art. 23.2 (a)</td>
<td>N/A N/A</td>
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<tr>
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<td>Applies to income which in accordance with the DTT shall be taxable only in Luxembourg</td>
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</tr>
<tr>
<td>Macedonia</td>
<td>1998</td>
<td>Ordinary credit Art. 23.2</td>
<td>Exemption with progression Art. 23.2 (a)</td>
<td>Matching exemption Art. 23.2 e) and f)</td>
</tr>
<tr>
<td></td>
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<td>Applies to income which in accordance with the DTT shall be taxable only in Macedonia</td>
<td>Applies to dividends paid by a Macedonian company if the profits are derived from certain listed business activities</td>
</tr>
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<td>In effect for a period of five years</td>
</tr>
<tr>
<td>Malaysia</td>
<td>2002</td>
<td>Ordinary credit Art. 23.2</td>
<td>Exemption with progression Art. 23.2 (a)</td>
<td>Matching exemption Art. 23.2 d) and e)</td>
</tr>
<tr>
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<td>Applies to income which in accordance with the DTT shall be taxable only in Malaysia</td>
<td>Applies to dividends paid by a Malaysian company if the profits are derived from certain listed business activities</td>
</tr>
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<td>In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Malta</td>
<td>1995</td>
<td>Ordinary credit Art. 22.2</td>
<td>Exemption with progression Art. 22.2 (a)</td>
<td>Matching exemption Art. 22.2 d) and e)</td>
</tr>
<tr>
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<td></td>
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<td>Applies to income which in accordance with the DTT shall be taxable only in Malta</td>
<td>Applies to dividends paid by a Maltese company if the profits are derived from certain listed business activities</td>
</tr>
<tr>
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<td>In effect for a period of ten years, no extension enacted</td>
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<td></td>
<td>Tax sparing credit Art. 22.2 d) and e)</td>
</tr>
</tbody>
</table>

701 The time limit is counted from the date of entry into force, which means that the tax sparing credit and matching exemption provisions expire on 31 December 2015.

342
<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method/s applied by Sweden</th>
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<tbody>
<tr>
<td>Mauritius</td>
<td>1992</td>
<td>Ordinary Credit Art. 22.3 (a)</td>
<td>Exemption with progression Art. 22.3 (b)</td>
<td>Full exemption Art. 23.3 (c) Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
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<td>Applies to income which in accordance with the DTT shall be taxable only in Mauritius</td>
<td>Tax sparing credit and tax sparing exemption Art. 23.3 d-g) In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Mexico</td>
<td>1992</td>
<td>Ordinary Credit Art. 22.2 (a)</td>
<td>Exemption with progression Art. 22.2 b)</td>
<td>Matching credit Art. 22.4 and 22.6 Applies to royalty In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
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<td></td>
<td></td>
<td>Applies to income which in accordance with Art. 19 (government service) shall be taxable only in Mexico</td>
<td>Matching exemption Art. 22.5 and 22.6 Applies to dividends paid by a company resident in Mexico if the profits are derived from certain listed business activities In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Morocco(^\text{702})</td>
<td>1961</td>
<td>Exemption with progression Art. 11</td>
<td>N/A</td>
<td>N/A</td>
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<td>Namibia</td>
<td>1993</td>
<td>Ordinary Credit Art. 23.2 (a)</td>
<td>Exemption with progression Art. 23.2 (b)</td>
<td>Full exemption Art. 23.2 (c) Applies to dividends*, subject to certain additional conditions</td>
</tr>
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<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Namibia</td>
<td>Tax sparing credit and tax sparing exemption Art. 23.2 d) and c) In effect for a period of ten years, no extension enacted</td>
</tr>
</tbody>
</table>

\(^{702}\) The DTT with Morocco has been terminated by Morocco and its effect in Swedish domestic law has ceased through SFS 2007:1255, but still applies in regard to income derived prior to 1 January 2008.
<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Netherlands</td>
<td>1991</td>
<td>Ordinary Credit Art. 24.1 (a)</td>
<td>Exemption with progression Art. 24.1 c) and e) Applies to income which in accordance with Arts. 18.3 (pensions and other payments under the social security legislation of a contracting state) or 19 (government service) may be taxed in the Netherlands and to income which in accordance with Art. 8.1 (shipping and air transport) shall be taxable only in the Netherlands</td>
<td>Full exemption Art. 24.1 d) Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td>New Zealand</td>
<td>1979</td>
<td>Ordinary credit Art. 23.2</td>
<td>Exemption with progression Art. 23.5 Applies to income which has been exempted under the DTT</td>
<td>N/A</td>
</tr>
<tr>
<td>Nigeria</td>
<td>2004</td>
<td>Ordinary credit Art. 22.2 a)</td>
<td>Exemption with progression Art. 22.2 b) Applies to income which has been exempted under the DTT</td>
<td>Tax sparing credit Art 22.2 d) and f) Applies to income from certain listed business activities In effect for a period of ten years</td>
</tr>
</tbody>
</table>

*Subject to certain additional conditions.
<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method/s applied by Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>The Nordic Countries(^{703})</td>
<td>1996</td>
<td>Ordinary credit, Art. 25.6 a)</td>
<td>Exemption with progression, Art. 25.6 b) and c), Art. 25.7.3 and Art 25.7.3</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Applies to income which in accordance with the DTT shall be taxable only in another contracting state and, subject to certain conditions, to income which may be taxed in the other state in accordance with Art. 15.1 (income from employment) or Art. 21.7 a) (income from employment in connection with exploration or exploitation of hydrocarbons).

\(^{703}\) The DTT between the Nordic countries is a multilateral treaty between Denmark, The Faeroe Islands, Finland, Iceland, Norway, and Sweden.
<table>
<thead>
<tr>
<th>Treaty partner</th>
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<th>Main method applied by Sweden</th>
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<th>Additional method applied by Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pakistan</td>
<td>1985</td>
<td>Ordinary Credit Art. 23.2 (a)</td>
<td>Exemption with progression Art. 23.2 (b) and c) Applies to income which in accordance with Arts. 7 (business profits) or 15.1 a) (independent personal services attributable to a fixed base in Pakistan) may be taxed in Pakistan** and to income which in accordance with Arts. 8.1 (shipping and air transport), 14.3 (capital gains from the alienation of ships or aircraft) and 19.1-2 (government service) shall be taxable only in Pakistan</td>
<td>Tax sparing credit Art. 23.2 (d) Applies to income from trade, business or manufacturing activity carried on or independent personal services performed in Pakistan or dividends, interest, royalties or technical fees received from an enterprise of Pakistan In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>The Philippines</td>
<td>1998</td>
<td>Ordinary credit Art. 22.2 (a)</td>
<td>Exemption with progression Art. 22.2 (b) Applies to income which in accordance with the DTT shall be taxable only in the Philippines</td>
<td>N/A</td>
</tr>
<tr>
<td>Poland</td>
<td>2004</td>
<td>Ordinary credit Art. 22.1 (a)</td>
<td>Exemption with progression Art. 22.1 (b) Applies to income which in accordance with the DTT shall be taxable only in Poland</td>
<td>N/A</td>
</tr>
<tr>
<td>Treaty partner</td>
<td>Year of signature</td>
<td>Main method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
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</tr>
<tr>
<td>Portugal</td>
<td>2002</td>
<td>Ordinary credit Art. 22.2</td>
<td>Exemption with progression Art. 22.2 (b) Applies to income which in accordance with the DTT shall be taxable only in Portugal</td>
<td>N/A</td>
</tr>
<tr>
<td>Romania</td>
<td>1976</td>
<td>Ordinary credit Art. 25.1 and 25.3</td>
<td>Modified exemption Art. 25.4 Applies to income which in accordance with the DTT shall be taxable only in Romania</td>
<td>Tax sparing credit Art. 23.2 Applies to income attributable to a PE in Romania In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Russia</td>
<td>1993</td>
<td>Ordinary Credit Art. 22.2 (a)</td>
<td>Exemption with progression Art. 22.2 (b) Applies to income which has been exempted under the DTT</td>
<td>N/A</td>
</tr>
<tr>
<td>Singapore</td>
<td>1968</td>
<td>Ordinary credit Art. XIX.3</td>
<td>Exemption with progression Art. XIX.10 Applies to income which has been exempted under the DTT Full exemption Art. XIX.4 Applies to dividends*, subject to certain additional conditions</td>
<td>Matching credit/tax sparing credit Art. XIX §§ 5, 7 and 9 Applies to dividends and interest and to income under Art. III (Business profits) and Art. XII (Income from employment) In effect until 31 December 1985 Extended until 31 December 2000704 Full exemption Art. XIX § 6 Applies to 50 per cent of royalty In effect until 31 December 1985 Extended until 31 December 2000705 Tax sparing exemption Art. XIX §§ 8 and 9 Applies to dividends In effect until 31 December 1985 Extended until 31 December 2000706</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Treaty partner</th>
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</tr>
</thead>
<tbody>
<tr>
<td>South Africa</td>
<td>1995</td>
<td>Ordinary credit Art. 22.2</td>
<td>Exemption with progression Art. 22.2 (b) Applies to income which has been exempted under the DTT</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(a)</td>
<td></td>
<td>N/A</td>
</tr>
<tr>
<td>South Korea (the Republic of Korea)</td>
<td>1981</td>
<td>Ordinary credit Art. 22.2</td>
<td>Modified exemption Art. 22.3 Applies to income which in accordance with the DTT shall be taxable only in South Korea</td>
<td>Matching Credit Art. 22.4 Applies to dividends, interest and royalties In effect for a period of ten years, extended for an additional period of five years[^707]</td>
</tr>
<tr>
<td>Spain</td>
<td>1976</td>
<td>Ordinary credit Art. XXIV.1</td>
<td>Modified exemption Art. XXIV.2 Applies to income which in accordance with Art. XIX (income from employment) shall be taxable only in Spain</td>
<td>Full exemption Art. XXIV.3 Applies to dividends*, subject to certain additional conditions Tax sparing credit Art. XXIV.4 Applies to dividends, interest and royalty No time limit[^708]</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Reverse credit Art. XXIV.5 Applies to income which in accordance with Art. XIII.5 (capital gains on shares in real estate companies derived by a former resident of Sweden, subject to certain requirements) or Art. XVIII.3 (pensions paid to a Swedish citizen under the Swedish social security legislation or on the basis of contributions to a pension insurance institution established in Sweden) may be taxed in Sweden</td>
<td></td>
</tr>
</tbody>
</table>

[^708]: However, according to p. IV of the protocol signed on the same day, the competent authorities shall agree on the specific Spanish legislation to which the tax sparing credit provision shall apply.
<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method/s applied by Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sri Lanka</td>
<td>1983</td>
<td>Ordinary Credit</td>
<td>Modified exemption Art. 23.4</td>
<td>Matching credit Art. 23.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Sri Lanka</td>
<td>Applies to dividends and interest</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Switzerland</td>
<td>1965</td>
<td>Ordinary credit Art. 25.1 and 25.3</td>
<td>Exemption with progression Art. 25.1</td>
<td>Full exemption Art. 25.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with Art. 20 (income from employment) shall be taxable only in Switzerland</td>
<td>Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Reverse credit Art. 25.2-4</td>
</tr>
<tr>
<td></td>
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<td></td>
<td></td>
<td>Individuals who (i) are resident in Sweden for tax purposes under Swedish internal law, (ii) have moved from Sweden in the last three years and (iii) are not Swiss citizens may be taxed in Sweden irrespective of any other provisions of the DTT, but a credit for Swiss tax is allowed. Reverse credit is also applied in respect of income which in accordance with Art. 19.2 (pension paid under the social security legislation of Sweden) may be taxed in Sweden</td>
</tr>
<tr>
<td>Taiwan (Taipei)</td>
<td>2001</td>
<td>Ordinary credit Art. 22</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Tanzania</td>
<td>1976</td>
<td>Ordinary credit Art. 24.4</td>
<td>Modified exemption Art. 24.1-2</td>
<td>Tax sparing credit Art. 24.5-6</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Tanzania</td>
<td>In effect for a period of ten years and extended for an additional period of ten years</td>
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<td>N/A</td>
</tr>
</tbody>
</table>

709 For political reasons, this DTT was entered into by the Swedish Trade Council and the Taipei Mission in Sweden.
<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method(s) applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>Thailand</td>
<td>1988</td>
<td>Ordinary credit Art. 23.3 (a)</td>
<td>Exemption with progression Art. 23.3 (b) and (c) Applies to income which in accordance with Arts. 7 (business profits), 13.2 (capital gains from the alienation of movable property attributable to a PE in Thailand) or 14 (independent personal services) may be taxed in Thailand** and to income which in accordance with Art. 18 (government service) shall be taxable only in Thailand</td>
<td>Matching credit/tax sparing credit Art. 23.3 a) No time limit</td>
<td>N/A</td>
</tr>
<tr>
<td>Trinidad and Tobago</td>
<td>1984</td>
<td>Ordinary credit Art. 23.2 (a)</td>
<td>Modified exemption Art. 23.2(b) Applies to income which in accordance with the DTT shall be taxable only in Trinidad and Tobago</td>
<td>Tax sparing credit Art. 23.3 In effect for a period of ten years, no extension enacted</td>
<td>N/A</td>
</tr>
<tr>
<td>Tunisia</td>
<td>1981</td>
<td>Ordinary credit Art 21.1</td>
<td>Modified exemption Art. 21.2 Applies to income which in accordance with the DTT shall be taxable only in Tunisia</td>
<td>Full exemption Art. 21.4 Applies to dividends*, subject to certain conditions Reverse credit Art. 21.5 Applies to income derived by individuals who are resident in Sweden for tax purposes under Swedish internal law</td>
<td>Tax sparing credit/Matching credit Art. 21.3 No time limit</td>
</tr>
<tr>
<td>Treaty partner</td>
<td>Year of signature</td>
<td>Main method applied by Sweden</td>
<td>Additional method applied by Sweden</td>
<td>Additional method/s/ applied by Sweden</td>
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</tr>
<tr>
<td>Turkey</td>
<td>1988</td>
<td>Ordinary credit Art. 23.2 (a)</td>
<td>Exemption with progression Art. 23.2 (b) and (d)</td>
<td>Applies to income which in accordance with Arts. 7 (business profits), 13.2 (gains from the alienation of movable property attributable to a PE in Turkey) or 14 (independent personal services) may be taxed in Turkey** and to income which in accordance with Art. 19.1 (government service) shall be taxable only in Turkey</td>
<td>Full exemption Art. 23.2 (c) Applies to dividends*</td>
</tr>
<tr>
<td>Ukraine</td>
<td>1995</td>
<td>Ordinary credit Art. 22.2 (a)</td>
<td>Exemption with progression Art. 22.2 (b)</td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Ukraine</td>
<td>Full exemption Art. 22.2 c) Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>1983</td>
<td>Ordinary credit Art. 22.2 (a)</td>
<td>Modified exemption Art. 22.2 (b)</td>
<td>Applies to income which in accordance with Art. 8 (shipping and air transport), Art 13.4 (capital gains from the alienation of ships or aircraft operated in international traffic) or Art. 19.1-2 (government service) shall be taxable only in the UK</td>
<td>Full exemption Art. 22.3 Applies to dividends*</td>
</tr>
</tbody>
</table>

** Tax sparing credit and tax sparing exemption Art. 22.2 d) and e) In effect for a period of ten years, no extension enacted

* Applies to dividends, interest and royalty

N/A
<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States of America</td>
<td>1994</td>
<td>Ordinary credit Art. 23.2 (a) and 23.3 (a)</td>
<td>Exemption with progression Art. 23.2 (b)</td>
<td>Full exemption Art. 23.2 (c)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with Art. 19.2 (pensions and annuities) and Art. 20 (government service) shall be taxable only in the U.S.</td>
<td>Applies to dividends provided that the profits out of which the dividends are paid have been subjected to the normal corporate tax in the U.S.</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>Reverse credit Art. 23.2 (a)</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>Applies to income which in accordance with Art. 13.7 (gains from the disposition of any property derived by an individual during a ten year period after a change of residence from Sweden to the U.S.) may be taxed in Sweden</td>
</tr>
<tr>
<td>Venezuela</td>
<td>1993</td>
<td>Ordinary credit Art 23.2 (a)</td>
<td>Exemption with progression Art. 23.2 (f)</td>
<td>Full exemption Art. 23.2 (b)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Venezuela</td>
<td>Applies to dividends*, subject to certain additional conditions</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Tax sparing credit and tax sparing exemption Art. 23.2 (c), d) and e) In effect until 31 December 2000, no extension enacted</td>
</tr>
<tr>
<td>Vietnam</td>
<td>1994</td>
<td>Ordinary credit Art. 22.2 a)</td>
<td>Exemption with progression Art. 22.2 (b)</td>
<td>Tax sparing credit and matching credit Art. 22.2 d), c) and f)</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Vietnam</td>
<td>Applies to income from certain listed business activities and to royalty payments In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>Matching exemption Art. 22.2 d) and f) Applies to incentives in respect of certain business activities In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td>Yugoslavia</td>
<td>1980</td>
<td>Ordinary credit Art. 22.1-2</td>
<td>Modified exemption Art. 22.4</td>
<td>Tax sparing credit Art 22.3</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to income which in accordance with the DTT shall be taxable only in Yugoslavia</td>
<td>Applies to income which in accordance with Art. 7 (Business profits) In effect for a period of ten years, no extension enacted</td>
</tr>
<tr>
<td></td>
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<td></td>
<td>N/A</td>
</tr>
</tbody>
</table>

\[710\] The credit shall not exceed the amount of the tax that would be paid to the U.S. according to the DTT if the resident were not a U.S. citizen or former citizen or former long-term resident.
<table>
<thead>
<tr>
<th>Treaty partner</th>
<th>Year of signature</th>
<th>Main method applied by Sweden</th>
<th>Additional method applied by Sweden</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Zambia 1974</td>
<td>Ordinary credit</td>
<td>N/A</td>
<td>Full exemption</td>
<td>Tax sparing credit</td>
</tr>
<tr>
<td></td>
<td>Art. XXII.2</td>
<td></td>
<td>Art. XXII.4</td>
<td>Art. XXII.3</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Applies to dividends*, subject to certain additional conditions</td>
<td>No time limit</td>
</tr>
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</tr>
<tr>
<td>Zimbabwe 1989</td>
<td>Ordinary credit</td>
<td>Exemption with progression</td>
<td>Matching credit</td>
<td>N/A</td>
</tr>
<tr>
<td></td>
<td>Art. 23.2 (a)</td>
<td>Art. 23.2 (b) and (d)</td>
<td>Art. 23.2 c)</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>Applies to income which in accordance with Arts. 7 (business profits), 14.2 (gains from the alienation of movable property attributable to a PE in Zimbabwe) or 15 (independent personal services) may be taxed in Zimbabwe** and to income which in accordance with Art. 20 (remuneration and pensions in respect of government service) shall be taxable only in Zimbabwe</td>
<td>Applies to interest, royalties and technical fees</td>
<td>In effect for a period of ten years, no extension enacted</td>
</tr>
</tbody>
</table>

* The exemption applies in respect of dividends paid by a company which is a resident of the other state to a company which is a resident of Sweden to the extent that the dividends would have been exempt under Swedish law if both companies had been Swedish companies.

** Provided that the principal part of the income of the PE or fixed base arises from business activities or independent personal services, other than the management of securities and other similar property, and that such activities or services are carried on within N through the PE or fixed base.
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Model Tax Convention on Income and on Capital, OECD, 22 July 2010 (abbrev. OECD Model)

Recommendation of the OECD Council concerning the OECD Model Tax Convention on income and on capital, adopted in its latest version by the Council on 23 October 1997, annexed to the OECD Model


Tax Sparing: A Reconsideration, OECD, 1998
United Nations and International Law Commission


Sweden

*Government Bills*

Prop. 1965:164 Kungl. Maj:ts proposition till riksdagen angående godkänning av avtal mellan Sverige och Brasilien för undvikande av dubbelbeskattning beträffande skatter på inkomst och förmögenhet

Prop. 1965:177 Kungl. Maj:ts proposition till riksdagen angående godkännande av avtal mellan Sverige och Schweiz för undvikande av dubbelbeskattning beträffande skatter på inkomst och förmögenhet

Prop. 1966:127 Kungl. Maj:ts proposition till riksdagen med förslag om ändring i kommunalskattelagen den 28 september 1928 (nr 370), m.m.

Prop. 1976/77:2 med förslag till godkännande av avtal mellan Sverige och Spanien för undvikande av dubbelbeskattning beträffande skatter

Prop. 1976/77:8 med förslag till godkännande av avtal mellan Sverige och Tanzania för undvikande av dubbelbeskattning beträffande skatter på inkomst och förmögenhet

Prop. 1976/77:154 om dubbelbeskattningsavtal mellan Sverige och Rumänien
Prop. 1981/82:107 om dubbelbeskattningsavtal mellan Sverige och Republiken Korea
Prop. 1982/83:14 om dubbelbeskattningsavtal mellan Sverige och Luxemburg
Prop. 1982/83:109 om dubbelbeskattningsavtal mellan Sverige och Japan
Prop. 1983/84:5 om dubbelbeskattningsavtal mellan Sverige samt Storbritannien och Nordirland
Prop. 1985/86:131 om den skattemässiga behandlingen av kostnader vid viss verksamhet i utlandet, m.m.
Prop. 1985/86:172 om dubbelbeskattningsavtal mellan Sverige och Pakistan
Prop. 1986/87:17 om dubbelbeskattningsavtal mellan Sverige och Folkrepubliken Kina
Prop. 1986/87:77 om dubbelbeskattningsavtal mellan Sverige och Irland
Prop. 1986/87:94 om dubbelbeskattningsavtal mellan Danmark, Finland, Island, Norge och Sverige, m. m.
Prop. 1988/89:145 om dubbelbeskattningsavtal mellan Sverige och Indonesien
Prop. 1991/92:45 om dubbelbeskattningsavtal mellan Sverige och Singapore och mellan Sverige och Republiken Korea
Prop. 1992/1993:177 om dubbelbeskattningsavtal mellan Sverige och Estland
Prop. 1992/93:187 om individuellt pensionssparande
Prop. 1995/96:55 Dubbelbeskattningsavtal mellan Sverige och Ukraina
Prop. 1999/2000:2 Inkomstskattelagen
Prop. 2003/04:10 Ändrade regler för CFC-beskattning
Prop. 2008/09:63 Undvikande av internationell dubbelbeskattning
Prop. 2010/11:165 Skatteöfverförandet
Prop. 2010/11:166 Följdändringar med anledning av införandet av skatteöfverförandelagen

Swedish Government Official Reports, Ministry Communication etc.
Skatteutskottets betänkande 1988/89:SkU25 Dubbelbeskattningsavtal mellan Sverige och Cypern
Rskr. 1988/89:159
Ds 2007:25 Riktlinjer för handläggningen av ärenden om internationella överenskommelser
SOU 1962:59 Internationella skattefrågor
SOU 1974:100 Internationella överenskommelser och svensk rätt

356
The Swedish Tax Agency

Riksskatteverkets meddelande (Eng. the Swedish Tax Agency’s information)

RSV S 1994:7


Ställningstagande (Eng. Published Position), 20 November 2007, dnr 131 696178-07/111

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United States


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357
<table>
<thead>
<tr>
<th>Reference</th>
<th>Pages</th>
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</thead>
<tbody>
<tr>
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<td>179</td>
</tr>
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<td>52</td>
</tr>
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<td>84</td>
</tr>
<tr>
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<td>145</td>
</tr>
<tr>
<td>RÅ78 1:22</td>
<td>115</td>
</tr>
<tr>
<td>RÅ79 1:47</td>
<td>163</td>
</tr>
<tr>
<td>RÅ83 1:87</td>
<td>52</td>
</tr>
<tr>
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<td>110</td>
</tr>
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<td>179–180</td>
</tr>
<tr>
<td>RÅ85 1:6</td>
<td>199–202</td>
</tr>
<tr>
<td>RÅ85 1:49</td>
<td>238, 264, 268</td>
</tr>
<tr>
<td>RÅ 1987 ref. 158</td>
<td>100</td>
</tr>
<tr>
<td>RÅ 1987 ref. 162</td>
<td>77, 83–84, 101, 118, 120, 156–158</td>
</tr>
<tr>
<td>RÅ 1989 ref. 37</td>
<td>77, 120</td>
</tr>
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<td>RÅ 1991 ref. 107</td>
<td>100</td>
</tr>
<tr>
<td>RÅ 1991 not. 228</td>
<td>100</td>
</tr>
<tr>
<td>RÅ 1993 ref. 29</td>
<td>138</td>
</tr>
<tr>
<td>RÅ 1993 not. 677</td>
<td>100</td>
</tr>
<tr>
<td>RÅ 1995 not. 68</td>
<td>101, 120, 161–162</td>
</tr>
<tr>
<td>RÅ 1996 ref. 38</td>
<td>206</td>
</tr>
<tr>
<td>RÅ 1996 ref. 84</td>
<td>69–70, 76–77, 100–101, 106–107</td>
</tr>
<tr>
<td>RÅ 1998 ref. 49</td>
<td>77</td>
</tr>
<tr>
<td>RÅ 1999 ref. 65</td>
<td>271</td>
</tr>
<tr>
<td>RÅ 2001 ref. 38</td>
<td>100</td>
</tr>
<tr>
<td>RÅ 2001 ref. 43</td>
<td>146, 272</td>
</tr>
<tr>
<td>RÅ 2001 ref. 46</td>
<td>128–129</td>
</tr>
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<td>RÅ 2001 ref. 50</td>
<td>100</td>
</tr>
<tr>
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<td>120</td>
</tr>
<tr>
<td>RÅ 2004 ref. 132</td>
<td>147</td>
</tr>
<tr>
<td>RÅ 2004 not. 59</td>
<td>83–84, 157–158, 176–177</td>
</tr>
<tr>
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<td>59–61, 63–65, 68, 186</td>
</tr>
<tr>
<td>RÅ 2008 not. 61</td>
<td>59–61, 63–65, 68, 186</td>
</tr>
<tr>
<td>RÅ 2009 ref. 91</td>
<td>48, 116</td>
</tr>
<tr>
<td>RÅ 2009 not. 24</td>
<td>220</td>
</tr>
<tr>
<td>RÅ 2010 ref. 112</td>
<td>63–65, 70, 121</td>
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