CHAPTER 7

ELIMINATION OF DOUBLE TAXATION

7.1. Exemption or credit: history in general

After returning from his performances abroad, the artiste is again confronted with taxation, because his residence country wants to tax his foreign performance fees as part of his worldwide income. But this threat of economic double taxation is normally relieved with financial compensation by the residence country (tax credit or tax exemption) which has been inserted in all bilateral tax treaties. Most countries also provide this double tax relief unilaterally.[1]

In general, there are two ways to avoid double taxation:
(1) exempting foreign income from domestic taxation; and
(2) granting a credit for foreign taxes.

When the first tax treaties were concluded 100 years ago by the continental European countries,[2] it was logical for two states to distribute the taxable earnings between themselves by allocating the tax right to only one state, making these earnings tax exempt in the other. Until World War II, this was the method unanimously applied by all double taxation conventions between continental European states.[3]

The credit method, in contrast, was originally introduced in 1894 by the United Kingdom for relief from double imposition of estate duty within the British Empire.[4] Issues of double income taxation were not prominent

1. An example is Austria, which has inserted a unilateral measure in Sec. 49 of the *Bundesabgabenordnung* (Federal Tax Code). An explanation can be found in Heinz Jirousek, Josef Schuch and Franz Sutter, "Unilateral Relief form Double Taxation in Austria", 58 *Bulletin for International Fiscal Documentation* 8/9 (2004), at 372.
2. With the Austria–Prussia Tax Convention, dated 21 June 1899, as the first real double tax treaty; see 2.4.
3. See Klaus Vogel, "Which Method Should the European Community Adopt for the Avoidance of Double Taxation?", 56 *Bulletin for International Fiscal Documentation* 1 (2002), at 4.
4. Sec. 20 of the Finance Act 1894. See Philip Baker, "Some Aspects of United Kingdom Double Taxation Relief", 52 *Bulletin for International Fiscal Documentation* 10 (1998), at 445.

in the United Kingdom until 1914.[5] In 1916 a purely temporary measure of double taxation relief was introduced, under which credit was granted for any "colonial" income tax, but not for income tax that had been paid in countries outside the British Empire.[6]

On the other side of the ocean, the United States first announced a credit for foreign taxes in 1918, as a unilateral measure in favour of US citizens.[7]

Both the United States and the United Kingdom initially inserted the tax credit only in their own tax legislation to compensate their citizens for the taxes they had paid in other (colonial) countries.

In its drafts of 1928-1946 the League of Nations considered that the credit method was an alternative treaty provision to the exemption method.[8] But during the 1920s and 1930s, both credit states, the United States and the United Kingdom, were reluctant to conclude double tax conventions and therefore tax treaties almost exclusively used the exemption method until, after the 1930s, the United States and the states of the British Commonwealth set about building up treaty networks of their own.

5. Not only were the UK tax rates low in the years before 1914, but foreign-source income was generally taxable, if at all, only on a remittance basis. This changed in 1914, both with respect to the rates of tax and the basis of taxation (Sec. 5 of the UK Finance Act 1914).
6. The question of double taxation received a full discussion in the context of the Royal Commission on the Income Tax in 1920. Its recommendations drew a sharp distinction between double income taxation within the British Empire and with foreign countries. Within the Empire, the Commission concluded that the removal of double taxation was an urgent necessity, because of the common interest in the well-being of every part of the Empire and the desire for free circulation of capital within it. The Commission took the position that these elements were lacking with respect to foreign states and recommended that the only solution was reciprocal arrangements between the United Kingdom and each foreign state (The Colwyn Commission, Cmd 615 of 11 March 1920).
The United Kingdom did not enter in to any comprehensive double taxation conventions providing for credit relief, but only concluded a number of limited agreements. This meant that relief from double income taxation was not a feature of the UK tax system prior to World War II. See Philip Baker (1998).
7. For a clear description and analysis of this early formative period of US international tax policy, see Michael J. Graetz and Michael M. O'Hear, "The Original Intent of US International Taxation", 46 *Duke Law Journal* 1021 (1997). They explained how Thomas Sewell Adams introduced the Foreign Tax Credit in 1918 as compensation for foreign taxes; this became necessary because the tax rates in both the United States and other countries were rising steeply in the years of World War I.
8. As explained in 2.5., the League of Nations models still serve as the basis for the model income tax treaties of the OECD, the United Nations and the United States. See also Mitchell B. Carroll, "Double Taxation Relief, Discussion of Conventions Drafted at the International Conference of Experts, 1927 and Other Measures", 1 *Department of Commerce Trade Information Bulletin* 523 (1927).

An important step forward for the United States and the United Kingdom was their bilateral double tax convention of 1945, in which the tax credit was mentioned as the relief method for avoiding double taxation. UK domestic legislation was changed in the Finance Act of 1945, which afterwards became known as the "Credit Code" of rules for computing foreign tax credit.[9]

After World War II the credit method gradually became more popular with some states of the European continent, which adopted it either as a unilateral method, like Germany, or in their treaties, like the Scandinavian states and, more recently, France, although many continental European countries still use the exemption method (unilaterally) as the preferred way to divide international taxation.

Whether the exemption method is better than the credit method has led to much discussion over the years. Not only tax experts but also economists have contributed to this discussion about the preferable neutrality of international taxation. The difference between "capital import neutrality" and "capital export neutrality" has already been discussed in 2.2.; the division between the exemption and the credit method contributes to this discussion.[10]

With the exemption method the country of residence leaves the taxing right solely with the source country, giving that country the responsibility to tax the source income according to its own tax rules and rates. With the credit method, the residence country gets a subsidiary tax right which will have its effect when the source country levies a lower tax than the country of residence, because then an additional amount of tax needs to be paid on the worldwide income.[11]

Both methods can have their restrictions, as will be shown in 7.2.

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9. Secs. 51 to 56 of the UK Finance Act 1945.
10. See Richard Musgrave, "Criteria for Foreign Tax Credit", in *Taxation and Operations Abroad* (Symposium, 1960), at 83, and Peggy Musgrave, "Taxation of Foreign Investment Income, An Economic Analysis" (1963). The Musgraves assumed that only "capital-export neutrality" corresponded with the goals of economic efficiency and that the way to achieve this was by combining the taxation of worldwide income with a credit for foreign taxes. This theory justifies the US system of international taxation, but has also recently been criticized, e.g. because it discriminates against investments in low-tax countries, in particular developing countries, and creates "fiscal imperialism".
11. See Klaus Vogel, "Which Method Should the European Community Adopt for the Avoidance of Double Taxation?", 56 *Bulletin for International Fiscal Documentation* 1 (2002), at 4.

Countries using the exemption method reserve this mainly for "active income" such as business profits (through permanent establishments) and employment income, while they use the credit method for "passive income" such as interest, dividends and royalties. This distinction has been taken over in the official recommendation of the exemption method in Article 23A of the OECD Model Tax Convention.

7.2. Explanation of tax exemption and tax credit methods

7.2.1. Two different systems, with two variations

Both the tax exemption and the tax credit method can be divided in two different systems: the "full exemption" and the "exemption with progression" – "full credit" and "ordinary credit". These methods have different results, as will be shown by the following example of two different cases, I and II.[12]

- an artiste earns 80,000 at home in State R(esidence) and 20,000 abroad in State S(ource) = worldwide income of 100,000;
- in State R the tax rates are progressive, namely 35% (average) on an income of 100,000 (= 35,000) and 30% (average) on an income of 80,000 (= 24,000); and
- in State S the tax rate is either 20% (in case I) or 40% (in case II), leading to 4,000 or 8,000 source tax

Without any relief for double taxation, the total initial tax burden would be:

	Case I	Case II
tax in State R, 35% x 100,000 =	35,000	35,000
+ tax in State S	4,000	8,000
total taxes	39,000	43,000

12. The figures for this explanation have been taken from the official Commentary on Article 23 of the OECD Model Treaty.

7.2.2. Full exemption

With the "full exemption", the home country, State R, simply omits the foreign income from its own taxation and only imposes tax on the domestic income of 80,000, at 30%:

	Case I	Case II
tax in State R, 30% x 80,000 =	24,000	24,000
+ tax in State S	4,000	8,000
total taxes	28,000	32,000
tax relief in State R: 35,000 – 24,000 =	*11,000*	*11,000*

7.2.3. Exemption with progression

With the "exemption with progression", the home country, State R, takes into account the exempted foreign income when calculating the amount of tax on the remaining, domestic income. Therefore, domestic income is taxed at the tax rate for worldwide income, i.e. 35%:

	Case I	Case II
tax in State R, 35% x 80,000 =	28,000	28,000
+ tax in State S	4,000	8,000
total taxes	32,000	36,000
tax relief in State R: 35,000 – 28,000 =	*7,000*	*7,000*

7.2.4. Full credit

With the "full credit", the home country, State R, simply allows the deduction of the foreign-source tax from the tax calculated on worldwide income:

	Case I	Case II
tax in State R, 35% x 100,000 =	35,000	35,000
– full tax credit	– 4,000	– 8,000
total tax in State R	31,000	27,000
+ tax in State S	4,000	8,000
total taxes	35,000	35,000
tax relief in State R (full tax credit) =	*4,000*	*8,000*

7.2.5. Ordinary credit

With the "ordinary credit", the home country, State R, also allows a deduction of the foreign-source tax from the tax calculated on the worldwide income, but not more than the proportion of tax that would be attributable to the income from State S (maximum deduction). This limitation to the average tax rate is a maximum of 35% x 20,000 = 7,000 in this example and applies in Case II:

	Case I	Case II
tax in State R, 35% x 100,000 =	35,000	35,000
– ordinary tax credit	– 4,000	– 7,000 (max.)
total tax in State R	31,000	28,000
+ tax in State S	4,000	8,000
total taxes	35,000	36,000
tax relief in State R (limited tax credit) =	*4,000*	*7,000 (max.)*

7.2.6. Summary of the figures

These figures can be summarized as follows:

– For Case I:

	Relief State R	Tax State S	Result
full exemption	11,000	– 4,000	= 7,000
exemption with progression	7,000	– 4,000	= 3,000
full credit	4,000	– 4,000	= 0
ordinary credit	4,000	– 4,000	= 0

– For Case II:

	Relief State R	Tax State S	Result
full exemption	11,000	– 8,000	= 3,000
exemption with progression	7,000	– 8,000	= – 1,000
full credit	8,000	– 8,000	= 0
ordinary credit	7,000	– 8,000	= – 1,000

7.2.7. Conclusions from example; recommendations in Article 23 of the OECD Model

Of the two *exemption* methods, the "full exemption" is usually the most advantageous method for eliminating double taxation for the artiste in this example. The "full exemption" will be given against the marginal, highest applicable tax rate, while the "exemption with progression" allows the exemption against the average tax rate on the income in the country of residence. This makes a big difference in a country with steep progressive tax rates.

In any case, in both situations the tax relief can be more than the foreign-source tax, but can also be lower. This will happen sooner with the "exemption with progression" method than with the "full exemption" method, as the examples in 7.2.2. and 7.2.3. and the summary in 7.2.6. show.

The "full exemption" method is regularly used for exemption in source states, but almost never for elimination of double taxation in the country of residence.[13] Article 23A of the OECD Model Tax Convention recommends the use of the "exemption with progression" method for countries that want to apply this to active foreign income.[14]

An important difference in favour of the "exemption with progression" method is the treatment of foreign losses. They can be offset against other, domestic, positive income items and therefore bring down the taxable income in the country of residence. This is more profitable than under the

13. An exception is the participation exemption, which is applied by some countries on (foreign) dividends and profits from subsidiaries.
14. The 2003 OECD Model Treaty recommends in Article 23A(2) the "ordinary" credit method for passive income from dividends (Article 10) and interest (Article 11).

"full exemption" method, where these foreign losses are included in the exemption.

From the two tax *credit* methods, the "full credit" gives the best result for the taxpayer. The tax relief from this method seems to be closest to the theory of "capital export neutrality", because the total tax burden after the full tax credit is equal to the tax that would be due if the income were earned in the home country only. At first sight, it is a nicely balanced credit system, with the same overall tax burden regardless of whether the income had a domestic or foreign source.

But problems can arise for state budgeters when the foreign-source tax rate is higher than the tax rate in the country of residence. This was already recognized in 1921 in the United States, a mere 3 years after the foreign tax credit was introduced in the Revenue Act. The limitation to "ordinary credit" was enacted to prevent taxes from countries with income tax higher than that in the United States from reducing US tax liability on US-source income. The reason was that the income tax rates in the United Kingdom in those post-war years were so high that the United States was afraid that all domestic tax revenue would be wiped out by a full foreign tax credit. The United States stated the opinion that at least it wanted to collect the taxes that fairly belonged it.[15] This provision still constitutes a fundamental basis of US law for taxing income earned abroad by US residents.

The United Kingdom also limits the tax credit to a maximum, which is the amount of UK tax attributable to the income which has been subject to foreign tax.[16] This is the same for other countries using the tax credit system.

Article 23B of the OECD Model Tax Convention follows the views of the United States and the United Kingdom and recommends in general the use of the "ordinary credit" method for countries wanting to apply the credit system to all types of foreign income, both active and passive. But the conclusion from the example is that this might lead to insufficient compensation for the foreign artiste tax, as shown in Case II in 7.2.4.

15. *Internal Revenue: Hearings on H.R. 8245 Before the Committee on Finance of the United States Senate*, 67th Congress, 1st Session (1921), reprinted in 95A Internal Revenue Acts of the United States 1909-1950, Legislative Histories, Laws and Administrative Documents (Bernard D. Reams, Jr., ed. 1979).
16. See Philip Baker (1998), at 445.

7.2.8. Differences in taxable income

In the examples, the taxable income was the same in both the source state (State S) and the residence state (State R). This is an ideal situation, but not very realistic for international performing artistes. They very often need to deduct in their residence country extra business expenses, mainly indirect and overhead expenses. And, like many others, artistes can have personal allowances, such as for mortgage interest, alimony, gifts, free taxable amounts, etc., that further reduce their taxable income in the country of residence. This has a negative effect on the results of all methods for the elimination of double taxation.

7.3. Recommended relief of double taxation under Article 17

7.3.1. No recommendation in 1963, introduction in 1977

The 1963 OECD Model Treaty expressed no preference for the method of elimination of the double taxation that resulted from Article 17. The income of international artistes was considered "active income", leading to the use of the exemption method in bilateral tax treaties by most of the continental European countries. Other countries, such as the United States and the United Kingdom, used the credit method for artistes, as they did for other sources of active income.

With the introduction of Article 17(2) in the 1977 OECD Model Tax Convention, a new Paragraph 5 was also added to the Commentary on Article 17, giving a recommendation for the method for eliminating the double taxation that would result from the article. The OECD advised its Member countries to use the credit method. This could be problematic in some countries, because they were not able to apply the credit method to this type of active income, and for these countries the OECD advised the introduction of a special, subsidiary tax right for foreign performance fees. The text of Paragraph 5 of the 1977 Commentary was as follows:

> 5. Where in the cases dealt with in paragraph 2 the exemption method for relieving double taxation is used by the State of residence of the person receiving the income, that State would be precluded from taxing such income even if the State where the activities were performed could not make use of its right to tax. It is therefore understood that the credit method should be used in such cases. The same result could be achieved by stipulating a subsidiary right

> to tax for the State of residence of the person receiving the income, if the State where the activities are performed cannot make use of the right conferred on it by paragraphs 1 and 2. Contracting States are free to choose any of these methods in order to ensure that the income does not escape taxation.

The 1987 OECD Report came with more extensive considerations about the preferred method for elimination of the double taxation caused by Article 17. Even after the 1977 recommendation some Member countries which had issued their papers for the 1987 Report were still unhappy with the use of the exemption method. The Report came to the following paragraph IV.D.4:

> 4. Subsidiary right to tax for the country of residence
>
> 99. The provisions of Article 17 could lead to double non-taxation where, on the one hand, the country of the artiste's or athlete's performance cannot exercise the taxing powers afforded it under the convention (for example, because under domestic law the income is not taxable or is specifically exempted) and, on the other hand, the country of residence applies the exemption method to relieve double taxation. This is seen as a major tax compliance issue in the countries of residence. The problem is of direct concern only to those countries of residence which apply the exemption method to relieving double taxation (either under internal law or under a convention). The problem arises not only where the income is not taxed at source; even when income is taxed in the country in which it is earned, the rate is often considerably lower than that of a progressive scale of taxation which would be applied by the country of residence. Some countries are very dissatisfied with this situation and resort to the use of the credit method in such cases.
>
> 100. The Commentary on Article 17 refers to this problem when dealing with the special case of artiste companies (in paragraph 5 of the text) and suggests as a solution, that either the credit method be used, or a subsidiary right to tax for the country of residence should be recognised. That country would be allowed to tax the income in question when this has not been done in the country where the performance takes place. The first of these solutions is also referred to in a more general context in paragraphs 32 and 47 of the Commentary on Article 23A. In cases where a country is unable to use the credit method, it should of course adopt the second solution.
>
> 101. The Committee's conclusion on this point is that there is nothing to prevent two Contracting States from adopting one or other of these two possible solutions in a bilateral convention. They should endeavour to do so when there is a high risk of double non-taxation, tax avoidance or evasion.

The advice to insert a subsidiary right to tax in the tax treaty for the residence country has found no following in practice. It is unclear why countries are ignoring this OECD opportunity that could strengthen their taxing rights regarding artistes. It may be that they do not consider the double non-taxation of artistes to be a real problem *or* that they trust that relying on the tax credit method for relief from double taxation (or even the exemption method) will be sufficient.[17]

The recommendation in the 1977 Commentary to use the ordinary credit method has been moved to Paragraph 12 in the 1992 issue of the Commentary on Article 17. Many countries follow this recommendation as compensation for foreign taxation. Some countries therefore deviate from their general tax treaty policy, in which they normally use the exemption method for active income.

The recommendation of the tax credit method for Article 17 of the OECD Model is different from the recommendations for Article 7 (Business profits) and Article 15 (Income from employment). OECD Member countries are free to choose between the tax credit and the tax exemption method for these sources of income.

7.3.2. Example: the Netherlands

This change in policy can be seen in the tax treaties that the Netherlands has concluded over the years. Initially the Netherlands inserted the exemption method in its tax treaties, following the general, continental European principle that the elimination of double taxation on "active income" was best prevented by the exemption method. But in the early 1970s the Netherlands started to change this policy regarding Article 17 and introduced the credit method in some of its new tax treaties. The 1980 tax treaty with the United Kingdom was the last treaty with the exemption method; subsequently the Netherlands followed the advice of the Commentary on Article 17 of the OECD Model Tax Convention.[18]

17. The option for a subsidiary right to tax or for a "subject to tax" clause was discussed at the 2004 IFA Congress in Vienna, with regard to the issue of "double non-taxation".
18. But interestingly enough the Netherlands does not say anything about this in its official tax treaty policy, *Nota "Internationaal fiscaal (verdrags)beleid"*, *VN* 1998/22.3.

Below is a list of the tax treaties of the Netherlands and the method of elimination of double taxation that is used for Article 17, sorted by the year in which the tax treaty was concluded:

Tax treaties the Netherlands and method of elimination double taxation from Article 17

Treaty countries	Year	Method
Switzerland	1949	*exemption*
Germany	1959	*exemption*
Netherlands Antilles	1964	*exemption*
Ireland	1965	*exemption*
Luxembourg	1967	*exemption*
Singapore	1968	*exemption*
South Africa	1968	*exemption*
Israel	1970	*exemption*
Japan	1970	*exemption*
Czech Republic	1972	credit
Slovak Republic	1972	credit
Spain	1973	*exemption*
France	1974	credit
Australia	1975	credit
Surinam	1975	credit
Thailand	1975	*exemption*
Malta	1976	credit
Morocco	1977	*exemption*
Poland	1978	credit
New Zealand	1979	credit
Sri Lanka	1979	credit
United Kingdom	1980	*exemption*
Greece	1981	credit
Korea (Rep.)	1982	credit
Pakistan	1982	credit
Zambia	1983	credit
Bosnia-Herzegovina	1984	credit
Slovenia	1984	credit
Yugoslavia	1984	credit
Malaysia	1985	credit
Canada	1987	credit
Hungary	1988	credit
Kyrgyzstan	1988	
Tajikistan	1988	

Treaty countries	Year	Method
Turkmenistan	1988	
China (People's Rep.)	1989	credit
India	1989	credit
Turkey	1989	credit
Norway	1991	credit
Brazil	1992	credit
Philippines	1992	credit
Zimbabwe	1992	credit
Italy	1993	credit
Nigeria	1993	
Sweden	1993	credit
United States	1994	credit
Bangladesh	1995	credit
Bulgaria	1995	credit
Estonia	1995	credit
Mexico	1995	credit
Argentina	1996	credit
Kazakhstan	1996	credit
Latvia	1996	credit
Tunisia	1996	credit
Vietnam	1996	credit
Ukraine	1997	credit
Belarus	1998	credit
Finland	1998	credit
Venezuela	1998	credit
Denmark	1999	credit
Iceland	1999	credit
Russia	1999	credit
Macedonia	2000	credit
Romania	2000	credit
Armenia	2001	credit
Egypt	2001	credit
Kuwait	2001	credit
Lithuania	2001	credit
Portugal	2001	credit
Croatia	2002	credit
Georgia	2002	credit
Indonesia	2002	credit
Moldova	2002	credit
Mongolia	2002	credit
Taiwan	2002	credit

Treaty countries	Year	Method
Austria	2003	credit
Belgium	2003	credit
Uzbekistan	2003	credit

7.3.3. Exceptions in other countries

Interestingly enough there are also countries that have not changed their national rules for eliminating double taxation and stick with exemption (with progression) as the proper method, even though their tax treaties contain the tax credit method. Examples of such countries are Belgium and Germany. The national tax legislation of these countries does not contain any measures to apply the tax credit system to active income, but only to passive income such as dividends, interest and royalties.

The difference in approach between tax credit and tax exemption can sometimes lead to a rare confrontation in a specific tax treaty between two countries, each following a different elimination method. An example is the 1980 Netherlands–United Kingdom tax treaty, granting UK artistes (and sportsmen) a tax credit for Dutch tax that has been paid on Dutch performances,[19] while allowing Dutch artistes (and sportsmen) a tax exemption for performance income earned in the United Kingdom.[20] This tax treaty clearly shows the difference between the traditional continental and Anglo-American methods for eliminating double taxation.[21]

7.3.4. Clearer position in the OECD Model Tax Convention?

It is remarkable that the recommendation of the tax credit method of Paragraph 12 of the 2003 Commentary has not been taken into Article 23A(2) of the OECD Model Tax Convention. In general Article 23 gives advice about the method for the elimination of double taxation and gives two options: the tax exemption method (Article 23A) or the tax credit method (Article 23B). But within Article 23A a second paragraph has been added, applying the tax

19. Article 22(1) of the 1980 Netherlands–United Kingdom tax treaty.
20. Article 22(2) of the 1980 Netherlands–United Kingdom tax treaty.
21. The position of the Netherlands is interesting because the earlier table of this paragraph shows that the Netherlands changed its tax treaty policy and was already inserting the tax credit method in its tax treaties before 1980. The 1980 UK treaty was the last one with the exemption method.

credit method as an exception for income from Article 10 (Dividends) and Article 11 (Interest). These earnings are very often taxed at a low rate in the source country (or perhaps not taxed at all) and a tax exemption could lead (partly) to double non-taxation. The same reasoning in favour of the tax credit method was used in Paragraph 12 of the Commentary on Article 17. It would have been a good opportunity for harmonization within the OECD Model Tax Convention if Article 17 (Artistes and sportsmen) had also been mentioned in the exceptions of Article 23A(2) and its Commentary.

7.4. Basket/overall method versus per-country method

The effect of a tax credit is influenced by the restrictions that a country can make to the cross-collateral clearance of artiste taxes from the various foreign countries. Basically, two systems exist, i.e. the overall (or basket) method and the per-country method.

With the overall (or basket) method the total of foreign artiste tax is added up and credited as one amount against the income tax in the residence country. High and low foreign artiste taxes cancel each other out before they are tested against the maximum of the (average) tax rate that is applicable in the residence country.

With the per-country method the maximum will be calculated per country, leading to limitations in foreign artiste tax credit for high-tax source countries, while for other low-tax countries foreign artiste tax can easily be absorbed by national income tax.

In a situation with only foreign profits the tax relief is highest when the overall (or basket) method has been inserted in the legislation of the residence country. This system evens out the differences in the level of the foreign-source taxes before applying the limitation test of the (average) tax rate in the country of residence.

But when the result from one or more source countries is negative, the per-country method can become more profitable because these losses can be offset against other, domestic, positive results and already give tax relief, while foreign tax credit can be used only for foreign profits.[22]

22. This division between foreign profits and losses can be important for foreign artistes because their expenses may be very high. See chapter 8 for a survey of these expenses.

The United States used the per-country method from 1932 until 1954, but then introduced the overall method as an option. In 1976, the per-country system was abolished. The overall system was modernized in 1986 and changed into the so-called basket system. The United States has created nine categories (or baskets) of income that qualify for foreign tax credit, such as passive income, financial services income, dividends, shipping income and a residual category called general limitation income. Artiste performance income falls in the general limitation income basket, leading to the result that no division needs be made between the various countries where performances have taken place, as in a normal overall credit system.[23] US artistes can therefore neutralize (in the same taxable year) the artiste tax from high-tax countries, such as Germany, Spain, Belgium and sometimes the United Kingdom, with the artiste tax from low-tax countries, such as the Netherlands, Denmark and Canada.

Income from royalties from a foreign source falls within the first category (basket) of passive income and therefore does not have any effect on the tax credit for foreign performances.

The United Kingdom still uses the per-country method for foreign tax credits for its artistes.

The Netherlands has changed its system from the per-country method to the overall method,[24] following other European countries, such as Germany,[25] Belgium[26] and France.

Other countries, such as Luxembourg[27] and Switzerland,[28] give their artistes a choice between the overall and the per-country method. This seems to be the most profitable system for the artiste, because his preference will be different depending on whether he has only foreign profits (overall method) or has a mix of foreign profits and losses (per-country method).

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23. § 904 of the US Internal Revenue Code.
24. Article 13(2) of the *Besluit ter voorkoming van dubbele belasting 2001* for non-treaty situations and *Besluit van staatssecretaris van Financiën 20 juli 2000* for treaty situations.
25. § 34c of the *Einkommensteuergesetz* (EstG).
26. Article 155 of the *Wetboek op de inkomstenbelastingen* 1992.
27. Xavier Hubaux, “Offsetting of Foreign Taxes for Resident Companies”, 39 *European Taxation* 1 (1999), at 21.
28. Howard R. Hull, “The Foreign Tax Credit in Switzerland”, 56 *Bulletin for International Fiscal Documentation* 3 (2002), at 124.

7.5. Tax credit problems

7.5.1. Tax exemption method is easier to apply

Using the tax credit method is more complicated than the preceding discussion would suggest. It sounds simple to "apply for a foreign tax credit", but various problems can arise, causing practical difficulties. Without doubt, the tax exemption method is easier to use because the allocation rule in Article 17 of the tax treaty already gives access to this compensation in the residence country, regardless of whether any information about the foreign artiste tax is available or even whether any tax has been paid in the foreign country.[29]

But this could also easily lead to double non-taxation if no source tax were paid in the country of performance.[30] This risk is mentioned in Paragraph 12 of the 2003 OECD Commentary on Article 17.

7.5.2. Tax certificate

A requirement for a foreign tax credit in the country of residence is that the withholding agent in the foreign country issues a tax certificate showing the taxable fee and the tax that has been paid to the foreign tax administration. It is even preferable to have the name and address of the responsible tax office in the foreign country on this tax certificate, perhaps together with a stamped signature by the local tax inspector. Without an official tax certificate many countries are reluctant to allow a credit for the foreign tax.

7.5.3. Qualification of foreign tax

What foreign tax is creditable? Not e.g. road tolls, VAT, sales tax, excise/duty tax or water tax, and also not interest and penalties or social security

29. Several Dutch court cases show that the exemption method gives easier access to a tax reduction in the source state: *Gerechtshof Den Bosch* 10 June 2003, *VN* 2003/56.1.3, *Gerechtshof Den Bosch* 10 July 2003, *NTFR* 2003/1488 and *Gerechtshof Den Bosch* 5 November 2003, *VN* 2004/14.1.2.

30. Especially in countries, such as Belgium, that apply the exemption method to foreign performance income and can – to some extent – be considered as tax havens for artistes (and sportsmen).

contributions,[31] but just the taxes that have been specified in Article 2 of a tax treaty, namely direct taxes on income (and capital).[32] This extends to taxes on the total amount of wages or salaries paid by undertakings, but social security charges, or any other charges paid where there is a direct connection between the levy and benefits to be received, are not regarded as creditable taxes.[33] It is not important which authority has imposed the taxes – the state itself or its political subdivisions or local authorities. The method of levying is equally immaterial: by direct assessment, by deduction at source, in the form of surcharges or as an additional tax.[34]

The qualification of the artiste tax in the source country can lead to confusion because many countries levy the tax from the gross performance fee without the deduction of any expenses. This means that it is not the "income" but the "earnings" that are taxed, giving the withholding tax the character of a indirect sales tax or VAT rather than a direct income tax. The question can arise whether this tax on gross earnings is creditable or whether an exemption can be allowed, because the source tax might not be a tax on income (and capital) that is mentioned in Article 2 of a specific tax treaty.[35] An old Dutch tax court decision of 1958 dealt with this issue, in which the special Swedish artiste tax for non-resident artistes was considered an indirect sales tax, not leading to a tax exemption for a Dutch

31. Social security contributions are levied in e.g. France and Germany. Sometimes these extra levies cannot be avoided, not even with a E-101 (or D-101 from the United States), as occurs in Germany with the *Künstlersozialversicherung* (Artistes Social Insurance).
32. See also Michael Lang, "Taxes covered – What is 'Tax' according to Art. 2 of the OECD Model?", 59 *Bulletin for International Fiscal Documentation* 6 (2005), at 216.
33. Paragraph 3 of the Commentary on Article 2 of the OECD Model Treaty.
34. Paragraph 2 of the Commentary on Article 2 of the OECD Model Treaty.
35. The issue of artiste tax as *Umsatzsteuer* (VAT) has also been discussed by Harald Grams in *Besteuerung von beschränkt steuerpflichtigen Künstlern*, Neue Wirtschafts Briefe (Herne/Berlin, 1999), at 35, especially in the European context. Grams defended the position that gross taxation without the deduction of expenses is a forbidden VAT for EU countries. See chapter 11 for further discussion.

artiste because it did not fall under the Netherlands–Sweden tax treaty.[36] It is not very likely that this decision would still be followed today.[37]

But the preceding will apply to the special VAT that is levied in Ireland from artistic performances and cannot be considered as Irish income tax.

7.5.4. Final and compulsory payments

The foreign tax must be a compulsory payment. Most countries do not allow a tax credit for taxes that were paid but could have been avoided. The American IRS e.g. expects taxpayers to exhaust all "effective and practical" procedural remedies to reduce the foreign tax burden", but not to take "futile, additional administrative steps" to attempt to further reduce foreign tax.[38]

The foreign tax must also be a final tax and not a prepayment or an advance withholding tax. When a later settlement, application or tax return is needed (or possible) to finalize the income tax, this procedure for getting taxes assessed must be followed, perhaps even leading to a tax refund. Only the final tax on the tax assessment can be credited in the residence country.

7.5.5. The person of the artiste

For the tax credit and exemption method the person of the taxpayer must be the same in both the foreign and the resident country. This may cause

36. *Hoge Raad* 5 March 1958, *BNB* 1958/147. An interesting decision, because a lower Dutch tax court had decided earlier in 1957 in another case that the Swedish wage tax of an artiste/employer did fall under the treaty and therefore a tax exemption was possible (*Gerechtshof Den Haag*, 29 May 1957, *BNB* 1957/328). The difference between the two decisions seems to be that the 1957 case dealt with normal Swedish wage tax and the 1958 case with the special gross taxation for self-employed, non-resident artistes. But the 1957 decision was not brought further to the Dutch *Hoge Raad*, so we will never know whether this subtle difference would have been upheld at appeal.
37. But another discussion can be whether the system of gross taxation of non-resident artistes may be considered within the European Community as a forbidden VAT. See 11.9. for a discussion on this.
38. Treas. Reg. § 1.901-2(e)(5)(i); see also *Schering v. Commissioner*, 69 T.C. 579 (1978). Source: Kenneth J. Vacovec, Tonya S. James and Les. L. Hoiberg, "The US Foreign Tax Credit for Corporate Taxpayers", 55 *Bulletin for International Fiscal Documentation* 9/10 (2001), at 397.

problems when an artiste is taxed at source in his personal (or even artiste) name, but he receives the income in his company which has a different legal structure. A tax credit or exemption can be refused in the residence country, even if there is sufficient evidence that the foreign tax was withheld and paid to the local tax administration.[39]

Many performance countries only recognize the "artiste" as the taxable person and "look through" the legal structure in their artiste tax system. This is confirmed when a tax treaty contains Article 17(2), but many countries are already doing this with their national legislation and therefore would not need the extension of this second paragraph.[40] But residence countries are very often not so flexible when a resident artiste applies for a tax exemption or tax refund for foreign performances, and they do not accept a "look-through-approach". This distinction between the broad view of non-resident artistes and the narrow view of resident artistes can easily occur within one country. But the negative result is economic double taxation.[41]

It is very unfortunate that neither Article 17 of the OECD Model Tax Convention nor its Commentary gives more clarity about this problematic situation. The result must be that Article 3(2) of the OECD Model Tax Convention as a general interpretation rule takes over and gives the countries involved the right to apply their national tax rules to the individual situations in both the source and the residence country.[42] Some authors have suggested that the definition in the source country should dictate where the source country has the right to tax the income from the specific person and that the residence country should follow this application.[43] But this view is not universally shared. If both the source and

39. This occurred e.g. in the Netherlands in *Hoge Raad* 9 October 1991, BNB 1991/324.
40. See Paragraph 8 of the Commentary on Article 17 of the OECD Model Treaty; see also 2.11. and further in this thesis. The issue was also discussed in depth in Angel J. Juárez, "Limitations to the Cross-Border Taxation of Artistes and Sportsmen under the Look-Through Approach in Article 17(1) of the OECD Model Convention", 43 *European Taxation* 11 (2003), at 409.
41. See Sandler (1995), at 196.
42. This issue of (non-)transparency not only happens with artistes, but also with partnerships, as explained in Jean Schaffner, "The OECD Report on the Application of Tax Treaties to Partnerships", 54 *Bulletin for International Fiscal Documentation* 5 (2000), at 218.
43. See John Avery Jones et al., "The Interpretation of Tax Treaties with Particular Reference to Art. 3(2) of the OECD Model", *British Tax Review* (1984), at 14 and 90.

the residence country apply Article 3(2) to a term in different ways this can lead to double taxation.

This problem very often arises with orchestras, theatre groups, musicals and dance companies, for whom the foreign tax in the country of performance is withheld and paid in the name of the main artiste, group or production,[44] but the tax credit or exemption in the residence country needs be granted individually, i.e. on the personal tax declarations of the performing artistes. This very often leads to the result that a tax credit cannot be divided between the artistes,[45] is not accepted by the tax authorities or is just simply forgotten. This a major tax credit or exemption problem for artistes; very often the foreign artiste tax remains as an unrecoverable loss in the annual accounts.[46]

7.5.6. Triangular situations

If a third party is involved in the agreement between the artiste and the organizer of the performance and the three parties are based in different countries, a tax credit problem can arise for either the artiste or the third party, or even for both. Particularly with the unlimited approach of Article 17(2), as discussed in chapter 2, the source country is allowed to tax the full performance fee, regardless of who is entitled to what proportion of it. The tax authorities of both the country of residence of the artiste and the third party can be unsure whether the tax treaty with the source state applies.

This gets even more complicated when the performing artistes of a group live in different countries.

44. E.g. the non-resident artiste tax rules in the Netherlands were simplified from 1 January 2002, after which the tax can be raised from the group instead of the individual artistes. It is also paid to the tax administration in the name of the group and there is no requirement to specify the details of the individual performing artistes.
45. See also Jörg Holthaus, "Besteuerung international tätiger nichtselbständiger Berufssportler und Künstler: Ein totgeschwiegenes Problem der Umsetzung der Regelungen der DBA in der Praxis", *Internationales SteuerRecht* 18/2002, at 633.
46. This problem was also discussed in Dick Molenaar and Harald Grams, "Rent-A-Star – The Purpose of Article 17(2) of the OECD Model", 56 *Bulletin for International Fiscal Documentation* 10 (2002), at 500.

7.5.7. Net deals: transfer of the tax burden to the organizer

Unrecoverable artiste tax can also become a problem for the organizers of performances, i.e. when a net performance fee has been agreed and the organizer needs to pay the artiste tax on top of the fee. When the artistes cannot achieve a tax credit or exemption in their residence country, they try to raise their performance fee to a gross level sufficient to pay the normal taxes in the residence country from the earnings. Then the artiste tax burden will be passed to the organizer, who is confronted with a higher performance fee and still has to pay the (unrecoverable) artiste tax on top of this (net) fee. The result is that the non-resident artiste becomes more expensive and will be in a less competitive position than resident artistes.[47]

If the non-resident artiste does not receive any information about the tax that has been paid with respect to his performance fee, he will not be able to apply for a foreign tax credit in his residence country. This lack of information leads to juridical and/or economic double taxation. The exemption method in the country of residence would remove this risk.

7.5.8. Differences in taxable base

The determination of taxable income (after expenses) can cause considerable problems. When the source country levies its artiste tax from a higher taxable base than the taxable income from which the tax credit or exemption is calculated in the residence country, it can easily be seen that an excess tax credit or insufficient tax exemption may occur. This has already been generally discussed in 7.2.8.

Practical examples of these problems will be given and discussed in chapter 9 of this thesis.

7.5.9. Year of tax credit (or exemption)

The year in which the tax credit needs to be claimed can also be problematic. This can be the year of the accrual, i.e. when the earnings arise and the source tax is officially due, but may also be the year in which

47. In the European Union this might lead to unequal treatment and form an obstruction to entry into other markets within the Union. See also chapter 11.

the tax was actually paid. US artistes (and other taxpayers) are entitled to choose between these two options,[48] making it possible to achieve the most advantageous outcome and avoid unnecessary excess credits.[49]

7.5.10. Creditable domestic tax in the residence country

Inevitably the question of against what domestic tax in the residence country the tax credit or exemption can be offset can also arise. Federal income, corporation and capital tax are obvious, but surcharges such as *Solidaritätszuschlag* (solidarity tax) in Germany or municipal taxes as surcharges on income tax in Belgium are not so clear. In Switzerland the foreign tax credit or exemption is set against the federal, cantonal and municipal tax, each accounting for one third.[50] In the United States the foreign tax credit cannot be offset against state taxes, which vary from 0% to 8% of taxable income. In the Netherlands a foreign tax credit or exemption cannot be offset against the *premies volksverzekeringen* (national insurance), even though they form part of the two lowest rates in the income tax brackets and no longer have a direct link with later benefits.[51]

7.5.11. Complexity of the system of foreign tax credits

The application of the system of foreign tax credit in the residence country can be very complex, as the decision *Evans v. Famous Music Corp.* in February 2004 has shown.[52] Ray Evans and four others were US music composers who had already entered into music publishing contracts with Famous Music Corp. (USA), in the 1940s and 1950s. These contracts give the composers "50% of all net sums actually received, less all expenses and charges and less all deductions for taxes". Most of the earnings came from US sources, while earnings from other countries were very often exempt from withholding tax because of Article 12 (Royalties) in bilateral

48. § 905 of the US Internal Revenue Code.
49. See Vacovec, James and Hoiberg (2001), p. 398, II.A.
50. See Rolf Wüthrich, "Switzerland: Foreign Tax Credit Modifications", 41 *European Taxation* 10 (2001), at 408.
51. In the Netherlands this very often leads to excess tax credits or insufficient tax exemption, because income tax rates start at 1% or 8% before going up to a reasonable percentage.
52. *Evans v. Famous Music Corp.*, Court of Appeals of New York City (USA), 24 February 2004, 302 AD2d 216.

tax treaties. But some tax treaties granted the source country the right to withhold a certain percentage of withholding tax on royalties, such as 10% for Japan,[53] 5%-10% for Italy and 5%-10% for Spain.

Famous Music Corp. did not apply for a foreign tax credit for the withholding tax, but just deducted this foreign tax before allocating 50% of the net profit to the composers. These composers started complaining in 1997 and asked for an equal portion of the foreign tax credit, but Famous Music refused.[54]

The New York Court of Appeals agreed with Famous Music, because the wording of the contract did not allow sharing the foreign tax credit, but more importantly, "the application of the tax credit was too complex, even by tax standards". Foreign-source income needs to be categorized in "baskets", which cannot be combined, and excess credits are possible.[55] The court stated that the foreign tax credit is "one of the most intricate and convoluted features of the entire US tax system".[56] It decided that Famous Music Corp. did not have to share any benefit from foreign tax credits with the composers.

This is an interesting decision, which highlights the possible foreign tax credit problems in the residence country. And the percentage of the foreign-source tax on royalties in this court case was much lower than the percentage of foreign-source tax on performance fees, making the applications for tax credits for performing artists in the residence country even more complicated.

53. This 10% was mentioned in the 1971 Japan–United States tax treaty. The new 2003 tax treaty, which will be effective from 1 January 2005, brings down the withholding tax to a maximum of 5%.
54. At the same time Famous Music Corp. began to apply for the foreign tax credit for itself.
55. These excess tax credits can be carried backward (for 2 years) or carried forward (for 5 years), but this makes the tax credit even more complicated.
56. Kaplan, *Federal Taxation of International Transactions* (West Publishing, 1988), at 81; also Graetz, "The David R. Tillinghast Lecture, Taxing International Income: Inadequate Principles, Outdated Concepts and Unsatisfactory Policies", 54 *Tax Law Review* 261 (2001), at 264.

7.6. Excess tax credits

It can easily happen that a tax credit in the residence country is insufficient to compensate the foreign artiste tax. The result will then be an excess tax credit, which in many countries must be taken as an unrecoverable net loss for the artiste. This is the case in e.g. the United Kingdom, Germany, Belgium and France.

Some countries have introduced the opportunity to carry back and/or carry forward this excess tax credit to years where there is more scope for compensation.[57] Examples are the United States[58] and the Netherlands,[59] but also other countries apply this. For artistes who are resident in these countries the tax credit method may in this specific situation lead to a better result than the tax exemption method, because the latter method does not take the amount of foreign tax into account and can therefore not "carry forward" or "carry back" any excess.

International artistes very often suffer excess tax credits, caused by high withholding taxes in the country of performance, the non-deductibility of production expenses in the source state and other practical difficulties, as explained in the preceding paragraph. This will be discussed further in chapter 9.

7.7. Deduction of foreign tax as an operating expense

Tax treaties almost never allow the deduction of source tax as an operating expense in the residence country. The OECD Model Tax Convention does not support it and individual bilateral tax treaties have not implemented this possible option. This is not surprising because it must be seen as a last resort, compensating only a part of the foreign-source tax. Many countries grant a right to deduct the foreign tax when no other means has been provided, i.e. when no tax treaty applies. But some countries give the deduction of foreign-source tax a stronger status, by offering the option to choose the deduction method in any situation. E.g., anyone in the United States with unlimited tax liability on his full worldwide income can choose not to take a tax credit for foreign tax, but to deduct the foreign tax as a

57. Although there may be limitations to the carry-back and/or carry-forward of the excess tax credit to other years.
58. § 904(c) of the Internal Revenue Code, 2 years back and 5 years forward.
59. Articles 13 and 14 of the *Besluit ter voorkoming van dubbele belasting 2001*.

business expense, so that the tax base will become considerably lower.[60] When normal tax rates are applicable, this will not be profitable, because the tax effect of this deduction will be lower than the potential tax credit. But when the foreign (artiste) tax is high or domestic income is low or negative, the choice of a deduction as an expense might become advantageous.

Germany also gives its residents with unlimited tax liability the option of choosing the deduction of the foreign tax from worldwide income as a business expense.[61]

Deduction of foreign artiste tax as an expense is allowable in the Netherlands when no tax treaty is applicable and the unilateral rules for elimination of double taxation apply, giving residents the option to choose between either an ordinary tax credit or the deduction of foreign tax from taxable income.[62] But many Dutch bilateral tax treaties also refer in Article 23 to the practical computation of the tax exemption or tax credit to the unilateral rules and therefore make it possible to choose to deduct the foreign-source tax as an operating expense.

7.8. General discussion and conclusions

The tax credit method is recommended for artistes as compensation in the residence country for the allocation of the taxing right to the country of performance. This deviates from the policy in many continental European countries which normally use the exemption method for “active income”. But strangely enough, no direct link has been made between this recommendation in Paragraph 12 of the OECD Commentary on Article 17 and Article 23A(2) (or Article 23B) of the OECD Model Tax Convention.

The recommendation of the OECD for the tax credit for Article 17 also deviates from the recommendations for other sources of active income in the OECD Model (Articles 7 and 12). Countries are free to choose for these sources whether they want to insert the tax credit or exemption method in their bilateral tax treaties.

60. § 901(a) of the US Internal Revenue Code.
61. § 34c (2) of the *Einkommensteuergesetz* (Income Tax Act).
62. Articles 18, 21 and 38 of the *Besluit ter voorkoming van dubbele belasting* 2001.

The recommended ordinary tax credit is unfortunately the method leading to the worst result of the four possible elimination methods. It looks reasonable that foreign income is not exempt but that the foreign tax is creditable, but the limitation to the amount of tax that is due in the residence country can easily lead to an excess tax credit. Therefore in the optimal situation an artiste can achieve a complete tax credit, but can also end up with overtaxation on his foreign income. This can become more likely when the residence country uses the per-country method for the tax credit.

Many tax credit problems may occur in practice, arising from the absence of a tax certificate, the qualification of the foreign tax, the person of the artiste, the differences in the taxable base and triangular situations to the complexity of the systems of foreign tax credits in many countries. There is a major risk that a tax credit in the country of residence may not be (fully) obtainable.

The tax exemption method would mitigate some of the problems and would seem to divide the issues of the proper elimination of double taxation more between the tax administration and the artiste. With the recommended tax credit method the risks unfortunately lie mainly with the international performing artistes and not with the tax authorities.

The deduction of the foreign artiste tax as an operating expense normally does not lead to a better result, but can in some extreme cases be an alternative.

The conclusion from this chapter needs to be that the elimination of double taxation for performing artistes is far from complete and causes many difficulties. Economically speaking, the existing system of taxation of international performing artistes leads to market inefficiencies.