Austria: Exemption Method and Progression

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I. Facts of the Case[1]

The taxpayer is a resident of Austria and an Italian citizen who used to work for the Italian customs administration as an employee and who is retired now. He receives a pension from the Italian government.

According to Article 19(3) of the tax treaty between Austria and Italy, pensions paid by a contracting state to an individual in respect of services rendered to that state are taxable only in this state. It was not in dispute that Italy had the exclusive taxation right over the pension. However, it was controversial whether Austria was entitled to take into account the exempted income in calculating the amount of tax on the remaining income as the tax treaty did not contain a proviso safeguarding progression. Moreover, the Austrian tax system does not explicitly provide for such a provision, either. According to prevailing opinion and case law, the general provisions on the tax base and the tax rate are the legal basis for the proviso safeguarding progression:[2] In the case of unlimited tax liability, worldwide income is taxable in Austria. The tax rate is determined according to the worldwide income as well. Therefore, that tax rate remains applicable even if parts of the tax base are exempt under a tax treaty.

The tax treaty between Austria and Italy provides for the credit method as far as the taxation of income is concerned. For the taxation of capital, however, the exemption method is applicable. According to Article 23(3b) of the treaty, capital which may be taxed in Italy has to be exempted in Austria. For such capital, the last sentence of Article 23(3b) states that the tax rate for taxing the remaining capital may be determined by taking into account the exempt capital. However, there is no provision dealing with the proviso safeguarding progression in respect of income taxation. In this respect, the treaty deviates from the 1977 version of the OECD MC that contains a proviso safeguarding progression in Article 23B OECD MC. However, this provision only became part of the OECD MC in 1977. In the earlier version of the Model no such provision was suggested in the context of Article 23B. Although the tax treaty between Austria and Italy had been signed in 1981 and went into force in 1985, it had already been negotiated in 1974.[3] This explains why Article 23 deviates from the current version of the OECD MC.

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1 The Judgment of the Austrian Supreme Administrative Court of 29 July 2010, 2010/15/0021.

2 See C. Widhalm, ‚Rechtsgrundlagen und Anwendungsbereich des Progressionsvorbehaltes', in *Methoden zur Vermeidung der Doppelbesteuerung, eds.* W. Gassner, M. Lang & E. Lechner (Vienna: Linde, 1995), 159 et seq.; VwGH 21 June 1960, 162/60; see also K. Vogel, *Klaus Vogel on Double Taxation Conventions*[3] (London: Kluwer Law Int., 1998), Art. 23 MN 69 et seq. and 208 et seq.

3 See H. Loukota in O.-C. Günther & C. Willvonseder, 'SWI-Jahrestagung: Befreiungsmethode im Zweifel mit Progressionsvorbehalt', *SWI* (2011), 307.

II. Reasoning of the Court

In its decision of September 2009, the local tax authority in Innsbruck took the exempt income into account for determining the tax rate which they applied on the remaining income.

This decision was appealed to the Independent Tax Tribunal in Innsbruck, which reversed it in December 2009.[4] The Tribunal referred to the absence of a provision on the proviso safeguarding progression in the tax treaty and concluded that the tax authorities are therefore prevented from taking into account the exempt income for calculating the tax rate. This decision was appealed by the local tax authorities and therefore the Austrian Supreme Administrative Court had to give a decision.

The Supreme Administrative Court rendered its judgment on 29 July 2010. The Court reversed the decision of the Independent Tax Tribunal again and held that the foreign exempt income has to be taken into account for the determination of the tax rate. The Court provided the following reasons:

- The legal basis for the proviso safeguarding progression lies in Austrian domestic tax law. The rules on worldwide income serve as a sufficient legal basis.
- The principle of equality was an additional reason to include the foreign exempt income for determining the tax rate.
- The foreign income has to be taken into account for this purpose unless the treaty prevents it. Since there is no provision in the treaty with Italy which prevents this, the exempt income has to be included.
- The German Bundesfinanzhof had changed its case law in 2001 accordingly.

The term 'only' used in Article 19(3) merely prevents Austria from applying the credit method in such a case but not from applying the proviso safeguarding progression.

III. Observations by the Author

Although the judgment of the Austrian Supreme Administrative Court leads to additional revenues for the Austrian government, the Austrian Ministry of Finance took a more generous position and was not in favour of applying the proviso safeguarding progression. Leading representatives of the Ministry have publicly stated that they are not at all convinced by the judgment of the Supreme Administrative Court.[5] It is, however, interesting that the local tax authorities of Innsbruck had not been prohibited from appealing the decision of the Tribunal at the Supreme Administrative Court. Since the local tax authorities are bound by

[4] UFS 15 Sep. 2009, RV/0612-I/09.

[5] See H. Loukota in O.-C. Günther & C. Willvonseder, 'SWI-Jahrestagung: Befreiungsmethode im Zweifel mit Progressionsvorbehalt', *SWI* (2011), 303 et seq.

directives of the Ministry, the Ministry could have forced them to accept the decision of the Tribunal.[6]

Critics have argued that the Court has not taken into consideration the Commentary to the OECD MC. *H. Loukota* has referred to the statement in the OECD Commentaries explaining why a specific provision concerning the proviso safeguarding progression had been inserted in Article 23B OECD MC: *'This paragraph has been added to enable the state of residence to retain the right to take the amount of income or capital exempted in that State into consideration when determining the tax to be imposed on the rest of the income and capital.'*[7] *H. Loukota* concludes from this statement that since the provision on the proviso safeguarding progression *'has been added to enable'* the state of residence to take into account the exempt income for determining the tax rate it is obvious that without such a provision the exempt income must not be taken into account.[8]

In my view, this argument is not convincing for several reasons: Firstly, the OECD Commentaries may provide some information as to what the drafters of the OECD MC had in mind, but is by far not the only or the most important means of interpretation.[9] One has to look at the language of the treaty, its context and its object and purpose as well.[10] However, one could have expected that the Court would provide reasoning on why it did not find the position taken by the OECD Commentaries convincing.

Secondly, and this argument gives a good explanation why the Court was finally right not to deal with the position expressed in the Commentaries, only versions of the Commentaries which were already in place when the treaty was negotiated should be considered. Although this issue is controversial,[11] in my view there is no reason to believe more recent versions of the OECD Commentaries should have any legal relevance. This case, however, is interesting because the treaty was negotiated in 1974 and not signed before 1981. In 1974 the paragraph to which *Loukota* referred was not part of the OECD Commentaries, since it was only added in 1977. Thus, in 1981, when the treaty was signed, it had already become part of the OECD Commentaries. If one assumes that the time of the conclusion is relevant, one could argue that the Commentaries should have been considered. However, in my view, one can only assume that the treaty negotiators considered a certain paragraph of the Commentaries if it was already in place at the time of their negotiations. Since this was not the case, the Austrian Supreme Administrative Court was right in not dealing with the Commentaries. If the treaty was based on the 1963 OECD MC and was negotiated in 1974, statements

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6 Art 20 B-VG.

7 Commentary to Art. 23 OECD Model Convention, MN 79.

8 See H. Loukota in O.-C. Günther & C. Willvonseder, *SWI* 2011, 304 et seq.

9 See M. Lang, *Introduction to the Law of Double Taxation Conventions* (Vienna: Linde, 2011), MN 85 et seq.

10 *Ibid.,* MN 64 et seq.

11 *Ibid.,* MN 93 et seq. with further references.

produced in 1977 cannot provide any information about the ideas the drafters of the OECD MC had in mind in 1963.

Thirdly, and this is the most important argument, the paragraph in the Commentaries explains a provision which is *not* part of the tax treaty between Austria and Italy. Since the treaty does not contain any specific provision on the proviso safeguarding progression in respect of income taxes, a statement in the OECD Commentaries which explains such a provision cannot really provide any guidance.[12] To sum up, there were several good reasons why the Court was right in ignoring the OECD Commentaries.

However, one could critically remark that the interpretation made by the Court makes the existing provision in Article 23(3b) concerning the proviso safeguarding progression in the area of taxes on capital and all other such provisions in other tax treaties superfluous: If the exempt income may be taken into account for the determination of the tax rate anyway, there is no need to insert a specific provision.[13]

In respect of the tax treaty between Austria and Italy, an additional argument could be derived from the fact that there is a specific provision concerning the proviso safeguarding progression in that treaty which is, however, limited to taxation of capital. One might ask why the drafters of the treaty had limited the language to taxes on capital when they had intended to include income taxes as well.[14]

However, it is not unusual in a legal system that rules are introduced which are just explanatory and not really necessary. Sometimes the legislator sees a need to clarify certain principles in order to avoid any doubts. We have similar experiences in the tax treaty area as well. A prominent example is Article 3(2) OECD MC, where the dynamic reference to domestic law was enshrined in the text of Article 3(2) in 1995.[15] This, however, also demonstrates how dangerous this is. Before this change, it was, with the exception of a Canadian court in the *Melford* case,[16] undisputed that Article 3(2) OECD MC refers, insofar as permitted by the context, to the domestic law which exists at the time of the application. After the change, the Austrian Supreme Administrative Court started to interpret all the old treaties which do not contain the changed version of Article 3(2) in a static way.[17] However, although such clarifications are not the expression of a perfect legal culture, they demonstrate that we quite often have to deal with provisions which do not have any independent meaning. Therefore, one could see Article 23(3b) as

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12 *Ibid.,* MN 66.

13 See also K. Vogel, *Klaus Vogel on Double Taxation Conventions*[3], Art 23 MN 208 with further references.

14 See C. Lenneis in O.-C. Günther & C. Willvonseder, *SWI* (2011): 305; C. Massoner, 'VwGH: Progressionsvorbehalt auch ohne Normierung im DBA', *ecolex* (2010) 1097.

15 See M. Lang, *Introduction to the Law of Double Taxation Conventions* (Vienna: Linde, 2011), MN 120.

16 Supreme Court of Canada, 28 Sep. 1982, R. v. Melford Development Inc., [1982] 2 S.C.R. 504.

17 See e.g. VwGH 19 Dec. 2006, 2005/15/015; 28 Nov. 2007, 2006/14/0057.

an explicit provision for the application of the proviso safeguarding progression in the area of taxes on capital, where the proviso has its main relevance in this treaty. This, however, does not rule out that the exempt sources may be taken into account for the purpose of determining the tax rate in the area of income tax as well, although this will only be relevant on rare occasions.

Especially against the backdrop that the state of residence may take into account foreign income, at least for determining the tax rate in all other cases of foreign income, one could shift the burden of proof and ask why pensions from Italian government sources should be treated beneficially not only compared to other Italian sources under the tax treaty between Austria and Italy but also compared to pensions from other countries in relation to which the specific treaty provisions do not leave any room for doubt.

This leads to the next argument which was raised by the Court, although merely in the margin. The Court mentioned the principle of equality and *Nikolaus Zorn*, who was one of the judges deciding the case, publicly raised constitutional arguments which support the judgment.[18]

At first sight, this seems to be an internal Austrian debate as to whether the principle of equality enshrined in the Austrian Constitution could have any impact on the interpretation of the tax treaty provisions. However, many constitutions have similar rules. If a court starts to examine seriously whether different tax treaty rules comply with the principle of equality, many provisions of the OECD MC are in danger: Courts could discuss whether and under which conditions it is justified to apply different source rules, distinguish between different allocation rules, have specific allocation rules for income from shipping, for government paid pensions or for frontier workers, apply different methods to avoid double taxation within one treaty or on the same type of income, depending on the treaty under which it is covered. In my view, it is not at all clear whether all rules of the OECD MC would survive if courts started to apply similar standards to the ones they apply in domestic law.

Even more interesting, one would have to debate whether constitutional deliberations may have impact on the interpretation of tax treaties or may only lead to the result that a tax treaty provision becomes inapplicable, is struck down or that the treaty has to be terminated. In a domestic context, quite often constitutional deliberations are used in the interpretation process. Every rule has to comply with the higher ranking rules. If different interpretations are available, the interpretation which is in line with the higher ranking rule prevails.[19] We apply such

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[18] See N. Zorn in O.-C. Günther & C. Willvonseder, *SWI* (2011): 303 et seq.; in particular, the Court referred to the arguments of C. Widhalm, ‚Rechtsgrundlagen und Anwendungsbereich des Progressionsvorbehaltes', in *Methoden zur Vermeidung der Doppelbesteuerung*, eds. W. Gassner, M. Lang & E. Lechner (Vienna: Linde, 1995), 153; see also VwGH 21 Oct. 1960, 0162/60; 30 Apr. 1964, 0880/62; 21 May 1985, 85/14/0001.

[19] See T. Öhlinger, *Verfassungsrecht*[8] (Vienna: Facultas, 2009), MN 36.

a concept in Union law[20] and also in many other legal systems.[21] In tax treaty law, however, we have to try to achieve an interpretation which can be accepted by the other country and its courts as well.[22] Therefore, principles which are limited to one contracting state must not come into play. Thus, I do not see any room to interpret a tax treaty provision in line with the Constitution. If the provision is unconstitutional, the treaty has to be terminated, renegotiated or will become inapplicable or the provision will be struck down, whatever the Constitution provides. However, the content of the provision of the tax treaty cannot change due to constitutional requirements in just *one* country.

IV. Potential Impact of the Judgment

Within Austria, this case has received some attention, especially as the deliberations of the Court may not only be relevant in the context of pensions or other remunerations paid for services rendered to the Italian government and received by Austrian residents. In particular, similar arguments might be raised in respect to taxpayers who are residents of another contracting state and who have their second home in Austria. Having a home in Austria, even if it is the second one, leads to unlimited tax liability in Austria. The OECD MC, however, only explicitly mentions resident taxpayers to whom the proviso safeguarding progression is applied. If one takes the view that in the absence of an explicit rule on taxpayers who have their second home in Austria, Austria is still entitled to take their exempt income into account for determining the tax rate despite the fact that their treaty residence is abroad, those taxpayers will have to declare their exempt foreign income for those purposes as well. Since they are liable to unlimited taxation in Austria, the Court could assume that there is a legal basis for doing so under Austrian domestic law.

Under similar reasoning, the judgment of the Supreme Administrative Court could be seen as confirmation that those countries which apply a proviso safeguarding progression on non-residents as well are in line with their treaty obligations: If one takes the view that the reference to residents in Article 23 is, for the purpose of determining the tax rate, without any independent legal relevance, one will also have to accept that countries take the exempt income into account for determining the tax rate in cases of non-residents as well.

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[20] See C.O. Lenz & K.-D. Borchardt, *EU Verträge Kommentar*[5] (Cologne: Bundesanzeiger 2010) EUV Art 19 MN 29 and 34; see also Ł. Adamczyk, ‚The Sources of EU Law Relevant for Direct Taxation', in *Introduction to European Tax law on Direct Taxation*[2], eds. M. Lang, P. Pistone, J. Schuch & C. Staringer (Vienna: Linde, 2010), 13 et seq.

[21] See, for example, with regard to Germany A. Pahlke & T. Cöster, *Abgabenordnung*[2] (Munich: Beck, 2009), § 4 MN 104 et seq.

[22] See M. Lang, *Introduction to the Law of Double Taxation Conventions* (Vienna: Linde, 2011), MN 112 et seq.