Chapter 1

The Netherlands: The Definition of "International Traffic" in Article 3(1)(e) of the OECD Model: Which Vessel Types Qualify? – *Dutch High Court 24 December 2021, nr. 20/03226, BNB 2022/37*

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1.1. Introduction

In December 2021, the Dutch Supreme Court rendered an interesting decision on the applicability of article 15(3) of the Netherlands-Switzerland Income Tax Treaty (2010), which is almost identical to article 15(3) of the OECD Model (in the pre-2017 version) on the wages earned by a Dutch resident seaman who worked on board a construction vessel. Although the case handles the applicability of article 15(3), the specific issue dealt with in the court case was the reference in article 15(3) to the definition of "international traffic" in article 3(1)(e) of the OECD Model and whether or not construction vessels could qualify as ships operated in international traffic. The special issue in this particular case was the fact that the construction vessel was not operated yet during the working periods of the Dutch seaman but was still in the construction phase. Therefore, two issues were to be decided by the Dutch tax courts in this case: (i) can construction vessels qualify as ships under article 3(1)(e) of the OECD Model?; and (ii) can a ship that is not in the operational phase but still in its construction phase already qualify as a ship operated in international traffic?

1.2. Facts of the case

Mr. X worked in 2014 and 2015 as "second mate" (second officer) on board a construction vessel. The vessel was designed for the single-lift installation and removal of large oil and gas platforms, as well as the installation of record-weight pipelines.[1] Mr. X lived (tax resident) in the Netherlands and was employed by a Swiss company (a sister company of the Swiss single

1. Tax court cases in the Netherlands are strictly anonymized. However, given the facts of the case ("world largest construction vessel" that was built between 2014 and 2015 in South Korea and Rotterdam), it was rather easy to find out the vessel's name: Pioneering Spirit. Surprisingly, the same vessel played a role in the Norwegian Supreme

ship company that owned and exploited the construction vessel). The vessel was built in South Korea starting in 2014, and in 2016 it started its first operations.[2] Mr. X was working during 2014 and 2015 for several periods "on board" the vessel, either at the Korean construction yard or in the Rotterdam harbour (where the outfitting and completion of the vessel construction was carried out). His remuneration was not taxed in Switzerland. Mr. X worked also on board the vessel when it sailed from the Korean construction yard to the outfitting location in the Rotterdam harbour. The following working periods can be distinguished:

– from 1 April 2014 to 17 November 2014: construction yard in South Korea;
– from 18 November 2014 to 8 January 2015: sailing from South Korea to Rotterdam; and
– from 8 January 2015 to 31 December 2015: outfitting location in Rotterdam.

1.3. The Dutch Supreme Court decision

1.3.1. Question/issue disputed

The court case dealt with the question of whether the income earned by the Dutch seaman (Mr. X) should be qualified as remuneration derived from employment that is exercised aboard a ship operated in international traffic (article 15(3) of the Netherlands-Switzerland Income Tax Treaty (2010)). If the answer to the question was positive (standpoint of the taxpayer), taxation rights would be allocated to Switzerland as the contracting state in which the place of effective management of the shipping enterprise was situated. In that case, the remuneration would be exempted[3] in the Netherlands based on article 22(2) of the tax treaty. In case of a negative answer (standpoint of the Dutch tax authorities), the taxation rights would be allocated to the Netherlands (article 15(1) of the tax treaty), as Mr. X did not work at all between 2014 and 2015 in Switzerland (working state).

More specifically, the question before the Dutch Supreme Court was whether the activities of seamen during the construction phase and the sailing period

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Court decision (NO: *Høyesterett* [Supreme Court], 8 June 2021, HR-2021-1243-A), *Farid Ati Allah & Others v. Skatteetaten (Poseidon)*, Case Law IBFD discussed by E. Furuseth during this year's Tax Treaty Case Law around the Globe seminar. *See* ch. 25 of this book.

2. In Norway as can be derived from the Norwegian *Poseidon* court case.
3. Exemption with progression reservation.

to a testing/completion site could be qualified as working aboard a ship that is operated in international traffic?

1.3.2. The Court's decision

The decision of the Dutch Supreme Court can be summarized as follows.

The Supreme Court started by stating that articles 3(1)(g), 8 and 15(3) of the Netherlands-Switzerland Income Tax Treaty (2010) are almost identical to those articles[4] of the OECD Model (2008) (art. 3(1)(e) OECD Model). For that reason, the OECD Commentary on those articles is, in the view of the Dutch Supreme Court, of "utmost importance" for the interpretation of those articles.

The Court continued its decision by stating that article 15(3) and article 8 are two sides of the same coin in the sense that they provide for special allocation rules for the operation of ships or aircrafts in international traffic. From the Commentary on Article 8 of the OECD Model, the Court found that profits derived from the exploitation of ships in international traffic meant profits directly related with the commercial transportation of goods and persons by ship in international traffic (including connected or ancillary activities).

The Court then decided that the facts of the case left no other conclusion than that the vessel was destined for the lifting and removal of big platforms and pipelaying. The transport of goods and persons by the ship was only incidental to this main activity. In such a case, it could not be said that profits from the exploitation of the vessel were directly connected with the commercial transport of goods and persons by ship in international traffic (including connected or ancillary activities).

In the view of the Dutch Supreme Court, there was no further need to answer the question of whether article 15(3) of the Netherlands-Switzerland Income Tax Treaty (2010) is also applicable during the construction phase of a ship that is destined for use in international traffic.

4. Art. 3(1)(g) of the *Netherlands-Switzerland Income Tax Treaty* (2010), Treaties & Models IBFD being identical to art. 3(1)(e) of *OECD Model Tax Convention on Income and on Capital* (17 July 2008), Treaties & Models IBFD.

1.4. Comments on the Court's reasoning

The reference by the Dutch Supreme Court to the OECD Commentary as a source of interpretation seems logical. The phrase "utmost importance" is already used a couple of times by the Court in older decisions.[5] The issue of dynamic versus static interpretation did not play a role in this court decision because both the OECD Commentary (2008) (negotiation of the tax treaty), (2010) (conclusion of the tax treaty), (2014-2015) (facts of the case) and (2017) (latest version) were identical on this issue.

The focus of articles 3(1)(e), 8 and 15(3) of the OECD Model on "transportation" activities can clearly be derived from the text of the OECD Model and its Commentary, and is furthermore confirmed by literature[6] and other international court cases.[7] In that respect, the decision of the Dutch Supreme Court does not come as a surprise. Already the text of article 3(1)(e) refers in its definition of "international traffic" to "any transport" by a ship or aircraft. Furthermore, paragraph 4 of the Commentary on Article 8 states, with regard to profits that are directly obtained from the operation of ships or aircrafts in international traffic: "The profits covered consist in the first place of the profits directly obtained by the enterprise from the transportation of passengers or cargo by ships or aircraft … that it operates in international traffic." Such link to transportation-related activities, of course, raises questions in the case of vessels with multi-purpose activities. In the case at hand, the Dutch Supreme Court said, in fact, that the main activity of the vessel is lifting or dismantling of offshore platforms and pipelaying. The transport of platforms/pipes is only ancillary to this activity. Therefore, there are no transportation activities and, thus, article 15(3) is not applicable. A similar reasoning can be found in a Danish case[8] concerning an offshore construction vessel where the Danish court searched for the "primary function" of the vessel.

The question remains open of how to treat any remuneration earned by seamen working aboard a ship during the pre-operational phase of 100% transportation vessels. The Dutch Supreme Court does not see a need to

5. NL: HR, 2 Sept. 1992, 27 252, BNB 1992/379; and NL: HR, 14 July 2017, 16/03578, BNB 2017/188.
6. *See* e.g. G. Kofler, *Article 8*, in *Klaus Vogel on Double Taxation Conventions* m.no. 30 (4th ed., E. Reimer & A. Rust eds., Wolters Kluwer 2015).
7. E.g. BE: *Cour d'Appel* [Court of Appeals] Liège, 4 Sept. 2013, Case 2009/RG/2013, Case Law IBFD on a deep water drilling ship; and DK: *Højesteret* [Supreme Court], 4 Jan. 2018, Case 8/2017 (SKM 2018.60 HR), Case Law IBFD, on an offshore construction vessel.
8. Case 8/2017 (SKM 2018.60.HR) (4 Jan. 2018).

answer this question; however, Advocate General Niessen does answer the question in his opinion to the court decision at hand. He sees two elements in the description of article 15(3)[9] that both need to be fulfilled: (i) "operated"; and (ii) "in international traffic". He defines the term "operated" as "commercial exploitation" which only starts after the vessel is put into use and earns income with the transportation of goods or persons. A comparable view can be found in German court cases[10] with regard to profits realized on ship contracts (article 8 is not applicable because the vessels were not put into use yet). For that reason, AG Niessen excludes any remuneration earned by seamen working aboard a ship during the pre-operational phase from the application of article 15(3). The Dutch Supreme Court uses the same wording "commercial" in the definition of "commercial transportation of goods and persons", which might be an indication that the Dutch Supreme Court would be of the same opinion to this unanswered question.

The question arises here of whether another view should also be possible.

Paragraph 19 of the Commentary on Article 8 regarding the splitting of activities refers to the actual use of the ship instead of the destination. This means that if the construction vessel, e.g., in a year was only used to transport pipes, the income in that year would qualify as income from the operation of a ship in international traffic. On the other hand, if a 100% transportation vessel is used in a year only for non-qualifying activities (e.g. a cruise vessel is used as housing for refugees or a hotel during the Olympic Games), the income from those activities would not qualify as income from the operation of a ship in international traffic. Paragraph 19 of the Commentary clearly is focusing on the splitting of income during the operational phase of a ship. This paragraph, however, does not automatically answer the question with regard to the activities during the pre-operational phase.

From literature,[11] it can be derived that there are basically two principles behind the special allocation rules of both articles 8 and 15(3) (pre-2017 version of the OECD Model) to the contracting state where the place of effective management of the shipping enterprise is situated: (i) mobility

9. Employment that is exercised aboard a ship or aircraft operated in international traffic.
10. DE: *Finanzgericht* [Tax Court] Bremen, 21 Dec. 2000, Case 100116 K 1., Case Law IBFD; and DE: *Bundesfinanzhof* [Federal Fiscal Court], 1 Apr. 2003, Case I R 31/02, Case Law IBFD.
11. F. Pötgens, *Income from International Private Employment: An Analysis of Article 15 of the OECD Model* p. 796 (IBFD 2006), Books IBFD.

(practical rule to avoid taxation/allocation/administrative duties in a number of countries); and (ii) deduction of wage costs in the country where article 8 allocates the income derived from the operation of the ship. From this perspective (compare e.g. the allocation of income/costs in the pre or post-operational phase of a permanent establishment (PE)[12]), one could also come to the conclusion to follow in the pre-operational phase the same allocation rules as those in the operational phase. For a 100% transportation vessel, this would mean that also the wages of seamen who are working aboard the vessel during the construction phase are only taxable in the state where the place of effective management of the shipping enterprise is situated (pre-2017 version of the OECD Model).

1.5. Conclusion

The decision of the Dutch Supreme Court in the case at hand is a logical consequence of the focus of both the text of article 3(1)(e) of the OECD Model and its Commentary on transportation activities. One could wonder whether, after seeing the development of (offshore service) vessel types that can carry out multiple activities, this focus on transportation activities is still valid nowadays. However, broadening the scope of vessel types that can qualify under articles 8 and 15(3) of the OECD Model requires a change to the Model and its Commentary, which is not foreseen on short notice.

Unfortunately, the Dutch Supreme Court did not see a need to answer the question of how to handle the situation when a 100% transportation vessel is not yet in its operational phase, e.g. because it is still under construction (like the case at hand). New court cases should shed further light on this interesting question. In the author's view, a reasonable position (comparable to the allocation of costs in the pre or post-operational phase of a PE) could be to follow in the pre-operational phase the same allocation rules as those in the operational phase.

12. *See* e.g. the German court decisions referred to by K. Vogel, *Article 6*, in *DBA-Kommentar* m.no. 6 (3rd ed., K. Vogel ed., Verlag C.H. Beck 1996).

Chapter 2

Brazil: Tax Treaty Issues under the *Montagna* Case

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2.1. Introduction

This chapter discusses a case (*Montagna* case)[1] involving the taxation of bank deposits of an unknown source that should be attributed to Tarcisio Montagna (taxpayer) as a Brazilian resident according to Brazilian tax authorities. The taxpayer challenged the tax assessment before the Brazilian Administrative Council of Tax Appeals (CARF). The fiscal year at dispute is 2004.

The case is comprised of two main controversial points. Firstly, whether the taxpayer was a tax resident in Brazil in 2004, not only for domestic purposes but also under the Brazil-Italy Income Tax Treaty (1978).[2] Secondly, whether the bank deposits of an unknown source made between 2002 and 2005 could be deemed to be attributable to the taxpayer for Brazilian income tax purposes.

While setting aside the question of whether the bank deposits could be deemed to be attributable to the taxpayer, this article focuses on the issue of tax residence, both under Brazilian domestic law and under the Brazil-Italy Income Tax Treaty (1978).

2.2. Facts of the case

The taxpayer stayed in Brazil for 79 days in 2004. At that time, he worked for the Brazilian company Verona Garden Ltda. In that period, some bank deposits of an unknown source were made to bank accounts of which he was the holder.

1. BR: CARF, 12 May 2021, Ruling 2201-008.799.
2. *Convention between the Government of the Federative Republic of Brazil and the Government of the Italian Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income* (3 Oct. 1978), Treaties & Models IBFD.

Therefore, the tax authorities considered the lack of proof of the origin of the bank deposits to conclude that income had been omitted by the taxpayer and thus issued him a tax assessment.

The taxpayer first challenged the tax assessment before a local tax administration body (*Delegacia de Julgamento da Receita Federal*, DRJ) in charge of reviewing local tax assessments. The DRJ upheld the tax assessment on the grounds that the lack of information about the origin of the bank deposits should lead to a presumption of income omission by the taxpayer as per article 42 of Law 9.430/1996.

Then, the taxpayer filed an appeal, this time before the CARF. At the CARF, both the taxpayer (*see* section 2.2.1.) and the tax authorities (*see* section 2.2.2.) presented their positions.

2.2.1. Taxpayer's position

The taxpayer challenged the tax assessment based on two main arguments: he would not have been a Brazilian tax resident in 2004; and the bank deposits' source would actually be known and not attributable to him.

Firstly, regarding his tax residence, the taxpayer argued that during the fiscal period in question, he would only have had a temporary Brazilian visa. He would have obtained his permanent visa only in 2005. Therefore, only in 2005 (and not in 2004) he could have been subject to the tax rules applicable to Brazilian residents (such as the rules on income omission). In addition, the taxpayer claimed that he would have stayed for a short period in the Brazilian territory in 2004 (just 79 days). Furthermore, he argued that he would not have had an employment relationship in 2004 since he would have held the position of delegate manager (and not that of employee).

As a result, he should have been qualified as a non-resident in 2004. Once considered a non-resident that year, the tax assessment issued against him should be cancelled due to the absence of competence of the Brazilian tax authorities to collect income taxes from a non-resident based on the assumption of income omission.

Secondly, as far as the income omission accusation is concerned, the taxpayer alleged that there would be clients of Verona Garden Ltda to which the bank deposits would belong. Therefore, deposits would not belong to the taxpayer. Furthermore, the taxpayer argued that the tax authorities would

not have managed to prove the existence of the income omission since they would have used the same bank deposits as object of a tax assessment against Verona Garden Ltda. In the taxpayer's view, this would have been a clear, illegal case of *bis in idem*.

2.2.2. Tax authorities' position

As to the issue of tax residence, the authorities claimed that the taxpayer would have been a Brazilian resident in 2004, in spite of the fact that he had stayed for less than 183 days in the country that year. In their view, even though the taxpayer was a non-Brazilian citizen living alternately abroad and in Brazil with a temporary visa, the taxpayer would have had an employment relationship in Brazil in 2004.

As the existence of an employment relationship triggers Brazilian tax residence according to Brazilian residence rules (article 2(III)(b) of Normative Ruling 208/2002), the taxpayer would have been a Brazilian tax resident in 2004. Furthermore, the taxpayer would have been subject to withholding income tax in relation to his employment income in earlier years in Brazil. Tax authorities also noticed that the taxpayer was a partner of a company in Brazil and the holder of three bank accounts. All this would prove his status as a Brazilian tax resident in 2004.

Regarding the presumption of income omission, tax authorities argued that article 42 of Law 9.430/1996 would authorize the presumption of income omission when the account holder does not prove the origin of bank deposits. Consequently, in this scenario, the burden of proof would fall upon the taxpayer, so that it would be up to him to prove the origin of the resources. Since the taxpayer failed to prove the source of the bank deposits, he should be subject to the tax consequences of income omission.

2.3. The CARF's decision

The CARF held that the tax assessment should be maintained.

Firstly, on the matter of the taxpayer's tax residence, the CARF highlighted that within the scope of international tax law, one's tax residence would be the result of the existence of a nexus between the person and the jurisdiction that intends to tax the latter. The CARF noticed that, in the case of Brazil,

nexus rules are established in article 2 of Normative Ruling 208 issued by the Brazilian Federal Revenue Service.

At the time the CARF decided the *Montagna* case, article 2 of the mentioned Normative Ruling provided that in the case of non-Brazilian citizens, Brazilian tax residence should be triggered upon the following alternative conditions: the existence of an employment relationship; the physical presence in Brazil on a permanent basis; or the physical presence in Brazil on a temporary basis, provided that the taxpayer stays for more than 183 days in the Brazilian territory.

In order to support the existence of the employment relationship, the CARF disagreed with the taxpayer's statement that the position he held at the company was that of a statutory director. The CARF sustained that, if he really had been a statutory director, he would have had his income taxed on a definitive, non-refundable basis in earlier years (i.e. before 2004), as determined by the Brazilian income tax rules applicable to non-residents. However, the CARF argued that this was not the case.

The CARF noticed that the taxpayer would have been submitted to a residence-based taxation regime in previous years, i.e. withholding, refundable taxation on a monthly basis, being the final amount of income taxes only calculated at the end of the year. The fact that the taxpayer would have had his income taxed in previous years according to tax rules applicable to Brazilian residents, argued the CARF, would prove that the taxpayer was a Brazilian resident in 2004.

To reinforce the conclusion about the residence of the taxpayer, the CARF considered the centre of vital interests as a tiebreaker criterion under the Brazil-Italy Income Tax Treaty (1978). In this regard, the CARF noticed that, even if the taxpayer had a permanent home in both countries, the second element to be considered would be the centre of vital interests (closest economic and personal relations). The CARF held that the centre of vital interests of the taxpayer would be in Brazil. This conclusion would be supported by the fact that the taxpayer had investments in the stock market and investment funds in Brazil, along with savings and checking account balances. In addition, the taxpayer's wealth in Brazil would have increased almost 900% from 2003 to 2004. All this would demonstrate his close economic ties to Brazil.