

Economic &

Social Affairs

United Nations

Model Double Taxation Convention

between Developed
and Developing Countries



United Nations

Department of Economic & Social Affairs

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Convention

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INTRODUCTION

A. ORIGIN OF THE UNITED NATIONS MODEL CONVENTION

1. The United Nations Model Double Taxation Convention between Developed and Developing Countries (the United Nations Model Convention) forms part of the continuing international efforts aimed at eliminating double taxation. These efforts were begun by the League of Nations and pursued in the Organisation for European Economic Co-operation (OEEC) (now known as the Organisation for Economic Co-operation and Development (OECD)) and in regional forums, as well as in the United Nations, and have in general found concrete expression in a series of model or draft model bilateral tax conventions.

2. These Models, particularly the United Nations Model Convention and the OECD Model Tax Convention on Income and on Capital (the OECD Model Convention) have had a profound influence on international treaty practice, and have significant common provisions. The similarities between these two leading Models reflect the importance of achieving consistency where possible. On the other hand, the important areas of divergence exemplify, and allow a close focus upon, some key differences in approach or emphasis as exemplified in country practice. Such differences relate, in particular, to the issue of how far one country or the other should forego, under a bilateral tax treaty, taxing rights which would be available to it under domestic law, with a view to avoiding double taxation and encouraging investment.

3. The United Nations Model Convention generally favours retention of greater so called “source country” taxing rights under a tax treaty—the taxation rights of the host country of investment—as compared to those of the “residence country” of the investor. This has long been regarded as an issue of special significance to developing countries, although it is a position that some developed countries also seek in their bilateral treaties.

4. The desirability of promoting greater inflows of foreign investment to developing countries on conditions which are politically acceptable as well as economically and socially beneficial has been frequently affirmed in resolutions of the General Assembly and the Economic and Social Council of the United Nations and the United Nations Conference on Trade and Development. The 2002 Monterrey Consensus on Financing for Development¹ and the follow up Doha Declaration on Financing for

¹United Nations 2002, A/CONF.198/11

Development of 2008² together recognize the special importance of international tax cooperation in encouraging investment for development and maximizing domestic resource mobilisation, including by combating tax evasion. They also recognize the importance of supporting national efforts in these areas by strengthening technical assistance (in which this Model will play a vital part) and enhancing international cooperation and participation in addressing international tax matters (of which the United Nations Model Convention is one of the fruits).

5. The growth of investment flows between countries depends to a large extent on the prevailing investment climate. The prevention or elimination of international double taxation in respect of the same income - the effects of which are harmful to the exchange of goods and services and to the movement of capital and persons, constitutes a significant component of such a climate.

6. Broadly, the general objectives of bilateral tax treaties therefore include the protection of taxpayers against double taxation with a view to improving the flow of international trade and investment and the transfer of technology. They also aim to prevent certain types of discrimination as between foreign investors and local taxpayers, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can confidently be carried on. With this background, tax treaties should contribute to the furtherance of the development aims of developing countries. In addition, the treaties seek to improve cooperation between taxing authorities in carrying out their functions, including by the exchange of information with a view to preventing avoidance or evasion of taxes and by assistance in the collection of taxes.

7. The desirability of encouraging the conclusion of bilateral tax treaties between developed and developing countries was recognized by the Economic and Social Council (ECOSOC) of the United Nations, in its resolution 1273 (XLIII) adopted on 4 August 1967. This led to the Secretary-General setting up in 1968 the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries. The Group was composed of tax officials and experts from both developing and developed countries, appointed in their personal capacity.

8. In 1980, the United Nations published, as a result of the Ad Hoc Group of Experts' deliberations, the United Nations Model Double Taxation Convention between Developed and Developing Countries, which was preceded in 1979 by the Manual for the Negotiation of Bilateral Tax Treaties

²United Nations 2008, A/CONF.212/L.1/Rev.1

between Developed and Developing Countries (the Manual). By its resolution 1980/13 of 28 April 1980, the Economic and Social Council renamed the Group of Experts as the “Ad Hoc Group of Experts on International Cooperation in Tax Matters” (the Ad Hoc Group of Experts) recognizing the importance of non tax treaty-related international tax cooperation issues.

9. In the 1990s, the Ad Hoc Group of Experts recognized that significant changes had taken place in the international economic, financial and fiscal environment. In addition, there was increasing focus on tax impacts of new financial instruments, transfer pricing, the growth of tax havens and globalization affecting international economic relations. The increasingly frequent updates to the OECD Model Convention contributed to the need for an ongoing review of process of greater reflection on international tax cooperation issues. Consequently, the Ad Hoc Group of Experts proceeded with the revision and update of the United Nations Model Convention and the Manual. This led to a new version of the United Nations Model Convention (revised in 1999 and published in 2001³) and a new version of the Manual (published electronically in 2003⁴).

10. In 2005 the Ad Hoc Group of Experts was upgraded by conversion into a Committee structure, which remains its current form. The 25 members of the Committee of Experts on International Cooperation in Tax Matters are nominated by countries and chosen by the Secretary-General of the United Nations to act in their personal capacities for a period of 4 years. The Committee now directly reports to the ECOSOC and it now meets every year rather than every second year.

11. At the time of completion of this updated version of the United Nations Model Convention, the members of the Committee were as follows:⁵

Armando Lara Yaffar (Mexico) Chairperson of the Committee; Tizhong Liao (China) First Vice-Chairperson; Anita Kapur (India) Second Vice-Chairperson; Henry John Louie (United States of America) Third Vice-Chairperson; Bernell L. Arrindell (Barbados); Claudine Devillet (Belgium); Marcos Aurelio Pereira Valadao (Brazil); Iskra Georgieva Slavcheva (Bulgaria); Amr El Monayer (Egypt); Liselott Kana (Chile); Wolfgang Lasars (Germany); Kwame Adjei-Djan (Ghana); Enrico Martino (Italy); Keiji Aoyama

³United Nations 2001, E.01. XVI.2. Available at: <http://www.un.org/esa/ffd/tax/index.htm>

⁴<http://www.un.org/esa/ffd/tax/manual.htm>

⁵The countries nominating the members are listed for information only, because as noted above, members of the Committee act in their personal capacity, rather than as representatives of those countries.

(Japan); Mansor Hassan (Malaysia); , Noureddine Bensouda (Morocco); Robin Moncrieff Oliver (New Zealand); Ifueko Omoigui-Okauru (Nigeria); Stig Sollund (Norway); Farida Amjad (Pakistan); Sae Joon Ahn (Republic of Korea); El Hadji Ibrahima Diop (Senegal); Ronald van der Merwe (South Africa), Julia Martinez Rico (Spain), Jürg Giraudi (Switzerland).

B. SPECIAL CHARACTERISTICS OF THE UNITED NATIONS MODEL CONVENTION

12. The United Nations Model Convention represents a compromise between the source principle and the residence principle, although as noted above, it gives more weight to the source principle than does the OECD Model Convention. The United Nations Model Convention is not intended to be prescriptive, but to equip decision-makers in countries with the information they need to understand the consequences of these differing approaches for their country's specific situation. As noted in the Introduction to the previous version of the United Nations Model Convention, the provisions of the Model Convention are not themselves enforceable. Its provisions are not binding and should not be construed as formal recommendations of the United Nations. Rather, the United Nations Model Convention is intended to facilitate the negotiation, interpretation and practical application of bilateral tax treaties based upon its provisions.

13. The United Nations Model Convention seeks to be balanced in its approach. As a corollary to the principle of taxation at source the Articles of the Convention are based on a recognition by the source country that (a) taxation of income from foreign capital should take into account expenses allocable to the earnings of the income so that such income is taxed on a net basis, that (b) taxation should not be so high as to discourage investment and that (c) it should take into account the appropriateness of the sharing of revenue with the country providing the capital. In addition, the United Nations Model Convention embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either a foreign tax credit or an exemption, as is also the case with the OECD Model Convention.

14. In drawing upon the United Nations Model Convention for guidance, a country should bear in mind the important relationship between treaties and domestic law, the nature of which may vary from country to country. In general, the provisions of tax treaties prevail over the provisions of domestic law in the event of a conflict between those provisions. More specifically, tax treaties establish which Contracting State shall have jurisdiction to tax a given item of income or capital and under what

conditions and subject to which limitations it may do so. Consequently, countries wishing to enter into bilateral tax treaty negotiations should analyse carefully the applicable provisions of their domestic tax laws in order to assess the implications of applying the treaty. They should also discuss the relevant domestic laws of potential treaty partners, as part of the preparation for and negotiation of a treaty.

15. Domestic tax laws in their turn exert a substantial influence on the content of bilateral tax treaties. They are an important reason for many of the differences between treaties, as countries seek to preserve domestic taxing rights in their treaty networks. Such domestic laws, and the treaty practice reflecting them, form the basis for the policy positions found in the various Models. Conversely, if countries do not exert certain taxing rights in domestic law, and see no likelihood of that changing, they generally do not seek to retain the ability to exert that taxing right under their treaties. Should their policy change, the domestic law may later be introduced to exert the domestic taxing right, but it would only operate to the extent that it was consistent with the treaty relationships.

16. The current revision of the United Nations Model Convention is the beginning of an ongoing process of review, which the Committee hopes will result in more frequent updates of particular Articles and Commentaries to keep up with developments, including in country practice, new ways of doing business, and new challenges. It will therefore operate as a process of continuous improvement. This means that some articles have not yet been substantively reviewed by the Committee.

17. The main objectives of this revision of the United Nations Model Convention have been to take account of developments in the area of international tax policies relevant for developing and developed countries. The Committee also identified treaty policy issues that require further work and it mandated one Subcommittee to address the issue of the taxation treatment of services in general and in a broad way including all related aspects and issues. Furthermore, the issue of taxation of fees for technical services should also be addressed. It was recognized that this was the initiation of extensive work and it was agreed that there would not be any results ready for incorporation into this version of the Model Convention. In the future, if the Committee so decides, any potential conclusions that could be useful may therefore be presented as a Committee Report which may shape the next revision of the United Nations Model Convention. The work programme of the Committee, including that on services, will be made available as it develops on the Committee's website.⁶

⁶<http://www.un.org/esa/ffd/tax/index.htm>

C. MAIN FEATURES OF THIS REVISION OF THE UNITED NATIONS MODEL CONVENTION

18. The main differences between the Articles of this version of the United Nations Model Convention and the previous version revised in 1999 and published in 2001 are as follows:

- A modified version of Article 13, paragraph 5 to address possible abuses;
- An optional version of Article 25 that provides for mandatory binding arbitration when a dispute cannot be solved under the usual Mutual Agreement Procedure;
- A new version of Article 26 that confirms and clarifies the importance of exchange of information under the United Nations Model Convention, along the lines of the current OECD Model Convention provision; and
- A new Article 27 on Assistance in the Collection of Taxes, along the lines of the current OECD Model Convention provision.

19. There have been changes to the Commentaries on the Articles to reflect the changes referred to above, as well as:

- Additions to the Commentary on Article 1 addressing the improper use of tax treaties (paragraphs 8-103);
- A generally updated Commentary on Article 5;
- Alternative text in the Commentary on Article 5 for cases where countries delete Article 14 and rely on Articles 5 and 7 to address cases previously covered by that Article (paragraphs 15.1-15.25);
- An addition to the text of the Commentary on Article 7, noting that the OECD approach to Article 7 evidenced in the 2010 OECD Model Convention Commentary (and deriving from the 2008 OECD Report on the Attribution of Profits to Permanent Establishments) has not been adopted in relation to the significantly different United Nations Model Convention Article (paragraph 1) ;
- Incorporation of revised text on beneficial ownership drawn from the OECD Model Convention in the Commentaries on Article 10 (paragraph 13), Article 11 (paragraph 18) and Article 12 (paragraph 5);
- New text in the Commentary on Article 11 on the treatment of certain instruments which, while technically not interest bearing

loans, are treated in the same fashion for treaty purposes. This is especially relevant for the treatment of certain Islamic financial instruments (paragraph 19.1-19.4); and

- Revisions to the Commentaries on a number of Articles to quote wording from more recent versions of OECD Model Convention Commentaries, where these are considered as helpful in interpreting provisions based on the United Nations Model Convention.

D. THE COMMENTARIES

20. The Commentaries on the Articles are regarded as part of the United Nations Model Convention, along with the Articles themselves. The United Nations Model Double Taxation Convention between Developed and Developing Countries is referred to in the Commentaries on the Articles as “the United Nations Model Convention”. The OECD Model Tax Convention on Income and on Capital is referred to in the Commentaries on the Articles as “the OECD Model Convention”, and references are to the 2010 version of that Model unless otherwise indicated. Sometimes wording from an older version of an OECD Commentary is quoted as being more relevant than the 2010 version to interpreting United Nations Model Convention, and this is noted in such cases.

21. In quoting the Commentaries on the Articles of the OECD Model Convention, sometimes parts of a paragraph or entire paragraphs, have been omitted as not being applicable, for whatever reason, to the interpretation of the United Nations Model Convention. In such cases, the omission is indicated by ellipsis [...]. It cannot necessarily be assumed that non-inclusion, of itself, represents any disagreement with the content of the deleted provisions, and the context of the omission should be considered in determining whether the omitted words were seen as irrelevant to interpretation of the United Nations Model Convention, on the one hand, or were instead left for future consideration. In some cases, the OECD Model Convention wording is quoted, but with minor amendments included in square brackets ([]) to reflect a relevant difference in the United Nations Model Convention, such as the retention of the “fixed base” concept. Where quoted OECD Model convention passages include footnotes, the footnotes have been given new numbering, rather than retaining the original OECD numbering.

22. In quoting the Articles and Commentaries of the OECD Model Convention it is noted that various OECD Member States have expressed “reservations” on certain Articles and have made “observations” on particular aspects of the Commentaries and that some non-OECD Member States have

expressed “positions” in relation to certain Articles and Commentaries. Such formal expressions of differences of view to those taken in the OECD Model Convention are contained in the text of the OECD Model Convention, as revised from time to time. The Committee has recognized in preparing this update to the United Nations Model Convention that such expressions of country views are a useful aspect of the OECD Model Convention in terms of understanding how it is interpreted and applied by the specific countries expressing those views, even though they have not been repeated in the text of the United Nations Model Convention for practical reasons.

23. This updated version of the United Nations Model Convention often reflects views upon which a consensus could not be reached, with, for example, other views held by one or more members also being noted. This has allowed a broader expression of views and approaches that the Committee considers may assist in the interpretation and application of bilateral tax treaties. It follows, however, that it should not be assumed that any individual member of the Committee took a particular view in respect of any particular issue addressed in this Convention. Additionally, in some cases, the views reflected in the Commentaries relate to discussions held by the former Group of Experts, or held by the Committee before or after particular individuals were members.

Part One

**ARTICLES OF THE UNITED NATIONS MODEL
DOUBLE TAXATION CONVENTION BETWEEN
DEVELOPED AND DEVELOPING COUNTRIES**

SUMMARY OF THE CONVENTION

Title and Preamble

CHAPTER I

Scope of the Convention

Article 1	Persons covered
Article 2	Taxes covered

CHAPTER II

Definitions

Article 3	General definitions
Article 4	Resident
Article 5	Permanent establishment

CHAPTER III

Taxation of income

Article 6	Income from immovable property
Article 7	Business profits
Article 8	Shipping, inland waterways transport and air transport (alternatives A and B)
Article 9	Associated enterprises
Article 10	Dividends
Article 11	Interest
Article 12	Royalties
Article 13	Capital gains
Article 14	Independent personal services
Article 15	Dependent personal services
Article 16	Directors' fees and remuneration of top-level managerial officials
Article 17	Artistes and sportspersons
Article 18	Pensions and social security payments (alternatives A and B)
Article 19	Government service
Article 20	Students
Article 21	Other income

CHAPTER IV
Taxation of capital

Article 22 Capital

CHAPTER V
Methods for elimination of double taxation

Article 23 A Exemption method

Article 23 B Credit method

CHAPTER VI
Special provisions

Article 24 Non-discrimination

Article 25 Mutual agreement procedure (alternatives A and B)

Article 26 Exchange of information

Article 27 Assistance in the collection of taxes

Article 28 Members of diplomatic missions and consular posts

CHAPTER VII
Final provisions

Article 29 Entry into force

Article 30 Termination

TITLE OF THE CONVENTION

**Convention between (State A) and (State B) with respect to
taxes on income and capital⁷**

PREAMBLE OF THE CONVENTION⁸

⁷States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.

⁸The Preamble of the Convention shall be drafted in accordance with the constitutional procedures of the Contracting States.

Chapter I

SCOPE OF THE CONVENTION

Article 1

PERSONS COVERED

This Convention shall apply to persons who are residents of one or both of the Contracting States.

Article 2

TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

(a) (in State A):

(b) (in State B):

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law.

Chapter II
DEFINITIONS

Article 3

GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:

- (a) The term “person” includes an individual, a company and any other body of persons;
- (b) The term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes;
- (c) The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
- (d) The term “international traffic” means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
- (e) The term “competent authority” means:
 - (i) (In State A):
 - (ii) (In State B):
- (f) The term “national” means:
 - (i) any individual possessing the nationality of a Contracting State
 - (ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.

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

Article 4

RESIDENT

1. For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.
2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:
 - (a) He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
 - (b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
 - (c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
 - (d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.
3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

ARTICLE 5

2. The term “permanent establishment” includes especially:
 - (a) A place of management;
 - (b) A branch;
 - (c) An office;
 - (d) A factory;
 - (e) A workshop;
 - (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term “permanent establishment” also encompasses:
 - (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
 - (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any 12-month period commencing or ending in the fiscal year concerned.

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:
 - (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
 - (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
 - (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
 - (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
 - (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.
 - (f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 7 applies—is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

- (a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or
- (b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this Article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Chapter III

TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.
2. The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.
3. The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.
4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment;

or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

(NOTE: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Article 8 (alternative A)

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 8 (alternative B)

1. Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from

such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ___ per cent. (The percentage is to be established through bilateral negotiations.)

3. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.

5. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 9

ASSOCIATED ENTERPRISES

1. Where:

- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the

profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

3. The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

Article 10

DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

- (a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;
- (b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt claims, participating in profits, as well

as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Article 11

INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular,

income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 12

ROYALTIES

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial

owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ____ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 or Article 14, as the case may be, shall apply.

5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13

CAPITAL GAINS

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.
3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:
 - (a) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.
 - (b) For the purposes of this paragraph, “principally” in relation to ownership of immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.
5. Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 12-month period preceding such

alienation, held directly or indirectly at least ____ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

Article 14

INDEPENDENT PERSONAL SERVICES

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

- (a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or
- (b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.

2. The term “professional services” includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Article 15

DEPENDENT PERSONAL SERVICES

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

- (a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and
- (b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
- (c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

1. Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.

2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

Article 17

ARTISTES AND SPORTSPERSONS

1. Notwithstanding the provisions of Articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself but to another person, that income may, notwithstanding the provisions of Articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsperson are exercised.

Article 18

PENSIONS AND SOCIAL SECURITY PAYMENTS

Article 18 (alternative A)

1. Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 18 (alternative B)

1. Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.

2. However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.

3. Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 19

GOVERNMENT SERVICE

1. (a) Salaries, wages and other similar remuneration paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who:
 - (i) is a national of that State; or
 - (ii) did not become a resident of that State solely for the purpose of rendering the services.
2. (a) Notwithstanding the provisions of paragraph 1, pensions and other similar remuneration paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
(b) However, such pensions and other similar remuneration shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.
3. The provisions of Articles 15, 16, 17 and 18 shall apply to salaries, wages, pensions, and other similar remuneration in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Article 20

STUDENTS

Payments which a student or business trainee or apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Article 21

OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of Article 7 or Article 14, as the case may be, shall apply.

3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing Articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

Chapter IV

TAXATION OF CAPITAL

Article 22

CAPITAL

1. Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.

2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services may be taxed in that other State.

3. Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

[4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.]

(The question of the taxation of all other elements of capital of a resident of a Contracting State is left to bilateral negotiations. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.)

Chapter V

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

Article 23 A

EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.
2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10, 11 and 12, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.
3. Where in accordance with any provision of this Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Article 23 B

CREDIT METHOD

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

ARTICLE 23 B

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

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

Chapter VI

SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.
2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.
3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11, or paragraph 6 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

Article 25

MUTUAL AGREEMENT PROCEDURE

Article 25 (alternative A)

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission

consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article.

Article 25 (alternative B)

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, may develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this Article.

5. Where,

- (a) under paragraph 1, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or

both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and

- (b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 within three years from the presentation of the case to the competent authority of the other Contracting State,

any unresolved issues arising from the case shall be submitted to arbitration if either competent authority so requests. The person who has presented the case shall be notified of the request. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. The arbitration decision shall be binding on both States and shall be implemented notwithstanding any time limits in the domestic laws of these States unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this paragraph.

Article 26

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws of the Contracting States concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to the Convention. In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes. The exchange of information is not restricted by Articles 1 and 2.

2. Any information received under paragraph 1 by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and it shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes referred to in paragraph 1, or the oversight of the above. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

3. In no case shall the provisions of paragraphs 1 and 2 be construed so as to impose on a Contracting State the obligation:

- (a) To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- (b) To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
- (c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (*ordre public*).

4. If information is requested by a Contracting State in accordance with this Article, the other Contracting State shall use its information gathering measures to obtain the requested information, even though that other State may not need such information for its own tax purposes. The obligation contained in the preceding sentence is subject to the limitations of paragraph 3 but in no case shall such limitations be construed to permit a Contracting State to decline to supply information solely because it has no domestic interest in such information.

5. In no case shall the provisions of paragraph 3 be construed to permit a Contracting State to decline to supply information solely because the information is held by a bank, other financial institution, nominee or person acting in an agency or a fiduciary capacity or because it relates to ownership interests in a person.

6. The competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made.

Article 27

ASSISTANCE IN THE COLLECTION OF TAXES⁹

1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Articles 1 and 2. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.
2. The term “revenue claim” as used in this Article means an amount owed in respect of taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation thereunder is not contrary to this Convention or any other instrument to which the Contracting States are parties, as well as interest, administrative penalties and costs of collection or conservancy related to such amount.
3. When a revenue claim of a Contracting State is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State.
4. When a revenue claim of a Contracting State is a claim in respect of which that State may, under its law, take measures of conservancy with a view to ensure its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of taking measures of conservancy by the competent authority of the other Contracting State. That other State shall take measures of conservancy in respect of that revenue claim in accordance with the provisions of its laws as if the revenue claim were a revenue claim of that other State even if, at the time when such measures are applied, the revenue claim is not enforceable in the first-mentioned State or is owed by a person who has a right to prevent its collection.

⁹In some countries, national law, policy or administrative considerations may not allow or justify the type of assistance envisaged under this Article or may require that this type of assistance be restricted, e.g. to countries that have similar tax systems or tax administrations or as to the taxes covered. For that reason, the Article should only be included in the Convention where each State concludes that, based on the factors described in paragraph 1 of the Commentary on the Article, they can agree to provide assistance in the collection of taxes levied by the other State.

5. Notwithstanding the provisions of paragraphs 3 and 4, a revenue claim accepted by a Contracting State for purposes of paragraph 3 or 4 shall not, in that State, be subject to the time limits or accorded any priority applicable to a revenue claim under the laws of that State by reason of its nature as such. In addition, a revenue claim accepted by a Contracting State for the purposes of paragraph 3 or 4 shall not, in that State, have any priority applicable to that revenue claim under the laws of the other Contracting State.

6. Proceedings with respect to the existence, validity or the amount of a revenue claim of a Contracting State shall not be brought before the courts or administrative bodies of the other Contracting State.

7. Where, at any time after a request has been made by a Contracting State under paragraph 3 or 4 and before the other Contracting State has collected and remitted the relevant revenue claim to the first-mentioned State, the relevant revenue claim ceases to be:

- (a) in the case of a request under paragraph 3, a revenue claim of the first-mentioned State that is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, or
- (b) in the case of a request under paragraph 4, a revenue claim of the first-mentioned State in respect of which that State may, under its laws, take measures of conservancy with a view to ensure its collection, the competent authority of the first-mentioned State shall promptly notify the competent authority of the other State of that fact and, at the option of the other State, the first-mentioned State shall either suspend or withdraw its request.

8. In no case shall the provisions of this Article be construed so as to impose on a Contracting State the obligation:

- (a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- (b) to carry out measures which would be contrary to public policy (*ordre public*);
- (c) to provide assistance if the other Contracting State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice;
- (d) to provide assistance in those cases where the administrative burden for that State is clearly disproportionate to the benefit to be derived by the other Contracting State.

Article 28

MEMBERS OF DIPLOMATIC MISSIONS
AND CONSULAR POSTS

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

Chapter VII
FINAL PROVISIONS

Article 29

ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at _____ as soon as possible.
2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
 - (a) (In State A):
 - (b) (In State B):

Article 30

TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year _____. In such event, the Convention shall cease to have effect:

- (a) (In State A):
- (b) (In State B):

TERMINAL CLAUSE

NOTE: The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

Part Two

**COMMENTARIES ON THE ARTICLES OF THE
UNITED NATIONS MODEL DOUBLE TAXATION
CONVENTION BETWEEN DEVELOPED AND
DEVELOPING COUNTRIES**

Commentary on chapter I

SCOPE OF THE CONVENTION

Article 1

PERSONS COVERED

A. GENERAL CONSIDERATIONS

1. Article 1 of the United Nations Model Convention reproduces Article 1 of the OECD Model Convention.

2. The title of Article 1 was changed in 1999 from “Personal scope” to “Persons covered”. The first article of the Convention should specify the types of persons or taxpayers to whom the Convention applies. The title “Personal scope” did not convey the scope of application of the Convention. Hence, the title of Article 1 was appropriately changed to “Persons covered” to convey the correct scope of the Convention.

3. Like the OECD Model Convention, the United Nations Model Convention applies to persons who are “residents of one or both of the Contracting States”. The personal scope of most of the earliest conventions was more restrictive, in that it encompassed “citizens” of the Contracting States. However, in some early conventions that scope was wider, covering “taxpayers” of the Contracting States, that is persons who, although not residing in either State, are nevertheless liable to tax on part of their income or capital in each of them. In some articles there are exceptions to this rule, for example in Articles 24, paragraph 1, 25, paragraph 1, and 26, paragraph 1.

4. The United Nations Model Convention does not contain special provisions relating to partnerships. The Contracting States are therefore left free to examine the problems concerning partnerships in bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate. The OECD Committee on Fiscal Affairs adopted in 1999 the report entitled “The application of the OECD Model Tax Convention to partnerships”. The report deals with the application of the provisions of the OECD Model Tax Convention, and indirectly of bilateral tax conventions based on that Model, to partnerships. The Committee on Fiscal Affairs recognizes, however, that many of the principles discussed in that report may also apply, *mutatis mutandis*, to other non-corporate entities. In that report,

references to “partnerships” cover entities which qualify as such under civil or commercial law as opposed to tax law. The wide differences in the views of the OECD member countries stem from the fact that their domestic laws treat partnerships in different ways. In some OECD countries, partnerships are treated as taxable units and sometimes even as companies, while other OECD countries do not tax the partnership as such and only tax individual partners on their shares of partnership income. Similar differences in the tax treatment of partnerships exist in the developing countries.

5. An important question is whether a partnership should itself be allowed the benefits of the Convention. If, under the laws of a Contracting State, partnerships are taxable entities, a partnership may qualify as a resident of that Contracting State under paragraph 1 of Article 4 and therefore be entitled to benefits of the Convention. However, if a partnership is a conduit and only partners are taxed on partnership income, the partnership may be disregarded under the Convention, at least in the absence of special rules in the Convention providing otherwise.

6. The application of the Convention to partners may also depend on the laws of the Contracting States. The laws of the Contracting States also determine the treatment under the Convention of a disposition of a partnership interest.

7. If the Contracting States differ in their treatments of partnerships, different articles of the Convention can apply to the same transaction in the two States, which may result in double taxation or non-taxation in both States.

Improper use of tax treaties

8. Provisions of tax treaties are drafted in general terms and taxpayers may be tempted to apply these provisions in a narrow technical way so as to obtain benefits in circumstances where the Contracting States did not intend that these benefits be provided. Such improper uses of tax treaties are a source of concern to all countries but particularly for countries that have limited experience in dealing with sophisticated tax-avoidance strategies.

9. The Committee considers that it would therefore be helpful to examine the various approaches through which those strategies may be dealt with and to provide specific examples of the application of these approaches. In examining this issue, the Committee recognizes that for tax treaties to achieve their role, it is important to maintain a balance between the need for tax administrations to protect their tax revenues from the misuse of tax treaty provisions and the need to provide legal certainty and to protect the legitimate expectations of taxpayers.

1. *Approaches to prevent the improper use of tax treaties*

10. There are a number of different approaches used by countries to prevent and address the improper use of tax treaties. These include:

- specific legislative anti-abuse rules found in domestic law
- general legislative anti-abuse rules found in domestic law
- judicial doctrines that are part of domestic law
- specific anti-abuse rules found in tax treaties
- general anti-abuse rules in tax treaties
- the interpretation of tax treaty provisions

11. These various approaches are examined in the following sections.

Specific legislative anti-abuse rules found in domestic law

12. Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law.

13. Many domestic rules may be relevant for that purpose. For instance, controlled foreign corporation (CFC) rules may apply to prevent certain arrangements involving the use, by residents, of base or conduit companies that are residents of treaty countries; foreign investment funds (FIF) rules may prevent the deferral and avoidance of tax on investment income of residents that invest in foreign investment funds established in treaty countries; thin capitalization rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country; exit or departure taxes rules may prevent the avoidance of capital gains tax through a change of residence before the realization of a treaty-exempt capital gain and dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains.

14. A common problem that arises from the application of many of these and other specific anti-abuse rules to arrangements involving the use of tax treaties is possible conflicts with the provisions of tax treaties. Where two Contracting States take different views as to whether a specific anti-abuse rule found in the domestic law of one of these States conflicts with the provisions of their tax treaty, the issue may be addressed through the mutual agreement procedure having regard to the following principles.

15. Generally, where the application of provisions of domestic law and the provisions of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of *pacta sunt servanda* which is incorporated in Article 26 of the 1969 Vienna Convention on the Law of Treaties.¹⁰ Thus, if the application of these rules had the effect of increasing the tax liability of a taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions should prevail under public international law.

16. As explained below, however, such conflicts will often be avoided and each case must be analysed based on its own circumstances.

17. First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 of the Convention specifically authorizes the application of domestic transfer pricing rules in the circumstances defined by that Article. Also, many treaties include specific provisions clarifying that there is no conflict (or, even if there is a conflict, allowing the application of the domestic rules) in the case, for example, of thin capitalization rules, CFC rules or departure tax rules or, more generally, domestic rules aimed at preventing the avoidance of tax.

18. Second, many tax treaty provisions depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person, the determination of what is immovable property and of when income from corporate rights might be treated as a dividend. More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the treaty. In many cases, therefore, the application of domestic anti-abuse rules will impact how the treaty provisions are applied rather than produce conflicting results.

19. Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the treaty and the domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equity ratio. While this greatly facilitates their application, it will sometimes result in the application of these rules to transactions that do not constitute abuses. In such cases, of course, a proper interpretation of the treaty provisions that would disregard abusive transactions only will not allow the application of the domestic rules if they conflict with provisions of the treaty.

¹⁰United Nations, *Treaty Series*, vol 1155, p.331.

General legislative anti-abuse rules found in domestic law

20. Some countries have included in their domestic law a legislative anti-abuse rule of general application, which is intended to prevent abusive arrangements that are not adequately dealt with through specific rules or judicial doctrines.

21. As is the case for specific anti-abuse rules found in domestic law, the main issue that arises with respect to the application of such general anti-abuse rules to improper uses of a treaty is possible conflicts with the provisions of the treaty. To the extent that the application of such general rules is restricted to cases of abuse, however, such conflicts should not arise. This is the general conclusion of the OECD, which is reflected in paragraphs 22 and 22.1 of the Commentary on Article 1 of the OECD Model Convention and with which the Committee agrees:

22. Other forms of abuse of tax treaties (*e.g.* the use of a base company) and possible ways to deal with them, including “substance-over-form”, “economic substance” and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties [...].

22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict [...].

22. Having concluded that the approach of relying on such anti-abuse rules does not, as a general rule, conflict with tax treaties, the OECD was therefore able to conclude that “[...] States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into.”¹¹

23. That conclusion leads logically to the question of what is an abuse of a tax treaty. The OECD did not attempt to provide a comprehensive reply to that question, which would have been difficult given the different approaches of its member countries. Nevertheless, the OECD presented the following general guidance, which was referred to as a “guiding principle”:¹²

A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable

¹¹Paragraph 9.4 of the Commentary on Article 1 of the OECD Model Convention.

¹²Paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention.

tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

24. The members of the Committee endorse that principle. They considered that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers. Clearly, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.

25. Under the guiding principle presented above, two elements must therefore be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:

- a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and
- obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions.

26. These two elements will also often be found, explicitly or implicitly, in general anti-avoidance rules and doctrines developed in various countries.

27. In order to minimize the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not solely the alleged intention of the parties. Thus, the determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements.

Judicial doctrines that are part of domestic law

28. In the process of determining how domestic tax law applies to tax avoidance transactions, the courts of many countries have developed different judicial doctrines that have the effect of preventing domestic law abuses. These include the business purpose, substance over form, economic substance, step transaction, abuse of law and *fraus legis* approaches. The particular conditions under which such judicial doctrines apply often vary from country to country and evolve over time based on refinements or changes resulting from subsequent court decisions.

29. These doctrines are essentially views expressed by courts as to how tax legislation should be interpreted and as such, typically become part of the domestic tax law.

30. While the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the Vienna Convention on the Law of Treaties, nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty to similar transactions.

Specific anti-abuse rules found in tax treaties

31. Some forms of treaty abuse can be addressed through specific treaty provisions. A number of such rules are already included in the United Nations Model Convention; these include, in particular, the reference to the agent who maintains a stock of goods for delivery purposes (subparagraph (b), paragraph 5 of Article 5), the concept of “beneficial owner” (in Articles 10, 11, and 12), the “special relationship” rule applicable to interest and royalties (paragraph 6 of Article 11 and paragraph 6 of Article 12), the rule on alienation of shares of immovable property companies (paragraph 4 of Article 13) and the rule on “star-companies” (paragraph 2 of Article 17). Another example of a provision that addresses treaty abuse would be the modified version of the limited force-of-attraction rule of paragraph 1 of Article 7 that is found in some tax treaties and that applies only to avoidance cases.

32. Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers than broad general anti-abuse rules or doctrines. This is acknowledged in paragraph 9.6 of the OECD Commentary on Article 1, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches.¹³

33. One should not, however, underestimate the risks of relying extensively on specific treaty anti-abuse rules to deal with tax treaty avoidance

¹³“The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy [...]”

strategies. First, specific anti-abuse rules are often drafted once a particular avoidance strategy has been identified. Second, the inclusion of a specific anti-abuse provision in a treaty can weaken the case as regards the application of general anti-abuse rules or doctrines to other forms of treaty abuses. Adding specific anti-abuse rules to a tax treaty could be wrongly interpreted as suggesting that an unacceptable avoidance strategy that is similar to, but slightly different from, one dealt with by a specific anti-abuse rule included in the treaty is allowed and cannot be challenged under general anti-abuse rules. Third, in order to specifically address complex avoidance strategies, complex rules may be required. This is especially the case where these rules seek to address the issue through the application of criteria that leave little room for interpretation rather than through more flexible criteria such as the purposes of a transaction or arrangement. For these reasons, whilst the inclusion of specific anti-abuse rules in tax treaties is the most appropriate approach to deal with certain situations, it cannot, by itself, provide a comprehensive solution to treaty abuses.

General anti-abuse rules found in tax treaties

34. There are a few examples of treaty provisions that may be considered to be general anti-abuse rules. One such provision is paragraph 2 of Article 25 of the treaty between Israel and Brazil, signed in 2002:

A competent authority of a Contracting State may deny the benefits of this Convention to any person, or with respect to any transaction, if in its opinion the granting of those benefits would constitute an abuse of the Convention according to its purpose. Notice of the application of this provision will be given by the competent authority of the Contracting State concerned to the competent authority of the other Contracting State.

35. In some cases, countries have merely confirmed that Contracting States were not prevented from denying the benefits of the treaty provisions in abusive cases. In such cases, however, it cannot be said that the power to deny the benefits of treaty arises from the provision itself. An example of that type of provision is found in paragraph 6 of Article 29 of the Canada-Germany treaty signed in 2001:

Nothing in the Agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State.

36. A country that does not feel confident that its domestic law and approach to the interpretation of tax treaties would allow it to adequately address improper uses of its tax treaties could, of course, consider including a general anti-abuse rule in its treaties. The guiding principle referred to above could form the basis for such a rule, which could therefore be drafted along the following lines:

Benefits provided for by this Convention shall not be available where it may reasonably be considered that a main purpose for entering into transactions or arrangements has been to obtain these benefits and obtaining the benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention.

When considering such a provision, some countries may prefer to replace the phrase “a main purpose” by “the main purpose” to make it clear that the provision should only apply to transactions that are, without any doubt, primarily tax-motivated. Other countries, however, may consider that, based on their experience with similar general anti-abuse rules found in domestic law, words such as “the main purpose” would impose an unrealistically high threshold that would require tax administrations to establish that obtaining tax benefits is objectively more important than the combination of all other alleged purposes, which would risk rendering the provision ineffective. A State that wishes to include a general anti-abuse rule in its treaties will therefore need to adapt the wording to its own circumstances, particularly as regards the approach that its courts have adopted with respect to tax avoidance.

37. Many countries, however, will consider that including such a provision in their treaties could be interpreted as an implicit recognition that, absent such a provision, they cannot use other approaches to deal with improper uses of tax treaties. This would be particularly problematic for countries that have already concluded a large number of treaties that do not include such a provision. For that reason, the use of such a provision would probably be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches.

The interpretation of tax treaty provisions

38. Another approach that has been used to counter improper uses of treaties has been to consider that there can be abuses of the treaty itself and to disregard abusive transactions under a proper interpretation of the relevant treaty provisions that takes account of their context, the treaty’s object and purpose as well as the obligation to interpret these provisions in good faith.¹⁴

¹⁴As prescribed by Article 31 of the Vienna Convention on the Law of Treaties.

As already noted, a number of countries have long used a process of legal interpretation to counteract abuses of their domestic tax laws and it seems entirely appropriate to similarly interpret tax treaty provisions to counteract tax treaty abuses. As noted in paragraph 9.3 of the Commentary on Article 1 of the OECD Model Convention:

Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the *Vienna Convention on the Law of Treaties*).

39. Paragraphs 23 to 27 above provide guidance as to what should be considered to be a tax treaty abuse. That guidance would obviously be relevant for the purposes of the application of this approach.

2. *Examples of improper uses of tax treaties*

40. The following paragraphs illustrate the application of the approaches described above in various cases involving the improper use of tax treaty provisions (these examples, however, are not intended to prejudge the legal treatment of these transactions in domestic law or under specific treaties).

Dual residence and transfer of residence

41. There have been cases where taxpayers have changed their tax residence primarily for the purposes of getting tax treaty benefits. The following examples illustrate some of these cases

- *Example 1:* Mr. X is a resident of State A who has accumulated significant pension rights in that country. Under the treaty between State A and State B, pensions and other similar payments are only taxable in the State of residence of the recipient. Just before his retirement, Mr. X moves to State B for two years and becomes resident thereof under the domestic tax law of that country. Mr. X is careful to use the rules of paragraph 2 of Article 4 to ensure that he is resident of that country for the purposes of the treaty. During that period, his accrued pension rights are paid to him in the form of a lump-sum payment, which is not taxable under the domestic law of State B. Mr. X then returns to State A.

- *Example 2:* Company X, a resident of State A, is contemplating the sale of shares of companies that are also residents of State A. Such a sale would trigger a capital gain that would be taxable under the domestic law of State A. Prior to the sale, company X arranges for meetings of its board of directors to take place in State B, a country that does not tax capital gains on shares of companies and in which the place where a company's directors meet is usually determinative of that company's residence for tax purposes. Company X claims that it has become a resident of State B for the purposes of the tax treaty between States A and B pursuant to paragraph 3 of Article 4 of that treaty, which is identical to the United Nations Model Convention. It then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (paragraph 5 of that Article would not apply as company X does not own substantial participations in the relevant companies).
- *Example 3:* Ms. X, a resident of State A, owns all the shares of a company that is also a resident of State A. The value of these shares has increased significantly over the years. Both States A and B tax capital gains on shares; however, the domestic law of State B provides that residents who are not domiciled in that State are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. In contemplation of the sale of these shares, Ms. X moves to State B for two years and becomes resident, but not domiciled, in that State. She then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (the relevant treaty does not include a provision similar to paragraph 5 of the United Nations Model Convention).

42. Depending on the facts of a particular case, it might be possible to argue that a change of residence that is primarily intended to access treaty benefits constitutes an abuse of a tax treaty. In cases similar to these three examples, however, it would typically be very difficult to find facts that would show that the change of residence has been done primarily to obtain treaty benefits, especially where the taxpayer has a permanent home or is present in another State for extended periods of time. Many countries have therefore found that specific rules were the best approach to deal with such cases.

43. One approach used by some of these countries has been to include in their tax treaties provisions allowing a State of which a taxpayer was previously resident to tax certain types of income, e.g. capital gains on significant

participations in companies or lump-sum payments of pension rights, realized during a certain period following the change of residence. An example of such a provision is found in paragraph 5 of Article 13 of the treaty signed in 2002 by the Netherlands and Poland, which reads as follows:

The provisions of paragraph 4 shall not affect the right of each of the Contracting States to levy according to its own law a tax on gains from the alienation of shares or “jouissance” rights in a company, the capital of which is wholly or partly divided into shares and which under the laws of that State is a resident of that State, derived by an individual who is a resident of the other Contracting State and has been a resident of the first-mentioned State in the course of the last ten years preceding the alienation of the shares or “jouissance” rights.

44. Countries have also dealt with such cases through the use of so-called “departure tax” or “exit charge” provisions, under which the change of residence triggers the realization of certain types of income, e.g. capital gains on shares. In order to avoid a conflict with the provisions of a tax treaty, such domestic rules may deem the realization of the income to take place immediately before the change of residence; they may also be combined with treaty provisions allowing for their application.

45. A proper interpretation of the provisions of paragraphs 2 and 3 of Article 4 may also be useful in dealing with cases similar to these examples. Concepts such as “centre of vital interests” and “place of effective management” require a strong relationship between a taxpayer and a country. The fact that a taxpayer has a home available to him in a country where he sojourns frequently is not enough to claim that that country is his centre of vital interests; likewise, the mere fact that meetings of a board of directors of a company take place in a country is not sufficient to conclude that this is where the company is effectively managed. Also, some countries have replaced paragraph 3 of Article 4, which deals with cases of dual residence of legal persons on the basis of their place of effective management, by a rule that leaves such cases of dual residence to be decided under the mutual agreement procedure. An example of such a provision is found in paragraph 3 of Article 4 of the treaty signed in 2004 by Mexico and Russia, which reads as follows:

Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavour to settle the question and to determine the mode of application of the Agreement to such person. In the absence of such agreement, such person shall be considered to be outside the scope of this Agreement, except for the Article “Exchange of information”.

46. Example 3 raises the potential for tax avoidance arising from remittance-based taxation. This issue is dealt with in paragraph 26.1 of the Commentary on Article 1 of the OECD Model Convention, which suggests that, in order to deal with such situations, countries may include a specific anti-abuse provision in their tax treaties with countries that allow that form of taxation:

26.1 Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:

Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State.

In some States, the application of that provision could create administrative difficulties if a substantial amount of time elapsed between the time the income arose in a Contracting State and the time it were taxed by the other Contracting State in the hands of a resident of that other State. States concerned by these difficulties could subject the rule in the last part of the above provision, *i.e.* that the income in question will be entitled to benefits in the first-mentioned State only when taxed in the other State, to the condition that the income must be so taxed in that other State within a specified period of time from the time the income arises in the first-mentioned State.

Treaty shopping

47. “Treaty shopping” is a form of improper use of tax treaties that refers to arrangements through which persons who are not entitled to the benefits of a tax treaty use other persons who are entitled to such benefits in order to

indirectly access these benefits. For example, a company that is a resident of a treaty country would act as a conduit for channelling income that would economically accrue to a person that is not a resident of that country so as to improperly access the benefits provided by a tax treaty. The conduit entity is usually a company, but may also be a partnership, trust or similar entity that is entitled to treaty benefits. Granting treaty benefits in these circumstances would be detrimental to the State of source since the benefits of the treaty would be extended to persons who were not intended to obtain such benefits.

48. A treaty shopping arrangement may take the form of a “direct conduit” or that of a “stepping stone conduit”, as illustrated below.¹⁵

49. Company X, a resident of State A, receives dividends, interest or royalties from company Y, a resident of State B. Company X claims that, under the tax treaty between States A and B, it is entitled to full or partial exemption from the domestic withholding taxes provided for under the tax legislation of State B. Company X is wholly-owned by a resident of third State C who is not entitled to the benefits of the treaty between States A and B. Company X was created for the purpose of obtaining the benefits of the treaty between States A and B and it is for that purpose that the assets and rights giving rise to the dividends, interest or royalties have been transferred to it. The income is exempt from tax in State A, e.g. in the case of dividends, by virtue of a participation exemption provided for under the domestic laws of State A or under the treaty between States A and B. In that case, company X constitutes a direct conduit of its shareholder who is a resident of State C.

50. The basic structure of a stepping stone conduit is similar. In that case, however, the income of company X is fully taxable in State A and, in order to eliminate the tax that would be payable in that country, company X pays high interest, commissions, service fees or similar deductible expenses to a second related conduit company, company Z, a resident of State D. These payments, which are deductible in State A, are tax-exempt in State D by virtue of a special tax regime available in that State.¹⁶ The shareholder who is a resident of State C is therefore seeking to access the benefits of the tax treaty between States A and B by using company X as a stepping stone.

51. In order to deal with such situations, tax authorities have relied on the various approaches described in the previous sections.

¹⁵See page R(6)-4, paragraph 4 of the OECD Report *Double Taxation Conventions and the use of Conduit Companies*. Reproduced in Volume II of the full-length version of the OECD Model Convention at page R(6)-1.

¹⁶*Id.*

52. For instance, specific anti-abuse rules have been included in the domestic law of some countries to deal with such arrangements. One example is that of the United States regulations dealing with financing arrangements. For the purposes of these regulations, a financing arrangement is a series of transactions by which the financing entity advances money or other property to the financed entity, provided that the money or other property flows through one or more intermediary entities. An intermediary entity will be considered a “conduit”, and its participation in the financing arrangements will be disregarded by the tax authorities if (i) tax is reduced due to the existence of an intermediary, (ii) there is a tax avoidance plan, and (iii) it is established that the intermediary would not have participated in the transaction but for the fact that the intermediary is a related party of the financing entity. In such cases, the related income shall be re-characterized according to its substance.

53. Other countries have dealt with the issue of treaty shopping through the interpretation of tax treaty provisions. According to a 1962 decree of the Swiss Federal Council, which is applicable to Swiss treaties with countries that, under the relevant treaties, grant relief from withholding tax that would otherwise be collected by these countries, a claim for such relief is considered abusive if, through such claim, a substantial part of the tax relief would benefit persons not entitled to the relevant tax treaty. The granting of tax relief shall be deemed improper (a) if the requirements specified in the tax treaty (such as residence, beneficial ownership, tax liability, etc.) are not fulfilled and (b) if it constitutes an abuse. The measures which the Swiss tax authorities may take if they determine that a tax relief has been claimed improperly include (a) refusal to certify a claim form, (b) refusal to transmit the claim form, (c) revoking a certification already given, (d) recovering the withholding tax, on behalf of the State of source, to the extent that the tax relief has been claimed improperly, and (e) informing the tax authorities of the State of source that a tax relief has been claimed improperly.

54. Other countries have relied on their domestic legislative general anti-abuse rules or judicial doctrines to address treaty shopping cases. As already noted, however, legislative general anti-abuse rules and judicial doctrines tend to be the most effective when it is clear that transactions are intended to circumvent the object and purpose of tax treaty provisions.

55. Treaty shopping can also, to some extent, be addressed through anti-abuse rules already found in most tax treaties, such as the concept of “beneficial ownership”.

56. Some countries, however, consider that the most effective approach to deal with treaty shopping is to include in their tax treaties specific anti-abuse

rules dealing with that issue. Paragraphs 13 to 21.4 of the Commentary on Article 1 of the OECD Model Convention, which are reproduced below, include various examples of such rules. The Committee considers that these examples are helpful in dealing with treaty shopping concerns that may arise with respect to treaties between developing and developed countries.

Conduit company cases

13. Many countries have attempted to deal with the issue of conduit companies and various approaches have been designed for that purpose. One solution would be to disallow treaty benefits to a company not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a “look-through” provision might have the following wording:

A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State.

Contracting States wishing to adopt such a provision may also want, in their bilateral negotiations, to determine the criteria according to which a company would be considered as owned or controlled by non-residents.

14. The “look-through approach” underlying the above provision seems an adequate basis for treaties with countries that have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it might be necessary to alter the provision or to substitute for it another one to safeguard bona fide business activities.

15. General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention does not recommend such a general provision. Whilst this seems adequate with respect to a normal international relationship, a subject-to-tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State

- a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
- b) exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law.

The concept of “substantial interest” may be further specified when drafting a bilateral convention. Contracting States may express it, for instance, as a percentage of the capital or of the voting rights of the company.

16. The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting bona fide provisions in the treaty to provide for the necessary flexibility (see paragraph 19 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as “stepping-stone strategies”.

17. The approaches referred to above are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use of conventions. It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:

Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State

- a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or
- b) exercise directly or indirectly, alone or together, the management or control of such company

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel

expenses, and depreciation of any kind of business assets including those on immaterial goods and processes).

18. A provision of this kind appears to be the only effective way of combatting “stepping-stone” devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underlie the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. States that consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause.

19. The solutions described above are of a general nature and they need to be accompanied by specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

a) *General bona fide provision*

“The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention.”

b) *Activity provision*

“The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations.”

c) *Amount of tax provision*

“The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident.”

d) *Stock exchange provision*

“The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned—directly or through

one or more companies each of which is a resident of the first-mentioned State—by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered.”

e) *Alternative relief provision*

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term “shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention.”

These provisions illustrate possible approaches. The specific wording of the provisions to be included in a particular treaty depends on the general approach taken in that treaty and should be determined on a bilateral basis. Also, where the competent authorities of the Contracting States have the power to apply discretionary provisions, it may be considered appropriate to include an additional rule that would give the competent authority of the source country the discretion to allow the benefits of the Convention to a resident of the other State even if the resident fails to pass any of the tests described above.

20. Whilst the preceding paragraphs identify different approaches to deal with conduit situations, each of them deals with a particular aspect of the problem commonly referred to as “treaty shopping”. States wishing to address the issue in a comprehensive way may want to consider the following example of detailed limitation-of-benefits provisions aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States, keeping in mind that adaptations may be necessary and that many States prefer other approaches to deal with treaty shopping:

1. Except as otherwise provided in this Article, a resident of a Contracting State who derives income from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a “qualified person” as defined in paragraph 2 and meets the other conditions of this Convention for the obtaining of such benefits.
2. A resident of a Contracting State is a qualified person for a fiscal year only if such resident is either:

- a) an individual;
 - b) a qualified governmental entity;
 - c) a company, if
 - (i) the principal class of its shares is listed on a recognised stock exchange specified in subparagraph *a)* or *b)* of paragraph 6 and is regularly traded on one or more recognised stock exchanges, or
 - (ii) at least 50 per cent of the aggregate vote and value of the shares in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision (i) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;
 - d) a charity or other tax-exempt entity, provided that, in the case of a pension trust or any other organization that is established exclusively to provide pension or other similar benefits, more than 50 per cent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or
 - e) a person other than an individual, if:
 - (i) on at least half the days of the fiscal year persons that are qualified persons by reason of subparagraph *a)*, *b)* or *d)* or subdivision *c) (i)* of this paragraph own, directly or indirectly, at least 50 per cent of the aggregate vote and value of the shares or other beneficial interests in the person, and
 - (ii) less than 50 per cent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a Contracting State such payment is attributable to a permanent establishment of that bank located in one of the Contracting States).
3. a) A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income,

derived from the other State, regardless of whether the resident is a qualified person, if the resident is actively carrying on business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer), the income derived from the other Contracting State is derived in connection with, or is incidental to, that business and that resident satisfies the other conditions of this Convention for the obtaining of such benefits.

- b) If the resident or any of its associated enterprises carries on a business activity in the other Contracting State which gives rise to an item of income, subparagraph *a)* shall apply to such item only if the business activity in the first-mentioned State is substantial in relation to business carried on in the other State. Whether a business activity is substantial for purposes of this paragraph will be determined based on all the facts and circumstances.
 - c) In determining whether a person is actively carrying on business in a Contracting State under subparagraph *a)*, activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to such person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) or another person possesses, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be considered to be connected to another if, based on all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.
4. Notwithstanding the preceding provisions of this Article, if a company that is a resident of a Contracting State, or a company that controls such a company, has outstanding a class of shares
- a) which is subject to terms or other arrangements which entitle its holders to a portion of the income of the company

derived from the other Contracting State that is larger than the portion such holders would receive absent such terms or arrangements (“the disproportionate part of the income”); and

- b) 50 per cent or more of the voting power and value of which is owned by persons who are not qualified persons the benefits of this Convention shall not apply to the disproportionate part of the income.

5. A resident of a Contracting State that is neither a qualified person pursuant to the provisions of paragraph 2 or entitled to benefits under paragraph 3 or 4 shall, nevertheless, be granted benefits of the Convention if the competent authority of that other Contracting State determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.

6. For the purposes of this Article the term “recognised stock exchange” means:

- a) in State A;
- b) in State B; and
- c) any other stock exchange which the competent authorities agree to recognise for the purposes of this Article.”

Provisions which are aimed at entities benefiting from preferential tax regimes

21. Specific types of companies enjoying tax privileges in their State of residence facilitate conduit arrangements and raise the issue of harmful tax practices. Where tax-exempt (or nearly tax-exempt) companies may be distinguished by special legal characteristics, the improper use of tax treaties may be avoided by denying the tax treaty benefits to these companies (the exclusion approach). As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause which would apply to the income received or paid by such companies and which could be drafted along the following lines:

No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a

company as defined under section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention.

The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).

21.1 Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.

21.2 Where it is not possible or appropriate to identify the companies enjoying tax privileges by reference to their special legal characteristics, a more general formulation will be necessary. The following provision aims at denying the benefits of the Convention to entities which would otherwise qualify as residents of a Contracting State but which enjoy, in that State, a preferential tax regime restricted to foreign-held entities (*i.e.* not available to entities that belong to residents of that State):

Any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State shall not be entitled to the benefits of this Convention if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust or partnership, or to any other person) is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more residents of that State.

Provisions which are aimed at particular types of income

21.3 The following provision aims at denying the benefits of the Convention with respect to income that is subject to low or no tax under a preferential tax regime:

1. The benefits of this Convention shall not apply to income which may, in accordance with the other provisions of the Convention, be taxed in a Contracting State and which is derived from activities the performance of which do not require substantial presence in that State, including:

- a) such activities involving banking, shipping, financing, insurance or electronic commerce activities; or
- b) activities involving headquarter or coordination centre or similar arrangements providing company or group administration, financing or other support; or
- c) activities which give rise to passive income, such as dividends, interest and royalties where, under the laws or administrative practices of that State, such income is preferentially taxed and, in relation thereto, information is accorded confidential treatment that prevents the effective exchange of information.

2. For the purposes of paragraph 1, income is preferentially taxed in a Contracting State if, other than by reason of the preceding Articles of this Agreement, an item of income:

- a) is exempt from tax; or
- b) is taxable in the hands of a taxpayer but that is subject to a rate of tax that is lower than the rate applicable to an equivalent item that is taxable in the hands of similar taxpayers who are residents of that State; or
- c) benefits from a credit, rebate or other concession or benefit that is provided directly or indirectly in relation to that item of income, other than a credit for foreign tax paid.

Anti-abuse rules dealing with source taxation of specific types of income

21.4 The following provision has the effect of denying the benefits of specific Articles of the convention that restrict source taxation where transactions have been entered into for the main purpose of obtaining these benefits. The Articles concerned are 10, 11, 12 and 21; the provision should be slightly modified as indicated below to deal with the specific type of income covered by each of these Articles:

The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned

with the creation or assignment of the [Article 10: “shares or other rights”; Article 11: “debt-claim”; Articles 12 and 21: “rights”] in respect of which the [Article 10: “dividend”; Article 11: “interest”; Articles 12 “royalties” and Article 21: “income”] is paid to take advantage of this Article by means of that creation or assignment.

57. When considering these examples, countries should take account of their ability to administer the various approaches that are proposed. For many developing countries, it may be difficult to apply very detailed rules that require access to substantial information about foreign entities. These countries might consider that a more general approach, such as the one proposed in paragraph 21.4, might be more adapted to their own circumstances.

Triangular Cases

58. With respect to tax treaties, the phrase “triangular cases” refers to the application of tax treaties in situations where three States are involved. A typical triangular case that may constitute an improper use of a tax treaty is one in which:

- dividends, interest or royalties are derived from State S by a resident of State R, which is an exemption country;
- that income is attributable to a permanent establishment established in State P, a low tax jurisdiction where that income will not be taxed.¹⁷

59. Under the State R-State S tax treaty, State S has to apply the benefits of the treaty to such dividends, interest or royalties because these are derived by a resident of State R, even though they are not taxed in that State by reason of the exemption system applied by that State.

60. Paragraph 71 of the Commentary on Article 24 of the OECD Model Convention, which is reproduced in the Commentary on Article 24 below, discusses this situation and suggests that it may be dealt with through the inclusion of a specific provision in the treaty between States R and S:

[...] If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise

¹⁷See page R(11)-3, paragraph 53 of the OECD Report *Triangular Cases*. Reproduced in volume II of the full-length version of the OECD Model Convention at page R(11)-1.

will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.

61. A few treaties include a provision based on that suggestion.¹⁸ If, however, similar provisions are not systematically included in the treaties that have been concluded by the State of source of such dividends, interest or royalties with countries that have an exemption system, there is a risk that the relevant assets will be transferred to associated enterprises that are residents of countries that do not have that type of provision in their treaty with the State of source.

Attributing Profits or Income to a Specific Person or Entity

62. A taxpayer may enter into transactions or arrangements in order that income that would normally accrue to that taxpayer accrues to a related person or entity so as to obtain treaty benefits that would not otherwise be available. Some of the ways in which this may be done (e.g. treaty shopping and the use of permanent establishments in low-tax countries) have already been discussed. The following discusses other income shifting scenarios.

i) Non arm's length transfer prices

63. It has long been recognized that profits can be shifted between associated enterprises through the use of non arm's length prices and the tax legislation of most countries now include transfer pricing rules that address such cases. These rules are specifically authorized by Article 9 of the United Nations and OECD Model Conventions. This, however, is a complex area, as shown by the extensive guidance produced by the OECD¹⁹ as to how these rules should operate.

¹⁸See for example, paragraph 5 of Article 30 of the France-United States treaty.

¹⁹OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, 1995 (as updated). As at 2012, the United Nations Committee of Experts is producing a manual on the practical aspects of transfer pricing with a focus on the issues faced by developing countries.

ii) *Thin capitalization*

64. In almost all countries, interest is a deductible expense whereas dividends, being a distribution of profits, are not deductible. A foreign company that wants to provide financing to a wholly-owned subsidiary may therefore find it beneficial, for tax purposes, to provide that financing through debt rather than share capital, depending on the overall tax on the interest paid. A subsidiary may therefore have almost all of its financing provided in the form of debt rather than share capital, a practice known as “thin capitalization”.

65. According to the OECD report on Thin Capitalisation,²⁰ countries have developed different approaches to deal with this issue. These approaches may be broadly divided between those that are based on the application of general anti-abuse rules or the arm’s length principle and those that involve the use of fixed debt-equity ratios.

66. The former category refers to rules that require an examination of the facts and circumstances of each case in order to determine whether the real nature of the financing is that of debt or equity. This may be implemented through specific legislative rules, general anti-abuse rules, judicial doctrines or the application of transfer pricing legislation based on the arm’s length principle.

67. The fixed ratio approach is typically implemented through specific legislative anti-abuse rules; under this approach, if the total debt/equity ratio of a particular company exceeds a predetermined ratio, the interest on the excessive debt may be disallowed, deferred or treated as a dividend.

68. To the extent that a country’s thin capitalization rule applies to payments of interest to non-residents but not to similar payments that would be made to residents, it could be in violation of paragraph 4 of Article 24, which provides that “interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State”. There is a specific exception to that rule, however, where paragraph 1 of Article 9, which deals with transfer pricing adjustments, applies. For that reason, as indicated in paragraph 74 of the OECD Commentary on Article 24:²¹

²⁰*Thin Capitalisation*. Reproduced in volume II of the full-length version of the OECD Model Convention at page R(4)-1. Available at www.oecd.org/dataoecd/42/20/42649592.pdf.

²¹Paragraph 74 of the OECD Commentary on Article 24 is reproduced in the Commentary on Article 24 of this Model.

Paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.

69. Paragraph 3 of the OECD Commentary on Article 9, which is reproduced under paragraph 5 of the Commentary on the same provision of this Model, clarifies that paragraph 1 of Article 9 allows the application of domestic rules on thin capitalization insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation. While this would typically be the case of thin capitalization rules that are based on the arm's length principle, a country that has adopted thin capitalization rules based on a fixed ratio approach would, however, typically find it difficult to establish that its thin capitalization rule, which does not refer to what independent parties would have done, satisfies that requirement.

70. For that reason, countries that have adopted thin capitalization rules based on a fixed ratio approach often consider that they need to include in their treaties provisions that expressly allow the application of these rules. For example, Article 13 of the Protocol to the treaty between France and Estonia provides as follows:

The provisions of the Convention shall in no case restrict France from applying the provisions of Article 212 of its tax code (code général des impôts) relating to thin capitalization or any substantially similar provisions which may amend or replace the provisions of that Article.

iii) The use of base companies

71. Base companies situated in low-tax jurisdictions may be used for the purposes of diverting income to a country where that income will be subjected to taxes that are substantially lower than those that would have been payable if the income had been derived directly by the shareholders of that company.

72. Various approaches have been used to deal with such arrangements. For example, a company that is a mere shell with no employees and no substantial economic activity could, in some countries, be disregarded for tax purposes pursuant to general anti-abuse rules or judicial doctrines. It could

also be possible to consider that a base company that is effectively managed by shareholders who are residents of another State has its residence or a permanent establishment in that State. The first approach is described by paragraph 10.1 of the Commentary on Article 1 of the OECD Model Convention, according to which claims to treaty benefits

[...] may be refused where careful consideration of the facts and circumstances of a case shows that the place of effective management of a subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that latter state for domestic law and treaty purposes (this will be relevant where the domestic law of a state uses the place of management of a legal person, or a similar criterion, to determine its residence).

73. The second approach is described in paragraph 10.2 of that Commentary, which reads as follows:

Careful consideration of the facts and circumstances of a case may also show that a subsidiary was managed in the state of residence of its parent in such a way that the subsidiary had a permanent establishment (*e.g.* by having a place of management) in that state to which all or a substantial part of its profits were properly attributable.

74. These approaches, however, might not be successful in dealing with arrangements involving companies that have substantial management and economic activities in the countries where they have been established. One of the most effective approaches to dealing with such cases is the inclusion, in domestic legislation, of controlled foreign corporation (CFC) legislation. While the view has sometimes be expressed that such legislation could violate certain provisions of tax treaties, the Committee considers that this would not be the case of typical CFC rules, as indicated in paragraph 23 of the Commentary on Article 1 of the OECD Model Convention (and as further explained in paragraphs 14 of the Commentary on Article 7 and 37 of the Commentary on Article 10 of that Model):

23. The use of base companies may also be addressed through controlled foreign companies provisions. A significant number of member and non-member countries have now adopted such legislation. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain

foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs 14 of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.

iv) Directors' fees and remuneration of top-level managers

75. According to Article 16 (Directors' fees), directors' fees and the remuneration of officials in a top-level managerial position of a company may be taxed in the State of residence of the company regardless of where the services of these directors and top-level managers are performed. A "salary split" arrangement could be used in order to reduce the taxes that would be payable in that State pursuant to that Article. Assume, for example, that company A, a resident of State A, has two subsidiaries, companies B and C, which are residents of States X and Y respectively. Mr. D, a resident of State X, is a director and an official in a top-level managerial position of subsidiary B. State X levies an income tax at progressive rates of up to 50 per cent. State Y has a similar income tax system but with a very low tax rate. Countries X and Y have a tax treaty which provides that State X applies the exemption method to income that may be taxed in State Y. For the purpose of reducing the tax burden of Mr. D, company A may appoint him as a director and an official in a top-level managerial position of company C and arrange for most of his remuneration to be attributed to these functions.

76. Paragraph 1 of Article 16 applies to directors' fees that a person receives "in his capacity" as a director of a company and paragraph 2 applies to salaries, wages and other similar remuneration that a person receives "in his capacity" as an official in top-level managerial position of a company. Thus, apart from the fact that such an arrangement could probably be successfully challenged under general anti-abuse rules or judicial doctrines, it could also be attacked through a proper analysis of the services rendered by Mr. D to each company from which he receives his income, as well as an analysis of the fees and remuneration paid to other directors and top-level managers of company C, in order to determine the extent to which director's

fees and remuneration received from that company by Mr. D can reasonably be considered to be derived from activities performed as a director or top-level manager of that company.

v) *Attribution of interest to a tax-exempt or government entity*

77. According to paragraph 12 of the Commentary on Article 11, countries may agree during bilateral negotiations to include in their treaties an exemption for interest of the following categories:²²

- Interest paid to Governments or government agencies;
- Interest guaranteed by Governments or government agencies;
- Interest paid to central banks;
- Interest paid to banks or other financial institutions;
- Interest on long-term loans;
- Interest on loans to finance special equipment or public works; or
- Interest on other government-approved types of investments (e.g. export finance).

78. Where a tax treaty includes one or more of these provisions, it may be possible for a party that is entitled to such an exemption to engage in back-to-back arrangements with other parties that are not entitled to that exemption or, where a contract provides for the payment of interest and other types of income that would not be exempt (e.g. royalties), to attribute a greater share of the overall consideration to the payment of interest. Such arrangements would constitute improper uses of these exemptions.

79. While it could be argued that an easy solution would be to avoid including such exemptions in a tax treaty, it is important to note that these are included for valid policy purposes, taking into account that source taxation on gross payments of interest will frequently act as a tariff and be borne by the borrower. Also, as long as a country has agreed to include such exemptions in one of its treaties, it becomes difficult to refrain from granting these in treaty negotiations with other similar countries.

80. Many of the approaches referred to above in the case of treaty shopping may be relevant to deal with back-to-back arrangements aimed at

²²Many treaties additionally exempt from source taxation interest paid to financial institutions, interest on sales on credit or interest paid to tax-exempt entities such as pension funds (see paragraphs 7.7-7.12 of the Commentary on Article 11 of the OECD Model Convention).

accessing the benefits of these exemptions. Also, cases where the consideration provided for in a mixed contract has been improperly attributed to interest payments can be challenged using specific domestic anti-abuse rules applicable to such cases, general domestic anti-abuse rules or doctrines or a proper interpretation of the treaty provisions. Where the overall consideration is divided among related parties, paragraph 6 of Article 11 and paragraph 1 of Article 9 may also be relevant to ensure that the benefit of the treaty exemption only applies to the proper amount of interest. Finally, some countries have included specific anti-abuse rules in their treaties to deal with such back-to-back arrangements. An example of such a rule is found in paragraph *b*) of Article 7 of the Protocol to the treaty signed in 2002 by Australia and Mexico, which reads as follows:

The provisions of [...] paragraph [2 of Article 11] shall not apply to interest derived from back-to-back loans. In such case, the interest shall be taxable in accordance with the domestic law of the State in which it arises.

Hiring-out of Labour

81. The Commentary on Article 15 reproduces the part of the Commentary on the OECD Model Convention that deals *inter alia* with arrangements known as “international hiring-out of labour”. This refers to cases where a local enterprise that wishes to hire a foreign employee for a short period of time enters into an arrangement with a non-resident intermediary who will act as the formal employer. The employee thus appears to fulfil the three conditions of paragraph 2 of Article 15 so as to qualify for the tax exemption in the State where the employment will be exercised. The Commentary on Article 15 includes guidance on how this issue can be dealt with, recognizing that domestic anti-abuses rules and judicial doctrines, as well as a proper construction of the treaty, offer ways of challenging such arrangements.

Artistes and sportspersons

82. A number of older tax treaties do not include paragraph 2 of Article 17 (Artistes and sportspersons), which deals with the use of so-called “star-companies”. In order to avoid the possible application of provisions based on paragraph 1 of that Article, residents of countries that have concluded such treaties may be tempted to arrange for the income derived from their activities as artistes or sportspersons, or part thereof, to be paid to a company set up for that purpose.

83. As indicated in the Commentary on Article 17, which reproduces paragraph 11 of the OECD Commentary on that Article, such arrangements may be dealt with under domestic law provisions that would attribute such income to the artistes or sportspersons:

[...] The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, *e.g.* a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries “look through” such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory [...].

84. Paragraph 11.2 of the OECD Commentary, which was added in 2003, clarifies that a State could also rely on its general anti-avoidance rules or judicial doctrines to deal with abusive arrangements involving star-companies:

11.2 As a general rule it should be noted, however, that, regardless of Article 17, the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsman or the star-company in abusive cases, as is recognised in paragraph 24 of the Commentary on Article 1.

85. Finally, as regards the anti-abuse rule found in paragraph 2 of Article 17, tax administrations should note that the rule applies regardless of whether or not the star-company is a resident of the same country as the country in which the artiste or sportsperson is resident. This clarification was also added to the OECD Commentary in 2003:

11.1 The application of paragraph 2 is not restricted to situations where both the entertainer or sportsman and the other person to whom the income accrues, *e.g.* a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer

or sportsman is not a resident of that other State. Conversely, where the income of an entertainer resident in one of the Contracting States accrues to a person, *e.g.* a star-company, who is a resident of a third State with which the State of source does not have a tax convention, nothing will prevent the Contracting State from taxing that person in accordance with its domestic laws.

Transactions that modify the treaty classification of income

86. Articles 6 to 21 allocate taxing rights differently depending on the nature of the income. The classification of a particular item of income for the purposes of these rules is based on a combination of treaty definitions and domestic law. Since taxpayers determine the contents of the contracts on which classification for the purposes of domestic law and treaty provisions is typically based, they may, in some cases, try to influence that classification so as to obtain unintended treaty benefits.

87. The following paragraphs provide a few examples of arrangements that seek to change the treaty classification of income. Depending on the circumstances, such arrangements may be addressed through specific domestic or treaty anti-abuse rules or under general anti-abuse rules or judicial doctrines. A practical issue, however, will often be that, in some of these cases, it will be difficult to discover and establish the connection between various transactions that will be entered into for the purpose of altering the treaty classification.

(i) Conversion of dividends into interest

88. Converting dividends into interest will be advantageous under a treaty that provides for source taxation of dividends but not of interest payments. Assume that X, a resident of State R, owns all the shares of company A, which is a resident of State S. In contemplation of the payment of an important dividend, X arranges for the creation of holding company B, which will also be a resident of State S; X is the only shareholder of company B. X then sells the shares of company A to company B in return for interest-bearing notes (State R and State S allow that transfer to be carried out free of tax). The payment of interest from company B to X will be made possible by the payment of dividends by company A to company B, which will escape tax in State S under a participation exemption or similar regime or because of the deduction of interest payments on the notes issued to X; X will thus indirectly receive the dividend paid by company A in the form of interest payments on the notes issued by company B and will avoid source taxation in State S.

(ii) Allocation of price under a mixed contract

89. A mixed contract covers different considerations, such as the provision of goods, services, know-how and the licensing of intangibles. These generate different types of income for treaty purposes. In many cases, the acquirer will be indifferent to the allocation of the price between the various considerations and the provider may therefore wish, in the relevant contract, to allocate a disproportionate part of the price to items of income that will be exempt in the State of source. For instance, a franchising contract may involve the transfer of goods to be sold, the provision of various services, the provision of know-how and royalties for the use of intellectual property (e.g. trademarks and trade names). To the extent that the non-resident franchisor does not have a permanent establishment in the State of residence of the franchisee, Article 7 would not allow that State to tax the business profits attributable to the provision of inventory goods and services but Article 12 would allow the taxation of the royalties and the payments related to know-how. Since all of these payments would normally be deductible for the franchisee, it may not care about how the overall price is allocated. The contract may therefore be drafted so as to increase the price for the provision of the goods and services and reduce the royalties and the price for the provision of know-how.

90. Since the parties to the contract are independent, domestic transfer pricing legislation and Article 9 of the Convention would typically not apply to such transactions. Developing countries may be particularly vulnerable to such transactions since custom duties, which would typically have made it less attractive to allocate the price to the transfer of goods, are gradually being reduced and the determination of the proper consideration for intangible property is often a difficult matter, even for sophisticated tax administrations.

(iii) Conversion of royalties into capital gains

91. A non-resident who owns the copyrights in a literary work wishes to grant to a resident of State S the right to translate and reproduce that work in that State in consideration for royalty payments based on the sales of the translated work. Instead of granting a license to the resident, the non-resident enters into a “sale” agreement whereby all rights related to the translated version of that work in State S are disposed of by the non-resident and acquired by the resident. The consideration for that “sale” is a percentage of the total sales of the translated work. The contract further provides that the non-resident will have the option to reacquire these rights after a period of five years.

92. Some countries have modified the definition of royalties to expressly address such cases. For example, subparagraph *a*) of paragraph 3 of Article 12 of the treaty between the United States and India provides that

The term “royalties” as used in this Article means:

a) payments of any kind received as a consideration for the use of, or the right to use, any copyright [...] including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof [...].

(iv) Use of derivative transactions

93. Derivative transactions can allow taxpayers to obtain the economic effects of certain financial transactions under a different legal form. For instance, depending on the treaty provisions and domestic law of each country, a taxpayer may obtain treaty benefits such as no or reduced source taxation when it is in fact in the same economic position as a foreign investor in shares of a local company. Assume, for instance, that company X, a resident of State A, wants to make a large portfolio investment in the shares of a company resident in State B, while company Y, a resident in State B, wants to acquire bonds issued by the government of State A. In order to avoid the cross-border payments of dividends and interest, which would attract withholding taxes, company X may instead acquire the bonds issued in its country and company Y may acquire the shares of the company resident in its country that company X wanted to acquire. Companies X and Y would then enter into a swap arrangement under which they would agree to make swap payments to each other based on the difference between the dividends and interest flows that they receive each year; they would also enter into future contracts to buy from each other the shares and bonds at some future time. Through these transactions, the taxpayers would have mirrored the economic position of cross-border investments in the shares and bonds without incurring the liability to source withholding taxes (except to the extent that the swap payments, which would only represent the difference between the flows of dividends and interest, would be subject to such taxes under Article 21 and the domestic law of each country).

Transactions that seek to circumvent thresholds found in treaty provisions

94. Tax treaty provisions sometimes use thresholds to determine a country’s taxing rights. One example is that of the lower limit of source tax on dividends found in subparagraph *(a)* of paragraph 2 of Article 10, which only applies if the beneficial owner of the dividends is a company which holds directly at least 10 per cent of the capital of the company paying the dividends.

95. Taxpayers may enter into arrangements in order to obtain the benefits of such provisions in unintended circumstances. For instance, a non-resident shareholder who owns less than 10 per cent of the capital of a resident company could, in contemplation of the payment of a dividend, arrange for his shares to be temporarily transferred to a resident company or non-resident company in the hands of which the dividends would be exempt or taxed at the lower rate. Such a transfer could be structured in such a way that the value of the expected dividend would be transformed into a capital gain exempt from tax in the source State. As noted in the Commentary on Article 10, which reproduces paragraph 17 of the OECD Commentary on that Article:

The reduction envisaged in subparagraph *a)* of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph *a)* a provision along the following lines:

provided that this holding was not acquired primarily for the purpose of taking advantage of this provision.

The following are other examples of arrangements intended to circumvent various thresholds found in the Convention.

Time limit for certain permanent establishments

96. Article 5, paragraph 3 of the Convention includes a rule according to which, in certain circumstances, the furnishing of services by a foreign enterprise during a certain period under the same or connected projects will constitute a permanent establishment. Taxpayers may be tempted to circumvent the application of that provision by splitting a single project between associated enterprises or by dividing a single contract into different ones so as to argue that these contracts cover different projects. Paragraphs 11 and 12 of the Commentary on Article 5 deal with such arrangements.

Thresholds for the source taxation of capital gains on shares

97. Paragraph 4 of Article 13 allows a State to tax capital gains on shares of a company (and on interests in certain other entities) the property of which consists principally of immovable property situated in that State. For the purposes of that provision, the property of such an entity is considered

to consist principally of immovable property situated in a State if the value of such immovable property exceeds 50 per cent of the value of all assets of the entity.

98. One could attempt to circumvent that provision by diluting the percentage of the value of an entity that derives from immovable property situated in a given State in contemplation of the alienation of shares or interests in that entity. In the case of a company, that could be done by injecting a substantial amount of cash in the company in exchange for bonds or preferred shares the conditions of which would provide that such bonds or shares would be redeemed shortly after the alienation of the shares or interests.

99. Where the facts establish that assets have been transferred to an entity for the purpose of avoiding the application of paragraph 4 of Article 13 to a prospective alienation of shares or interests in that entity, a country's general anti-abuse rules or judicial doctrines may well be applicable. Some countries, however, may wish to provide expressly in their treaties that paragraph 4 will apply in these circumstances. This could be done by adding to Article 13 a provision along the following lines:

For the purposes of paragraph 4, in determining the aggregate value of all assets owned by a company, partnership, trust or estate, the assets that have been transferred to that entity primarily to avoid the application of the paragraph shall not be taken into account.

3. *The importance of proper mechanisms for the application and interpretation of tax treaties*

100. The Committee recognizes the role that proper administrative procedures can play in minimizing risks of improper uses of tax treaties. Many substantive provisions in tax treaties need to be supported by proper administrative procedures that are in line with the procedural aspects of domestic tax legislation. Developing countries may consider developing their own procedural provisions regarding treaty application by learning from countries that have successful experience of treaty application.

101. The Committee also recognizes the importance of proper mechanisms for tax treaty interpretation. In many countries, there is a long history of independent judicial interpretations of tax treaties, which provide guidance to tax administration. Countries that have a weaker judicial system or where there is little judicial expertise in tax treaty interpretation may consider alternative mechanisms to ensure correct, responsive and responsible treaty interpretations.

102. Whilst anti-abuse rules are important for preventing the improper use of treaties, the application of certain anti-abuse rules may be challenging for tax administrations, especially in developing countries. For instance, whilst an effective application of domestic transfer pricing rules may help countries to deal with certain improper uses of treaty provisions, countries that have limited expertise in the area of transfer pricing may be at a disadvantage. In addition, countries that have inadequate experience of combating improper uses of treaties may feel uncertain about how to apply general anti-abuse rules, especially where a purpose-test is involved. This increases the need for appropriate mechanisms to ensure a proper interpretation of tax treaties.

103. Developing countries may also be hesitant to adopt or apply general anti-abuse rules if they believe that these rules would introduce an unacceptable level of uncertainty that could hinder foreign investment in their territory. Whilst a ruling system that would allow taxpayers to quickly know whether anti-abuse rules would be applied to prospective transactions could help reduce that concern, it is important that such a system safeguards the confidentiality of transactions and, at the same time, avoids discretionary interpretations (which, in some countries, could carry risks of corruption). Clearly, a strong independent judicial system will help to provide taxpayers with the assurance that anti-abuse rules are applied objectively. Similarly, an effective application of the mutual agreement procedure will ensure that disputes concerning the application of anti-abuse rules will be resolved according to internationally accepted principles so as to maintain the integrity of tax treaties.

Article 2

TAXES COVERED

A. GENERAL CONSIDERATIONS

1. Article 2 of the United Nations Model Convention reproduces Article 2 of the OECD Model Convention.

2. This Article is designed to clarify the terminology and nomenclature concerning the taxes to be covered by the Convention. In this connection, it may be observed that the same income or capital may be subject in the same country to various taxes—either taxes which differ in nature or taxes of the same nature levied by different political subdivisions or local authorities. Hence double taxation cannot be wholly avoided unless the methods for the

relief of double taxation applied in each Contracting State take into account all the taxes to which such income or capital is subject. Consequently, the terminology and nomenclature relating to the taxes covered by a treaty must be clear, precise and as comprehensive as possible. As noted in the Commentary on Article 2 of the OECD Model Convention, this is necessary:

1. [...] to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified, and to ensure for each Contracting State notification of significant changes in the taxation laws of the other State.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 2

Paragraph 1

3. This paragraph states that the Convention applies to taxes on income and on capital, irrespective of the authority on behalf of which such taxes are imposed (e.g. the State itself or its political subdivisions or local authorities) and irrespective of the method by which the taxes are levied (e.g. by direct assessment or by deduction at the source, in the form of surtaxes or surcharges or as additional taxes).

Paragraph 2

4. This paragraph defines taxes on income and on capital, as taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on capital appreciation and taxes on the total amounts of wages or salaries paid by enterprises. Practices regarding the coverage of taxes on the total amount of wages and salaries paid by enterprises vary from country to country and this matter should be taken into account in bilateral negotiations. According to paragraph 3 of the Commentary on Article 2 of the OECD Model Convention, taxes on the total amount of wages do not include “[s]ocial security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received”. The OECD Commentary further observes:

4. Clearly a State possessing taxing powers—and it alone—may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty.

5. The Article does not mention “ordinary taxes” or “extraordinary taxes”. Normally, it might be considered justifiable to include extraordinary taxes in a Model Convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. They may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But, as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention’s field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions.

Paragraph 3

5. This paragraph provides the Contracting States an opportunity to enumerate the taxes to which the Convention is to apply. According to the Commentary on Article 2, paragraph 3, of the OECD Model Convention, the list “is not exhaustive”, for “it serves to illustrate the preceding paragraphs of the Article”. In principle, however, it is expected to be “a complete list of taxes imposed in each State at the time of signature and covered by the Convention”.

Paragraph 4

6. The Commentary on Article 2, paragraph 4 of the OECD Model Convention is applicable:

7. This paragraph provides, since the list of taxes in paragraph 3 is purely declaratory, that the Convention is also to apply to all identical or substantially similar taxes that are imposed in a Contracting State after the date of signature of the Convention in addition to, or in place of, the existing taxes in that State.

8. Each State undertakes to notify the other of any significant changes made to its taxation laws by communicating to it, for example,

details of new or substituted taxes. Member countries are encouraged to communicate other significant developments as well, such as new regulations or judicial decisions; many countries already follow this practice. Contracting States are also free to extend the notification requirement to cover any significant changes in other laws that have an impact on their obligations under the convention. Contracting states wishing to do so may replace the last sentence of the paragraph by the following:

The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws or other laws affecting their obligations under the Convention.

Commentary on chapter II

DEFINITIONS

Article 3

GENERAL DEFINITIONS

A. GENERAL CONSIDERATIONS

1. Article 3 of the United Nations Model Convention is the same as Article 3 of the OECD Model Convention, except that Article 3 of the OECD Model Convention defines the terms “enterprise” and “business” in subparagraphs *c*) and *h*) of paragraph 1 while Article 3 of the United Nations Model Convention does not. This is because the OECD Model Convention has deleted Article 14 (Independent Personal Services) while the United Nations Model Convention still maintains it.

2. Several general definitions are normally necessary for the understanding and application of a bilateral tax convention, although terms relating to more specialized concepts are usually defined or interpreted in special provisions. On the other hand, there are terms whose definitions are not included in the Convention but are left to bilateral negotiations.

3. Article 3 of the United Nations Model Convention, like Article 3 of the OECD Model Convention, sets forth a number of general definitions required for the interpretation of the terms used in the Convention. These terms are “person”, “company”, “enterprise of a Contracting State”, “international traffic”, “competent authority” and “national”. Article 3 leaves space for the designation of the “competent authority” of each Contracting State. The terms “resident” and “permanent establishment” are defined in Articles 4 and 5 respectively, while the interpretation of certain terms used in the articles on special categories of income (e.g. immovable property, dividends) is clarified in the articles concerned. The parties to a convention are left free to agree bilaterally on a definition of the terms “a Contracting State” and “the other Contracting State”. They also may include in the definition of a Contracting State a reference to continental shelves.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 3

Paragraph 1

(a) The term “person”

4. The term “person”, which is defined in subparagraph (a) as including an individual, a company and any other body of persons, should be interpreted very broadly. According to paragraph 2 of the Commentary on Article 3 of the OECD Model Convention, the term also includes “any entity that, although not incorporated, is treated as a body corporate for tax purposes. Thus, e.g. a foundation (*fondation, Stiftung*) may fall within the meaning of the term “person”. Partnerships will also be considered to be “persons” either because they fall within the definition of “company” or, where this is not the case, because they constitute other bodies of persons.”

(b) The term “company”

5. The definition of the term “company”, like the corresponding definition in the OECD Model Convention, is formulated with special reference to Article 10 on dividends. The definition is relevant to that Article and to Article 5, paragraph 8, and Article 16, corresponding respectively to Article 5, paragraph 7, and Article 16 of the OECD Model Convention.

(c) The term “enterprise of a Contracting State”

6. Subparagraph (c) defines the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State”. It does not define the term “enterprise” per se, because, as noted in the Commentary on the OECD Model Convention, “[t]he question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States”.

(d) The term “international traffic”

7. The definition of the “international traffic” is based on the principle that the right to tax profits arising from the operation of ships or aircraft in international traffic resides only in the Contracting State in which the place of effective management is situated. This principle is set forth in Article 8 (alternative A), paragraph 1 (corresponding to Article 8, paragraph 1, of

the OECD Model Convention), and in Article 8 (alternative B), paragraph 1, and the first sentence of paragraph 2 (provided in the latter case that the shipping activities concerned are not more than casual). However, the Contracting States may agree on a bilateral basis to substitute a reference to residence in subparagraph (*d*) if appropriate to conform to the general tenor of the other articles relating to international traffic. In such cases, as noted in the Commentary on the OECD Model Convention, “the words ‘an enterprise that has its place of effective management in a Contracting State’ should be replaced by ‘an enterprise of a Contracting State’ or ‘a resident of a Contracting State’”.

8. As also noted in the OECD Commentary, “[t]he definition of the term “international traffic” is broader than the term is normally understood [in order] to preserve for the State of the place of effective management the right to tax purely domestic traffic as well as international traffic between third States, and to allow the other Contracting State to tax traffic solely within its borders”.

(*e*) The term “competent authority”

9. As in the OECD Model Convention, the definition of the term “competent authority” is left to the Contracting States, which are free to designate one or more authorities as being competent for the purpose of applying the Convention. This approach is necessary because in some countries the implementation of double taxation conventions may not lie solely within the jurisdiction of the highest tax authorities in so far as some matters may be reserved to, or may fall within the competence of, other authorities.

(*f*) The term “national”

10. Initially, the definition of the term “national” occurred in paragraph 2 of Article 24 relating to “Non-discrimination”. As a result, the definition of the term “national” would have restricted application only for the purposes of Article 24. Since the term “national” has been referred to in other articles of the Convention as well, namely, Article 4, paragraph 2, subparagraphs (*c*) and (*d*), Article 19, Article 24 and Article 25, it was decided in 1999 to shift the definition of the term “national” from paragraph 2 of Article 24 to subparagraph (*f*) of paragraph 1 of Article 3. For natural persons, the definition merely states that the term applies to any individual possessing the nationality of a Contracting State. It has not been found necessary to introduce into the text of the Convention any considerations on the signification of the concept of nationality, any more than it seemed appropriate to make any special comment on the meaning and application of the word. In determining what

is meant by “the nationals of a Contracting State” in relation to individuals, reference must be made to the sense in which the term is usually employed and each State’s rules on the acquisition or loss of nationality.

11. Subparagraph (f) is more specific as to legal persons, partnerships and associations. By declaring that any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State is considered to be a national, the provision disposes of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, some States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.

12. Moreover, in view of the legal relationship created between the company and the State under whose laws it is constituted, which resembles the relationship of nationality for individuals, it seems appropriate not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term “national”.

Paragraph 2

13. Like Article 3, paragraph 2, of the OECD Model Convention, this paragraph contains a general rule concerning the meaning of terms used but not defined in the Convention. According to the OECD Commentary, paragraph 2 was amended in 1995 in order:

13.1 [...] to conform its text more closely to the general and consistent understanding of member states. For purposes of paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws. States that are able to enter into mutual agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof) that establish the meanings of terms not defined in the Convention should take those agreements into account in interpreting those terms.

When a conflict arises between the law in force when the Convention was signed and that in force when the Convention is applied, the latter law prevails.

14. The OECD Commentary states:

12. However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.

13. Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).

Article 4

RESIDENT

A. GENERAL CONSIDERATIONS

1. Article 4 of the United Nations Model Convention reproduces Article 4 of the OECD Model Convention with one adjustment, namely, the addition in 1999 of the criterion “place of incorporation” to the list of criteria in paragraph 1 for taxation as a resident. According to the Commentary on Article 4 of the OECD Model Convention:

1. The concept of “resident of a Contracting State” has various functions and is of importance in three cases:

- a) in determining a convention’s personal scope of application;
- b) in solving cases where double taxation arises in consequence of double residence;
- c) in solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source or situs.

2. Like Article 4 of the OECD Model Convention, Article 4 of the United Nations Model Convention defines the expression “resident of a Contracting

State” and establishes rules for resolving cases of double residence. In the two typical cases of conflict between two residences and between residence and source or *situs*, the conflict arises because, under their domestic laws, one or both Contracting States claim that the person concerned is resident in their territory. In this connection the OECD Commentary provides the following clarification:

3. Generally the domestic laws of the various States impose a comprehensive liability to tax—“full tax liability”—based on the taxpayers’ personal attachment to the State concerned (the “State of residence”). This liability to tax is not imposed only on persons who are “domiciled” in a State in the sense in which “domicile” is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State. Some legislations impose full liability to tax on individuals who perform services on board ships which have their home harbour in the State.

4. Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as “resident” and, consequently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on “residence” have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.

5. This manifests itself quite clearly in the cases where there is no conflict at all between two residences, but where the conflict exists only between residence and source or *situs*. But the same view applies in conflicts between two residences. The special point in these cases is only that no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned. In these cases special provisions must be established in the Convention to determine which of the two concepts of residence is to be given preference.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 4

Paragraph 1

3. The former Group of Experts decided to adopt as paragraph 1 of Article 4, the paragraph 1 of Article 4 of the OECD Model Convention, and

had initially decided not to adopt the second sentence which reads: “This term [resident of a Contracting State], however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein”. The second sentence, which was included in the OECD Model Convention to deal, for example, with the special situation of foreign diplomats and consular staffs serving in a country which taxed residents on the basis of their worldwide income, who might be considered (under the domestic law of the country in which they are serving) as residents but, because of their special status, might nevertheless be taxable only on income from sources in that State, was incorporated in 1999 in paragraph 1 of Article 4 of the United Nations Model Convention as well.

4. The OECD Commentary observes:

8.1 In accordance with the provisions of the second sentence of paragraph 1, however, a person is not to be considered a “resident of a Contracting State” in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, *e.g.* in the case of foreign diplomatic and consular staff serving in their territory.

8.2 According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State foreign held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State’s tax law, are considered to be residents of another State pursuant to a treaty between these two States. The exclusion of certain companies or other persons from the definition would not of course prevent Contracting States from exchanging information about their activities (see paragraph 2 of the Commentary on Article 26). Indeed States may feel it appropriate to develop spontaneous exchanges of information about persons who seek to obtain unintended treaty benefits.

5. Paragraph 1, similar to the corresponding provision of the OECD Model Convention, refers to the concept of residence contained in the domestic laws of the Contracting States and lists the criteria for taxation as a resident: domicile, residence, place of management (to which the United Nations Model Convention adds “place of incorporation”) or any other criterion of a similar nature. Thus formulated, the definition of the term “resident of a

Contracting State” is, according to the OECD Commentary, aimed at covering, as far as individuals are concerned, “[...] the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax)”.²³

6. The OECD Commentary observes:

8.4 It has been the general understanding of most member countries that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that State for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, Article 4 was amended to conform the text of the Model to this understanding.

(It may be mentioned that in 1999, the United Nations Model Convention also adopted the same amendment.)

8.6 Paragraph 1 refers to persons who are “liable to tax” in a Contracting State under its laws by reason of various criteria. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organisations may be exempted from tax, but they are exempt only if they meet all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most States would view such entities as residents for purposes of the Convention (see, for example, paragraph 1 of Article 10 and paragraph 5 of Article 11).

8.7 In some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. Contracting States taking this view are free to address the issue in their bilateral negotiations.

8.8 Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership “flows through” to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded

²³Paragraph 8 of the OECD Commentary on Article 4.

by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

Some members of the Committee of Experts disagree with the proposition in paragraph 8.8 of the OECD Commentary extracted above that the partners of fiscally transparent partnerships can claim the benefits of the Convention. They are of the view that a special rule is required in a Convention to provide such a result.

Paragraph 2

7. This paragraph, which reproduces Article 4, paragraph 2, of the OECD Model Convention, lists in decreasing order of relevance a number of subsidiary criteria to be applied when an individual is a resident of both Contracting States and the preceding criteria do not provide a clear-cut determination of his status as regards residence. It may be noted that in 1999, the word “only” was inserted in subparagraphs (a), (b) and (c) of paragraph 2, following the changes previously made to the OECD Model Convention. The OECD Commentary states:

9. This paragraph relates to the case where, under the provisions of paragraph 1, an individual is a resident of both Contracting States.

10. To solve this conflict special rules must be established which give the attachment to one State a preference over the attachment to the other State. As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State. The facts to which the special rules will apply are those existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. For example, in one calendar year an individual is a resident of State A under that State’s tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was

a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.

11. The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, *e.g.* where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.

12. Subparagraph *a)* means, therefore, that in the application of the Convention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.

13. As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.).

14. If the individual has a permanent home in both Contracting States, paragraph 2 gives preference to the State with which the personal and economic relations of the individual are closer, this being understood as the centre of vital interests. In the cases where the residence cannot be determined by reference to this rule, paragraph 2 provides as subsidiary criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Article 25.

15. If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless

obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

16. Subparagraph *b)* establishes a secondary criterion for two quite distinct and different situations:

- a)* the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;
- b)* the case where the individual has a permanent home available to him in neither Contracting State.

Preference is given to the Contracting State where the individual has an habitual abode.

17. In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.

18. The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.

19. In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has a habitual abode, subparagraph *b)* does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

20. Where, in the two situations referred to in subparagraph *b)* the individual has a habitual abode in both Contracting States or in neither, preference is given to the State of which he is a national. If, in these cases still, the individual is a national of both Contracting

States or of neither of them, subparagraph *d*) assigns to the competent authorities the duty of resolving the difficulty by mutual agreement according to the procedure established in Article 25.

Paragraph 3

8. Paragraph 3, which reproduces Article 4, paragraph 3, of the OECD Model Convention, deals with companies and other bodies of persons, irrespective of whether they are legal persons. The OECD Commentary indicates in paragraph 21 that “[i]t may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State, but it is, of course, possible if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc. also, special rules as to the preference must be established”. According to paragraph 22 of the OECD Commentary, “[i]t would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed”. It may be mentioned that, as in the case of the OECD Model Convention, the word “only” was added in 1999 to the tie-breaker test for determining the residence of dual residents, other than individuals.

9. The OECD Commentary goes on to state:

23. The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the “place of management” of the enterprise is situated; other conventions attach importance to its “place of effective management”, others again to the “fiscal domicile of the operator”.

24. As a result of these considerations, the “place of effective management” has been adopted as the preference criterion for persons other than individuals [...].

10. It is understood that when establishing the “place of effective management”, circumstances which may, inter alia, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view and the place where the most important accounting books are kept. In this respect the OECD Commentary refers to some relevant country practices:

24.1 Some countries, however, consider that cases of dual residence of persons who are not individuals are relatively rare and should be dealt with on a case-by-case basis. Some countries also consider that such a case-by-case approach is the best way to deal with the difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies. These countries are free to leave the question of the residence of these persons to be settled by the competent authorities, which can be done by replacing the paragraph by the following provision:

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

Competent authorities having to apply such a provision to determine the residence of a legal person for purposes of the Convention would be expected to take account of various factors, such as where the meetings of its board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc. Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without an indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant. Also, since the application of the provision would normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25, the request should be made within three years from the first notification to that person that its taxation is not in accordance with the Convention since it is considered to be a resident

of both Contracting States. Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.

11. A particular issue, as regards a bilateral treaty between State A and State B, can arise in relation to a company which is under paragraph 1 of Article 4, a resident of State A, and which is in receipt of, say, interest income, not directly, but instead, through a permanent establishment which it has in a third country, State C. Applying the Model Convention has the effect that such a company can claim the benefit of the terms on, say, withholding tax on interest in the treaty between State A and State B, in respect of interest that is paid to its permanent establishment in State C. This is one example of what is known as a “triangular case”. Some concern has been expressed that treaties can be open to abuse where, in the example given, State C is a tax haven and State A exempts the profits of permanent establishments of its resident enterprises. The situation is discussed in depth in the OECD study on the subject.²⁴ States which wish to protect themselves against potential abuse can take advantage of the possible solutions suggested there, by adopting additional treaty provisions.

Article 5

PERMANENT ESTABLISHMENT

A. GENERAL CONSIDERATIONS

1. Article 5 of the United Nations Model Convention is based on Article 5 of the OECD Model Convention but contains several significant differences. In essence these are that under the United Nations Model Convention:

- there is a six-month test for a building or construction site constituting a permanent establishment, rather than the twelve-month test under the OECD Model Convention, and it expressly extends to assembly projects, as well as supervisory activities in connection with building sites and construction, assembly or installation projects (paragraph 3 (a));
- the furnishing of services by an enterprise through employees or other personnel results in a permanent establishment where such activities continue for a total of more than 183 days in any

²⁴Reproduced in Volume II of the full-length version of the OECD Model Convention at page R(11)-1.

twelve-month period commencing or ending in the fiscal year concerned (paragraph 3 (b));

- Article 14 (Independent personal services) has been retained, whereas in the OECD Model Convention, Article 14 has been deleted, and Article 5 addresses cases that were previously considered under the “fixed base” test of that Article. As noted below (in paragraph 15.1 and thereafter), while the United Nations Model Convention has retained Article 14, the present Commentary provides guidance for those countries not wishing to have such an article in their bilateral tax agreements;
- in the list of what is deemed *not* to constitute a permanent establishment in paragraph 4 (often referred to as the list of “preparatory and auxiliary activities”) “delivery” is not mentioned in the United Nations Model Convention, but is mentioned in the OECD Model Convention. Therefore a delivery activity might result in a permanent establishment under the United Nations Model Convention, without doing so under the OECD Model Convention;
- the actions of a “dependent agent” may constitute a permanent establishment, even without having and habitually exercising the authority to conclude contracts in the name of the enterprise, where that person habitually maintains a stock of goods or merchandise and regularly makes deliveries from the stock (paragraph 5 (b));
- there is a special provision specifying when a permanent establishment is created in the case of an insurance business; consequently a permanent establishment is more likely to exist under the United Nations Model Convention approach (paragraph 6); and
- an independent agent acting as such will usually not create a permanent establishment for the enterprise making use of the agent because such an agent is effectively operating his own business providing a service. As compared with the OECD Model Convention, the United Nations Model Convention indicates that such an agent devoting all or nearly all their time to a particular client and not dealing with the client at an arm’s length basis is not treated as having the necessary independence (paragraph 7).

These differences are considered in more detail below.

2. The concept of “permanent establishment” is used in bilateral tax treaties to determine the right of a State to tax the profits of an enterprise of

the other State. Specifically, the profits of an enterprise of one State are taxable in the other State only if the enterprise maintains a permanent establishment in the latter State and only to the extent that the profits are attributable to the permanent establishment. The concept of permanent establishment is found in the early model conventions including the 1928 model conventions of the League of Nations. The United Nations Model Convention reaffirms the concept.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 5

Paragraph 1

3. This paragraph, which reproduces Article 5, paragraph 1 of the OECD Model Convention, defines the term “permanent establishment”, emphasizing its essential nature as a “fixed place of business” with a specific “situs”. According to paragraph 2 of the OECD Commentary, this definition contains the following conditions:

- the existence of a “place of business”, *i.e.* a facility such as premises or, in certain instances, machinery or equipment;
- this place of business must be “fixed”, *i.e.*, it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

The OECD Commentary goes on to observe:

3. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, *i.e.* contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has a “productive character” it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (see Commentary on paragraph 4).

4. The term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (*e.g.* for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

4.1 As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.

4.2 Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. These principles are illustrated by the following examples where representatives of one enterprise are present on the premises of another enterprise. A first example is that of a salesman who regularly visits a major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer’s premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (*e.g.* a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer,

provided that the office is at his disposal for a sufficiently long period of time so as to constitute a “fixed place of business” (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer’s warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

4.5 A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (*i.e.* painting) constitute a permanent establishment of that painter.

4.6 The words “through which” must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business “through” the location where this activity takes place.

5. According to the definition, the place of business has to be a “fixed” one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but see paragraph 20 below).

5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single “place of business” (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.

5.2 This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an “office hotel” in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

The OECD Commentary then examines some examples relating to the provision of services. In quoting the following two paragraphs, the Committee notes that Article 5, paragraph 3, subparagraph (b) of the United Nations Model Convention provides a specific provision in relation to furnishing of services by an enterprise through employees or personnel engaged for that purpose. In practice, therefore, the points made in paragraphs 5.3 and 5.4 of the OECD Commentary (as with other parts of the OECD Commentary to Article 5, paragraph 1) may have less significance for the United Nations Model Convention than in their original context.

5.3 By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business. For example, where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically.

5.4 Conversely, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered

separately. However if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations.

The OECD Commentary then continues:

6. Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, *i.e.* if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by member countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

The Committee agrees with the approach taken in paragraph 6 of the OECD Commentary, while recognizing that such exceptional situations will not often arise in practice, and that special care should therefore be taken when relying on paragraph 6 as applicable in an actual case. The OECD Commentary continues:

6.1 As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to

exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

6.2 Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraph 18 on arrangements intended to abuse the 12-month period provided for in paragraph 3 would equally apply to such cases.

6.3 Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a permanent establishment but is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and thus—retrospectively—a permanent establishment. A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (*e.g.* death of the taxpayer, investment failure), it was prematurely liquidated.

7. For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

8. Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment etc. This remains the case even when, for example, the lessor supplies personnel after installation to

operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of [six] months applies. Other cases have to be determined according to the circumstances.

10. The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). These personnel include employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business [...]. But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

11. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent

establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as a closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessors; in general, the lessors permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

Paragraph 2

4. Paragraph 2, which reproduces Article 5, paragraph 2 of the OECD Model Convention, lists examples of places that will often constitute a permanent establishment. However, the provision is not self-standing. While paragraph 2 notes that offices, factories, etc., are common types of permanent establishments, when one is looking at the operations of a particular enterprise, the requirements of paragraph 1 must also be met. Paragraph 2 therefore simply provides an indication that a permanent establishment may well exist; it does not provide that one necessarily does exist. This is also the stance of the OECD Commentary, where it is assumed that States interpret the terms listed “in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1”. Developing countries often wish to broaden the scope of the term “permanent establishment” and some believe that a warehouse should be included among the specific examples. However, the deletion of “delivery” from the excluded activities described in subparagraphs (a) and (b) of paragraph 4 means that a “warehouse” used for any purpose is (subject to the conditions in paragraph 1 being fulfilled) a permanent establishment under the general principles of the Article. The OECD Commentary points out in paragraph 13 that the term “place of management” is mentioned separately because it is not necessarily an “office” and that “where the laws of the two Contracting States do not contain the concept of a ‘place of management’ as distinct from an ‘office’, there will be no need to refer to the former term in their bilateral convention”.

5. In discussing subparagraph (f), which provides that the term “permanent establishment” includes mines, oil or gas wells, quarries or any other place of extraction of natural resources, the OECD Commentary states that “the term ‘any other place of extraction of natural resources’ should be interpreted broadly” to include, for example, all places of extraction of hydro-

carbons whether on or offshore. Because subparagraph (f) does not mention exploration for natural resources, whether on or offshore, paragraph 1 governs whether exploration activities are carried on through a permanent establishment. The OECD Commentary states:

15. [...] Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:

- a) shall be deemed not to have a permanent establishment in that other State; or
- b) shall be deemed to carry on such activities through a permanent establishment in that other State; or
- c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

The Contracting States may moreover agree to submit the income from such activities to any other rule.

6. As mentioned above, in subparagraph (f) the expression “any other place of extraction of natural resources” should be interpreted broadly. Some have argued that, for this purpose, a fishing vessel could be treated as a place of extraction or exploitation of natural resources since “fish” constitute a natural resource. In their analysis, although it is true that all places or apparatus designated as “permanent establishments” in subparagraphs (a) to (e) in paragraph 2 have a certain degree of permanence or constitute “immovable property”, fishing vessels can be considered as a place used for extraction of natural resources, which may not necessarily mean only minerals embedded in the earth. In this view, fishing vessels can be compared to the movable drilling platform that is used in offshore drilling operations for gaining access to oil or gas. Where such fishing vessels are used in the territorial waters or the exclusive economic zone of the coastal State, their activities would constitute a permanent establishment, situated in that State. However, others are of the view that such an interpretation was open to objection in that it constituted too broad a reading of the term “permanent establishment” and of the natural language of the subparagraph. Accordingly, in their opinion, any treaty partner countries which sought to advance such a proposition in respect of fishing activities, should make that explicit by adopting it as a new and separate category in the list contained in this Article. Consequently,

the interpretation on the nature of this activity has been left to negotiations between Contracting States so that, for example, countries which believe that a fishing vessel can be a permanent establishment might choose to make that explicit in this Article, such as by the approach outlined in paragraph 13 of this Commentary. The interpretation as to the nature of this activity would, therefore, be left to negotiations between Contracting States.

Paragraph 3

7. This paragraph covers a broader range of activities than Article 5, paragraph 3 of the OECD Model Convention, which states, “A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months”. In addition to the term “installation project” used in the OECD Model Convention, subparagraph (a) of paragraph 3 of the United Nations Model Convention includes an “assembly project” as well as “supervisory activities” in connection with “a building site, a construction, assembly or installation project”. Another difference is that while the OECD Model Convention uses a time limit of 12 months, the United Nations Model Convention reduces the minimum duration to six months. In special cases, this six-month period could be reduced in bilateral negotiations to not less than three months. The Committee notes that there are differing views about whether subparagraph (a) of paragraph 3 is a “self-standing” provision (so that no resort to paragraph 1 is required) or whether (in contrast) only building sites and the like that meet the criteria of paragraph 1 would constitute permanent establishments, subject to there being a specific six-month test. However, the Committee considers that where a building site exists for six months, it will in practice almost invariably also meet the requirements of paragraph 1. In fact, an enterprise having a building site, etc., at its disposal, through which its activities are wholly or partly carried on will also meet the criteria of paragraph 1.

8. Some countries support a more elaborate version of subparagraph (a) of paragraph 3, which would extend the provision to encompass a situation “where such project or activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or activities exceed 10 per cent of the sale price of the machinery or equipment”. Other countries believe that such a provision would not be appropriate, particularly if the machinery were installed by an enterprise other than the one doing the construction work.

9. Article 5, paragraph 3, subparagraph (b) deals with the furnishing of services, including consultancy services, the performance of which does not,

of itself, create a permanent establishment in the OECD Model Convention. Many developing countries believe that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can generate large profits. In the 2011 revision of the United Nations Model Convention, the Committee agreed to a slight change in the wording of subparagraph (b) of paragraph 3, which was amended to read: “but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned”, rather than, “but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period”, as it formerly read. This was seen as providing greater consistency with the approach taken in Article 14, paragraph 1, subparagraph (b).

10. A few developing countries oppose the six-month (or 183 days) thresholds in subparagraphs (a) and (b) of paragraph 3 altogether. They have two main reasons: first, they maintain that construction, assembly and similar activities could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise; second, and more fundamentally, they simply believe that the period during which foreign personnel remain in the source country is irrelevant to their right to tax the income (as it is in the case of artistes and sportspersons under Article 17). Other developing countries oppose a time limit because it could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory. However, the purpose of bilateral treaties is to promote international trade, investment, and development, and the reason for the time limit (indeed for the permanent establishment threshold more generally) is to encourage businesses to undertake preparatory or ancillary operations in another State that will facilitate a more permanent and substantial commitment later on, without becoming immediately subject to tax in that State.

11. In this connection, the OECD Commentary observes, with changes in parentheses to take account of the different time periods in the two Models:

18. The [six] month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several

persons (*e.g.* for a row of houses). The [six] month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than [six] months and attributed to a different company, which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

The Committee points out that measures to counteract abuses would apply equally in cases under Article 5, paragraph 3, subparagraph (*b*). The Commentary of the OECD Model Convention continues as follows:

19. A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, *e.g.* if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st [August] because of bad weather conditions or a lack of materials but resumed work on 1st [October], completing the road on 1st [January the following year], his construction project should be regarded as a permanent establishment because [eight] months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st [January] of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project subcontracts parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. The subcontractor himself has a permanent establishment at the site if his activities there last more than [six] months.

The Committee considers that the reference in the penultimate sentence of this paragraph of the OECD Commentary to “parts” of such a project should not be taken to imply that an enterprise subcontracting *all* parts of the project could never have a permanent establishment in the host State.

The Commentary of the OECD Model Convention continues as follows:

19.1 In the case of fiscally transparent partnerships, the [six] month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds [six] months, the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site.

20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipelines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such cases the fact that the work force is not present for [six] months in one particular location is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts for more than [six] months.

12. Subparagraph (b) encompasses service activities only if they "continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned". The words "for the same or a connected project" are included because it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of 95 days' duration and another enterprise with two unrelated projects, each of 95 days' duration, one following the other. However, some countries find the "project" limitation either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of 120 or 150 days' duration.

13. If States wish to treat fishing vessels in their territorial waters as constituting a permanent establishment (see paragraph 6 above), they could add a suitable provision to paragraph 3, which, for example, might apply only to catches over a specified level, or by reference to some other criterion.

14. If a permanent establishment is considered to exist under paragraph 3, only profits attributable to the activities carried on through that permanent establishment are taxable in the source country.

15. The following passages of the OECD Commentary are relevant to Article 5, paragraph 3, subparagraph (a) of the United Nations Model Convention, although the reference to an “assembly project” in the United Nations Model Convention and not in the OECD Model Convention, and the six-month period in the United Nations Model Convention should, in particular, be borne in mind:

16. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which do not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than twelve months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed and risks assumed through that office or workshop are attributed to the permanent establishment. This could include profits attributable to functions performed and risks assumed in relation to the various construction sites but only to the extent that these functions and risks are properly attributable to the office.

17. The term “building site or construction or installation project” includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Additionally, the term “installation project” is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors. On-site planning and supervision of the erection of a building are covered by paragraph 3. States wishing to modify the text of the paragraph to provide expressly for that result are free to do so in their bilateral conventions.

Alternative text for countries wishing to delete Article 14

15.1. Some countries have taken the view that Article 14 should be deleted and its coverage introduced into Articles 5 and 7. Countries taking such a view often do so because they perceive that the “fixed base” concept in Article 14 has widely acknowledged uncertainties and that the “permanent establishment” concept can accommodate the taxing rights covered by Article 14. This approach is expressed by the Commentary on Article 5 of the OECD Model Convention as follows:

1.1 Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, *i.e.* Article 14. The provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The elimination of Article 14 therefore meant that the definition of permanent establishment became applicable to what previously constituted a fixed base.

15.2 Many countries disagree with these views and do not believe they are sufficient to warrant deletion of Article 14. Further some countries consider that differences in meaning exist between the “fixed base” (Article 14) and “permanent establishment” (Article 5) concepts. In view of these differences, the removal of Article 14 and reliance on Articles 5 and 7 will, or at least may, in practice lead to a reduction of source State taxing rights. Considering the differences of views in this area, differences which could not be bridged by a single provision, the Committee considers that Article 14 should be retained in the United Nations Model Convention but that guidance in the form of an alternative provision would be provided in this Commentary for countries wishing to delete Article 14.

15.3 This alternative differs from that provided for under the OECD Model Convention, which reflected in its changes the conclusions of a report on Article 14 released in a 2000 OECD report.²⁵ That report suggested certain changes to Articles of the OECD Model Convention (and bilateral treaties)

²⁵*Issues Related to Article 14 of the OECD Model Tax Convention*. Reproduced in Volume II of the full-length version of the OECD Model Convention at page R(16)-1.

as well as consequential changes to the Commentaries. Since most countries deleting Article 14 will be doing so for the reasons outlined in the OECD report, and are likely to follow the recommendations in the OECD Model Convention, the changes to the Articles proposed in that report, as they now appear in the OECD Model Convention, are addressed in the paragraphs below regarding the possible deletion of Article 14. The differences between that approach and the alternative wording provided below, result from relevant differences between Article 14 of the United Nations Model Convention and Article 14 as it previously appeared in the OECD Model Convention.

15.4 Since the deletion of Article 14 is merely presented as an option that some countries may prefer to follow, the entire discussion on the consequential implications of such an approach is addressed in this Commentary on Article 5, including identifying the possibility, and in most cases the need, to make certain consequential changes reflecting the deletion of Article 14, the need to remove references to “independent personal services” and “fixed base” and the possibility of removing references to “dependent personal services” for the sake of clarity.

Changes to Articles 14 and 5

15.5 Article 14 would be deleted. Subparagraph (b) of paragraph 3 of Article 5 would read as follows:

- (b) the furnishing of services by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned;

15.6 The changes to the version of this subparagraph in the 1999 United Nations Model Convention are minor, comprising (i) the deletion of the words “including consultancy services”, after the words “the furnishing of services”, on the basis that the wording was unnecessary and confusing, such services being clearly covered; (ii) the replacement of the six-month test with the 183 days test, as noted in paragraph 9 above; and (iii) the use of a semicolon rather than a period at the end of the subparagraph, with the introduction of subparagraph (c). In relation to the wording of subparagraph (b), some members of the Committee consider, however, that the words “(for the same or a connected project)” should be eliminated as no such requirement exists in Article 14.

15.7 A new subparagraph (c) of paragraph 3 would also be inserted, as follows:

- (c) for an individual, the performing of services in a Contracting State by that individual, but only if the individual's stay in that State is for a period or periods aggregating more than 183 days within any twelve-month period commencing or ending in the fiscal year concerned.

15.8 Subparagraph (c) is intended to ensure that any situation previously covered by Article 14 would now be addressed by Articles 5 and 7. The wording reflects the fact that deletion of Article 14 of the United Nations Model Convention would involve deletion of the “days of physical presence” test found in subparagraph (b) of paragraph 1 of Article 14 of that Model, which had no counterpart in the OECD Model Convention when the deletion of Article 14 was agreed for that Model.

15.9 It should be noted that subparagraph (c), in attempting to reflect the operation of the current Article 14, paragraph 1, subparagraph (b), more explicitly indicates that the subparagraph only applies to individuals. In this respect, it follows and makes clearer the interpretation found in paragraph 9 of the Commentary on Article 14, to the effect that Article 14 deals only with individuals. The Committee notes that some countries do not accept that view and should seek to clarify the issue when negotiating Article 14.

15.10 It should also be noted that the last part of Article 14, paragraph 1, subparagraph (b) has not been transposed into Article 5: (“... in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State”). The reason for this is that Article 7 provides its own attribution rules, which, in most cases, means that only the profits of an enterprise attributable to that permanent establishment (that is, the “physical presence” in subparagraph (c) of paragraph 3) may be taxed by the State where the permanent establishment exists. Where a “limited force of attraction” rule as provided in Article 7 has been adopted in bilateral treaties, other business activities of a same or similar kind as those effected through the physical presence permanent establishment may be taxed by the State where the permanent establishment exists, which can be justified as treating various forms of permanent establishment in the same way. In the event of States agreeing to a limited force of attraction rule in Article 7 and also to deletion of Article 14, but not wishing to apply the limited force of attraction rule to cases formerly dealt with by Article 14, paragraph 1, subparagraph (b), it could explicitly be provided that such a rule did not apply to subparagraph (c) of paragraph 3 cases.

Consequential changes to other Articles

15.11 In paragraph 1 of Article 3, existing subparagraphs (c) to (f) should be renumbered as subparagraphs (d) to (g) and the following new subparagraphs (c) and (h) added:

- (c) the term “enterprise” applies to the carrying on of any business;
- (h) the term “business” includes the performance of professional services and of other activities of an independent character.

15.12 The reasoning for this change is reflected in paragraphs 4 and 10.2 of the OECD Commentary on Article 3 as follows:

4. The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No exhaustive definition of the term “enterprise” has therefore been attempted in this Article. However, it is provided that the term “enterprise” applies to the carrying on of any business. Since the term “business” is expressly defined to include the performance of professional services and of other activities of an independent character, this clarifies that the performance of professional services or other activities of an independent character must be considered to constitute an enterprise, regardless of the meaning of that term under domestic law. States which consider that such clarification is unnecessary are free to omit the definition of the term “enterprise” from their bilateral conventions.

10.2 The Convention does not contain an exhaustive definition of the term “business”, which, under paragraph 2, should generally have the meaning which it has under the domestic law of the State that applies the Convention. Subparagraph *h*), however, provides expressly that the term includes the performance of professional services and of other activities of an independent character. This provision was added in 2000 at the same time as Article 14, which dealt with Independent Personal Services, was deleted from the Convention. This addition, which ensures that the term “business” includes the performance of the activities which were previously covered by Article 14, was intended to prevent that the term “business” be interpreted in a restricted way so as to exclude the performance of professional services, or other activities of an independent character, in States where the domestic law does not consider that the performance of such services or activities can constitute a business. Contracting States for which this is not the case are free to agree bilaterally to omit the definition.

15.13 Paragraph 4 of Article 6 should be amended by removing the reference to independent personal services as follows:

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise ~~and to income from immovable property used for the performance of independent personal services.~~

15.14 Paragraph 4 of Article 10 should be amended as follows:

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein ~~or performs in that other State independent personal services from a fixed base situated therein~~ and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment ~~or fixed base~~. In such case the provisions of Article 7 ~~or Article 14, as the case may be,~~ shall apply.

15.15 Paragraph 5 of Article 10 should be amended as follows:

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment ~~or a fixed base~~ situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

15.16 Paragraph 4 of Article 11 should be amended as follows:

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, ~~or performs in that other State independent personal services from a fixed base situated therein,~~ and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment ~~or fixed base~~, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 ~~or Article 14, as the case may be,~~ shall apply.

15.17 Paragraph 5 of Article 11 should be amended as follows:

5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment ~~or a fixed base~~ in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment ~~or a fixed base~~, then such interest shall be deemed to arise in the State in which the permanent establishment ~~or a fixed base~~ is situated.

15.18 Paragraph 4 of Article 12 should be amended as follows:

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, ~~or performs in that other State independent personal services from a fixed base situated therein~~, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment, ~~or a fixed base~~, or with (b) business activities referred to in (c) of paragraph 1 of Article 7. In such cases the provisions of Article 7 ~~or Article 14, as the case may be~~, shall apply.

15.19 Paragraph 5 of Article 12 should be amended as follows:

5. Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment ~~or a fixed base~~ in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment ~~or fixed base~~, then such royalties shall be deemed to arise in the State in which the permanent establishment ~~or fixed base~~ is situated.

15.20 Paragraph 2 of Article 13 should be amended as follows:

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State ~~or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services~~, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) ~~or of such fixed base~~, may be taxed in that other State.

15.21 If Article 14 is deleted, it would depend on agreement between the countries as to whether the following Articles are renumbered, but the usual practice is to renumber those Articles, or to rename an additional article as Article 14.

15.22 Countries may wish to replace the title of Article 15 as follows: “INCOME FROM EMPLOYMENT ~~DEPENDENT PERSONAL SERVICES~~”, as provided for in the 2000 and subsequent OECD Model Conventions. The basis for this change is that where Article 14 is removed it will usually represent a conscious decision to move away from the concepts of independent and dependent personal services, and an acceptance that Article 15 deals only with employment services, any other provision of services, being dealt with under Article 7 or by specific articles such as Articles 16 or 17.

15.23 Subparagraph (c), paragraph 2 of Article 15 should be amended by removing references to the fixed base concept, as follows:

- (c) the remuneration is not borne by a permanent establishment ~~or a fixed base~~ which the employer has in the other State.

15.24 The following amendments should be made to Article 17 so as to remove references to the deleted Article 14 and so as to add references to Article 7:

- (a) Modify paragraph 1 of Article 17 to read as follows:

1. Notwithstanding the provisions of Articles ~~14~~ 7 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

- (b) Modify paragraph 2 of Article 17 to read as follows:

2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles ~~7-14~~ 7 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised.

15.25 Paragraph 2 of Article 21 should be amended as follows:

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a

resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, ~~or performs in that other State independent personal services from a fixed base situated therein,~~ and the right or property in respect of which the income is paid is effectively connected with such permanent establishment ~~or fixed base~~. In such case, the provisions of Article 7 ~~or Article 14, as the case may be,~~ shall apply.

15.26 Paragraph 2 of Article 22 should be amended as follows:

2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State ~~or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services,~~ may be taxed in that other State.

Paragraph 4

16. This paragraph reproduces Article 5, paragraph 4 of the OECD Model Convention with one substantive amendment: the deletion of “delivery” in subparagraphs (a) and (b). In view of the similarities to the OECD Model Convention provision and the general relevance of its Commentary, the general principles of Article 5, paragraph 4 under both Models are first noted below and then the practical relevance of the deletion of references to “delivery” in the United Nations Model Convention is considered.

17. The deletion of the word “delivery” reflects the majority view of the Committee that a “warehouse” used for that purpose should, if the requirements of paragraph 1 are met, be a permanent establishment.

18. The OECD Commentary on paragraph 4 of the OECD Article reads as follows:

21. This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in subparagraph e), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover subparagraph f) provides that combinations of activities mentioned in subparagraphs a) to e) in the same fixed place of

business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.

22. Subparagraph *a*) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Subparagraph *b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. Subparagraph *c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph *d*) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many “tentacles” of the parent body; to exempt such a bureau is to do no more than to extend the concept of “mere purchase”.

23. Subparagraph *e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this subparagraph provides a generalised exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

24. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place

of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of subparagraph *e*). A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called “management office” in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a “place of management” within the meaning of subparagraph *a*) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph *e*) of paragraph 4.

25. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as this goes beyond the pure delivery mentioned in subparagraph *a*) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph *e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of

the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

26. Moreover, subparagraph *e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph *e*).

26.1 Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a*), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e*) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a*) would be applicable [...].

27. As already mentioned in paragraph 21 above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to subparagraph *f*) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in the subparagraphs *a*) to *e*) of paragraph 4 does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion “preparatory

or auxiliary character” is to be interpreted in the same way as is set out for the same criterion of subparagraph *e*) (see paragraphs 24 and 25 above). States which want to allow any combination of the items mentioned in subparagraphs *a*) to *e*), disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words “provided” to “character” in subparagraph *f*).

27.1 Subparagraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not “separated organisationally” where they each perform in a Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

28. The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude the contracts necessary for maintaining the institution and who exercises this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.

29. If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the

disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation (see paragraph 11 above and paragraph 2 of Article 13). Since, for example, the display of merchandise is excepted under subparagraphs *a*) and *b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

30. A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.

19. Subparagraph (*f*) was added to Article 5, paragraph 4 in 1999. It follows the OECD Model Convention and provides that “the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (*a*) to (*e*)” is not a permanent establishment if “the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character”.

20. As noted above, the United Nations Model Convention, in contrast to the OECD Model Convention, does not refer to “delivery” in subparagraphs (*a*) or (*b*). The question whether the use of facilities for the “delivery of goods” should give rise to a permanent establishment has been debated extensively. A 1997 study revealed that almost 75 per cent of the tax treaties of developing countries *included* the “delivery of goods” in the list of exceptions in subparagraphs (*a*) and (*b*) of paragraph 4. Nevertheless, some countries regard the omission of the expression in the United Nations Model Convention as an important point of departure from the OECD Model Convention, believing that a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country.

21. In reviewing the United Nations Model Convention, the Committee retains the existing distinction between the two Models, but it notes that even if the delivery of goods is treated as giving rise to a permanent establishment, it may be that little income could properly be attributed to this activity. Tax authorities might be led into attributing too much income to this activity if they do not give the issue close consideration, which would lead to prolonged litigation and inconsistent application of tax treaties. Therefore, although the reference to “delivery” is absent from the United Nations Model Convention, countries may wish to consider both points of view when entering into bilateral tax treaties, for the purpose of determining the practical results of utilizing either approach.

Paragraph 5

22. It is generally accepted that, if a person acts in a State for an enterprise in such a way as to closely tie up the activity of the enterprise with the economic life of that State, the enterprise should be treated as having a permanent establishment in that State—even if it does not have a fixed place of business in that State under paragraph 1. Paragraph 5 achieves this by deeming a permanent establishment to exist if the person is a so-called dependent agent who carries out on behalf of the enterprise an activity specified in subparagraph (a) or (b). Subparagraph (a) follows the substance of the OECD Model Convention and proceeds on the basis that if a person with the authority to conclude contracts in the name of the enterprise creates for that enterprise a sufficiently close association with a State, then it is appropriate to deem that such an enterprise has a permanent establishment there. The condition in subparagraph (b), relating to the maintenance of a stock of goods, is discussed below.

23. In relation to subparagraph (a), a dependent agent causes a “permanent establishment” to be deemed to exist only if his authority is used repeatedly and not merely in isolated cases. The OECD Commentary states further:

32.1 Also, the phrase “authority to conclude contracts in the name of the enterprise” does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.

33. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person’s activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise

this authority “in that State”, even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.

33.1 The requirement that an agent must “habitually” exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency of activity necessary to conclude that the agent is “habitually exercising” contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.

24. The Committee’s view is that where paragraph 33 of the OECD Commentary above refers to “[a] person who is authorised to negotiate all elements and details of a contract”, this should be taken to include a person who has negotiated all the essential elements of the contract, whether or not that person’s involvement in the negotiation also extends to other non-essential aspects.

25. With the addition of paragraph 5, subparagraph (b), relating to the maintenance of a stock of goods, this paragraph is broader in scope than paragraph 5 of the OECD Model Convention. Some countries believe that a narrow formula might encourage an agent who was in fact dependent to represent himself as acting on his own behalf.

26. The former Group of Experts understood that paragraph 5, subparagraph (b) was to be interpreted such that if all the sales-related activities take place outside the host State and only delivery, by an agent, takes place there,

such a situation would not lead to a permanent establishment.²⁶ The former Group of Experts noted, however, that if sales-related activities (for example, advertising or promotion) are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of such goods or merchandise, a permanent establishment may exist.²⁷

Paragraph 6

27. This paragraph of the United Nations Model Convention does not correspond to any provision in Article 5 of the OECD Model Convention and is included to deal with certain aspects of the insurance business. The OECD Model Convention nevertheless discusses the possibility of such a provision in bilateral tax treaties in the following terms:

39. According to the definition of the term “permanent establishment” an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD member countries include a provision which stipulates that insurance companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there—other than an agent who already constitutes a permanent establishment by virtue of paragraph 5—or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

28. Paragraph 6 of the United Nations Model Convention, which achieves the aim quoted above, is necessary because insurance agents generally have no authority to conclude contracts; thus, the conditions of paragraph 5, sub-

²⁶See paragraph 25 of the Commentary on Article 5 of the 1999 version of the United Nations Model Convention.

²⁷*Ibid.*

paragraph (a) would not be fulfilled. If an insurance agent is independent, however, the profits of the insurance company attributable to his activities are not taxable in the source State because the provisions of Article 5 paragraph 7 would be fulfilled and the enterprise would not be deemed to have a permanent establishment.

29. Some countries, however, favour extending the provision to allow taxation even where there is representation by such an independent agent. They take this approach because of the nature of the insurance business, the fact that the risks are situated within the country claiming tax jurisdiction, and the ease with which persons could, on a part-time basis, represent insurance companies on the basis of an “independent status”, making it difficult to distinguish between dependent and independent insurance agents. Other countries see no reason why the insurance business should be treated differently from activities such as the sale of tangible commodities. They also point to the difficulty of ascertaining the total amount of business done when the insurance is handled by several independent agents within the same country. In view of this difference in approach, the question how to treat independent agents is left to bilateral negotiations, which could take account of the methods used to sell insurance and other features of the insurance business in the countries concerned.

Paragraph 7

30. The first sentence of this paragraph reproduces Article 5, paragraph 6 of the OECD Model Convention, with a few minor drafting changes. The relevant portions of the Commentary on the OECD text are as follows:

36. Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business [...]. Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph [7] has been inserted in the Article for the sake of clarity and emphasis.

37. A *person* will come within the scope of paragraph [7], *i.e.* he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:

- a) he is independent of the enterprise both legally and economically, and
- b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents.

38.1 In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.

38.2 The following considerations should be borne in mind when determining whether an agent may be considered to be independent.

38.3 An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

38.4 Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent's authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

38.5 It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent.

Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

38.7 Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.

31. In the 1980 edition of the United Nations Model Convention,²⁸ the second sentence of paragraph 7 read: "However, when the activities of such an agent are devoted wholly or almost wholly on behalf of the enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph."

32. It was subsequently recognized that this sentence had given rise to anomalous situations. The concern was that if the number of enterprises for

²⁸United Nations Publication: ST/ESA/102: Sales No. E.80.XVI.3.

which an independent agent was working fell to one, the agent would, without further examination, be treated as dependent. In the 1999 revision of the Model, the wording was therefore amended as follows:

However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered as an agent of an independent status within the meaning of this paragraph.

33. The revised version makes clear that the essential criterion for *automatically* treating an agent as not being of “an independent status” is the absence of the arm’s-length relationship. The mere fact that the number of enterprises for which the independent agent acts has fallen to one does not of itself change his status from independent to dependent, though it might serve as an indicator of the absence of the independence of that agent.

Paragraph 8

34. The present paragraph reproduces Article 5, paragraph 7 of the OECD Model Convention. The Commentary on the OECD text is as follows:

40. It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.

41. A parent company may, however, be found, under the rules of paragraphs 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company [...] and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraphs 3 and 4 of the Article (see for instance, the example in paragraph 4.3 above). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude

contracts in the name of the parent [...], unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies.

41.1 The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal [...] and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article [...]. The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.

35. The Committee notes that determining whether or not a permanent establishment exists on a separate entity basis may entail vulnerability to abusive arrangements. Depending on the domestic law of States, safeguards against purely artificial structures may be found through application of a rule according to which substance overrides form. The Commentary of the OECD Model Convention also states the following:

42. Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a

different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

36. The Commentary of the OECD Model Convention has been amended to include the following section on “electronic commerce”:

Electronic commerce

42.1 There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

42.2 Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a “place of business” as there is no “facility such as premises or, in certain instances, machinery or equipment” (see paragraph 2 above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a “fixed place of business” of the enterprise that operates that server.

42.3 The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraph 4 above), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location.

In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5 Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, *e.g.* automatic pumping equipment used in the exploitation of natural resources.

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the

various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:

- providing a communications link—much like a telephone line— between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an “e-tailer”) that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the

customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISPs. Whilst this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a “person” as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph.

37. The Committee of Experts notes that the OECD Commentary, in paragraph 42.3, draws a distinction between a contract with an Internet Service Provider and one with a place of business at the disposal of the enterprise. In this regard, the Committee recognizes that some businesses could seek to avoid creating a permanent establishment by managing the contractual terms in cases where the circumstances would justify the conclusion that a permanent establishment exists. Such abuses may fall under the application of legislative or judicial anti-avoidance rules.

Commentary on chapter III
TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

A. GENERAL CONSIDERATIONS

1. Article 6 of the United Nations Model Convention reproduces Article 6 of the OECD Model Convention with the exception of the phrase “and to income from immovable property used for the performance of independent personal services” which appears at the end of paragraph 4 of the United Nations Model Convention. This phrase is included in the United Nations Model Convention as a result of the retention of Article 14 dealing with Independent Personal Services.

2. In taxing income from immovable property, the object should be the taxation of profits rather than of gross income; the expenses incurred in earning income from immovable [real] property or from agriculture or forestry should therefore be taken into account. This objective should not, however, preclude the use of a withholding tax on rents from immovable [real] property, based on gross income; in such cases the rate should take into account the fact that expenses have been incurred. On the other hand, if a withholding tax on gross rents is used, it will be just as satisfactory if the owner of the immovable [real] property can elect to have the income from the property taxed on a net basis under the regular income tax. Article 6 is not intended to prevent a country which taxes income from agriculture or other immovable property on an estimated or similar basis from continuing to use that method.

3. Some members of the former Group of Experts were of the view that the distribution of dividends by a company referred to in Article 13, paragraph 4, should be treated as income from immovable property and, therefore, as covered by Article 6. However, this view was not shared by most other members.

4. It was noted that in some countries, a person may receive income (typically rental income) from immovable property in circumstances where that person instead of directly owning the immovable property owns shares of a company owning that property and that the ownership of those shares

entitles that person to the use or enjoyment of the property. Contracting States are free to expand the scope of the Article to cover the deemed income from that use or enjoyment. They may also expand the scope of Article 22 to allow source taxation of shares of such companies.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 6

Paragraph 1

5. This paragraph grants the right to tax income from immovable property (including income from agriculture or forestry) to the State of source, that is, the State where the property in question is situated. In the words of the Commentary on the OECD Model Convention, this provision is based on “the fact that there is always a very close economic connection between the source of this income and the State of source”.²⁹

6. The OECD Commentary observes:

1. [...] Although income from agriculture or forestry is included in Article 6, Contracting States are free to agree in their bilateral conventions to treat such income under Article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such income.

Paragraph 2

7. This paragraph, which gives the term “immovable property” the meaning that it has under the law of the Contracting State in which the property is situated, is intended to alleviate difficulties of interpretation with regard to whether an asset or a right is to be regarded as immovable property. In addition the paragraph lists a number of assets and rights which are in any case to be regarded as covered by the term. On the other hand, the paragraph provides that ships, boats and aircraft shall not be regarded as immovable property. Interest from debt secured by immovable property is not covered by Article 6, but is a matter which is instead dealt with under Article 11 relating to interest.

²⁹Paragraph 1 of the OECD Commentary on Article 6.

Paragraph 3

8. This paragraph provides that the general rule set forth in paragraph 1 shall apply regardless of the form in which immovable property is used.

Paragraph 4

9. This paragraph stipulates that the provisions of paragraphs 1 and 3 apply also to income from immovable property, of industrial, commercial and other enterprises and to income from immovable property used for the performance of independent personal services. The OECD Commentary also observes that:

4. [...] the right to tax of the State of source has priority over the right to tax of the other State and applies also where in the case of an enterprise income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the Article do not prejudice the application of domestic law as regards the manner in which income from immovable property is to be taxed.

These observations apply equally in the case of non-industrial and non-commercial activities by reason of the inclusion in paragraph 4 of the United Nations Model Convention on income from immovable property used for the performance of independent personal services.

Article 7

BUSINESS PROFITS

A. GENERAL CONSIDERATIONS

1. Article 7 of the United Nations Model Convention consists of several provisions of Article 7 of the 2008 OECD Model Convention, either unchanged or substantially amended, and some new provisions. The Committee of Experts decided at its 2009 annual session not to adopt the OECD approach to Article 7 arising from the OECD's 2008 report

Attribution of Profits to Permanent Establishments³⁰ (the 2008 Permanent Establishments Report). The 2008 Permanent Establishments Report envisions taking into account dealings between different parts of an enterprise such as a permanent establishment and its head office to a greater extent than is recognized by the United Nations Model Convention. That approach by the OECD is now reflected in the new Article 7 in the 2010 OECD Model Convention and the Commentary on that Article. The Committee of Experts decided not to adopt this OECD approach because it was in direct conflict with paragraph 3 of Article 7 of the United Nations Model Convention which generally disallows deductions for amounts “paid” (other than toward reimbursement of actual expenses) by a permanent establishment to its head office. That rule is seen as continuing to be appropriate in the context of the United Nations Model Convention, whatever changes have been made to the OECD Model Convention and Commentaries. It should therefore be noted that all subsequent references to Article 7 of the OECD Model Convention and its Commentary relate to the 2008 OECD Model Convention. Article 7 in the United Nations Model Convention and the 2008 OECD Model Convention are largely consistent (except for the specific United Nations additions). Aspects of the 2008 OECD Commentary in places reflect views contained in the 2008 Permanent Establishments Report. Where the 2008 OECD Commentary reflects the approach of that Report, reference is instead made to the 2005 OECD Model Convention which is not affected in this way.

2. There is general acceptance of the arm’s length principle embodied in the OECD Model Convention, under which the profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market. The profits so attributable are normally the profits shown on the books of the establishment. Nevertheless, this principle permits the authorities of the country in which the permanent establishment is located to rectify the accounts of the enterprise, so as to reflect properly income which the establishment would have earned if it were an independent enterprise dealing with its head office at arm’s length. The application of the arm’s length principle to the allocation of profits between the home office and its permanent establishment presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm’s length principle.

3. The application of the arm’s length principle is particularly important in connection with the difficult and complex problem of deductions to be

³⁰Report on the Attribution of Profits to Permanent Establishments, 2008. Available at <http://www.oecd.org/dataoecd/20/36/41031455.pdf>.

allowed to the permanent establishment. It is also generally accepted that in calculating the profits of a permanent establishment, allowance should be made for expenses, wherever incurred, for the purpose of the business of the permanent establishment, including executive and general administrative expenses. Apart from what may be regarded as ordinary expenses, there are some classes of expenditure that give rise to special problems. These include interest and royalties etc. paid by the permanent establishment to its head office in return for money lent or patent rights licensed by the latter to the permanent establishment. They further include commission fees (except for reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the establishment. In this case, it is considered that the payments should not be allowed as deductions in computing the profits of the permanent establishment. Conversely, such payments made to a permanent establishment by the head office should be excluded from the profits of the permanent establishment. On the other hand, an allocable share of such payments, e.g., interest and royalties, paid by the enterprise to third parties should be allowed. As noted in paragraph 1 above, this approach is consistent with the approach adopted in interpreting Article 7 in the 2008 OECD Model Convention but it varies from the approach adopted by the OECD in its 2008 Permanent Establishments Report.

4. Under the OECD Model Convention, only profits attributable to the permanent establishment may be taxed in the source country. The United Nations Model Convention amplifies this attribution principle by a limited force of attraction rule, which permits the enterprise, once it carries out business through a permanent establishment in the source country, to be taxed on some business profits in that country arising from transactions by the enterprise in the source country, but not through the permanent establishment. Where, owing to the force of attraction principle, the profits of an enterprise other than those attributable directly to the permanent establishment may be taxed in the State where the permanent establishment is situated, such profits should be determined in the same way as if they were attributable directly to the permanent establishment.

5. The United Nations Model Convention does not contain paragraph 5 of Article 7 of the 2008³¹ OECD Model Convention, which states, “No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise”. When drafting the 1980 United Nations Model Convention the former Group of Experts could not reach a consensus on whether profits should be

³¹Paragraph 5 of Article 7 of the OECD Model Convention was deleted as part of the 2010 update of the OECD Model Convention.

attributed to a permanent establishment by reason of the mere purchase of goods and therefore decided to include in Article 7 a note stating that this question should be settled in bilateral negotiations. When this issue was considered by the former Group of Experts, several members from developing countries believed that this provision could be included if it were amended to include a statement that in the case of a permanent establishment engaged in purchasing and other activities, profits derived from purchasing activities should be attributed to the permanent establishment. Other members from developing countries felt that the provision should be omitted because, even where purchasing is the sole activity of an enterprise in the source country, a permanent establishment could exist in that country, the purchasing activity may contribute to the overall profit of the enterprise, and some portion of that profit thus may appropriately be taxed by that country. The members from developed countries generally favoured inclusion of paragraph 5 of Article 7 of the OECD Model Convention, without amendment.³²

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 7

Paragraph 1

6. This paragraph reproduces Article 7, paragraph 1, of the 2008 OECD Model Convention, with the addition of clauses (b) and (c). In the discussion preceding the adoption by the former Group of Experts of this paragraph, several members from developing countries expressed support for the force of attraction rule, although they would limit its application. Clauses (b) and (c) mean that the United Nations Model Convention amplifies the corresponding Article in the OECD Model Convention by including a limited force of attraction rule. This allows the country in which the permanent establishment is located to tax not only the profits attributable to that permanent establishment but other profits of the enterprise derived in that country to the extent allowed under the Article. It is noted that the force of attraction rule is limited to business profits covered by Article 7 and does not extend to income from capital (dividends, interest and royalties) covered by other treaty provisions. Those in favour of such a rule argue that neither sales through independent commission agents nor purchasing activities would become taxable to the principal under that rule. Some members from developed countries pointed out that the force of attraction rule had been found unsatisfactory and abandoned in recent tax treaties concluded by them because of the undesirability of taxing income from an activity that was totally unrelated to the establishment and that was in itself not extensive

³²The wording favoured by those members was identical to that found in paragraph 5 of the 2008 OECD Model Convention.

enough to constitute a permanent establishment. They also stressed the uncertainty that such an approach would create for taxpayers. Members from developing countries pointed out that the force of attraction approach avoids some administrative problems because, under that approach, it is not necessary to determine whether particular activities are related to the permanent establishment or the income involved attributable to it. That was the case especially with respect to transactions conducted directly by the home office within the country that are similar in nature to those conducted by the permanent establishment. However, after discussion, it was proposed that the “force of attraction” rule in Article 7 should be limited to that last situation so that it would apply to sales of goods or merchandise and other business activities in the following manner: If an enterprise has a permanent establishment in the other Contracting State for the purpose of selling goods or merchandise, sales of the same or a similar kind may be taxed in that State even if they are not conducted through the permanent establishment; a similar rule applies if the permanent establishment is used for other business activities and the same or similar activities are performed without any connection with the permanent establishment.

7. When the United Nations Model Convention was revised in 1999, however some members considered that this limited force of attraction rule should not apply where an enterprise is able to demonstrate that the sales or business activities were carried out for reasons other than obtaining treaty benefits. This recognizes that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment.

8. The Committee considers that the following part of the Commentary on paragraph 1 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7:

11. When referring to the part of the profits of an enterprise that is attributable to a permanent establishment, the second sentence of paragraph 1 refers directly to paragraph 2, which provides the directive for determining what profits should be attributed to a permanent establishment. As paragraph 2 is part of the context in which the sentence must be read, that sentence should not be interpreted in a way that could contradict paragraph 2, *e.g.* by interpreting it as restricting the amount of profits that can be attributed to a permanent establishment to the amount of profits of the enterprise as a whole. Thus, whilst paragraph 1 provides that a Contracting State may only tax the profits of an enterprise of the other Contracting State to the extent that they are attributable to a permanent establishment situated in the first State, it is paragraph 2 that determines the meaning of the

phrase “profits attributable to a permanent establishment”. In other words, the directive of paragraph 2 may result in profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits: conversely, that directive may result in no profits being attributed to a permanent establishment even though the enterprise as a whole has made profits.

12. Clearly however, the Contracting State of the enterprise has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with Article 23, eliminate double taxation on the profits properly attributable to the permanent establishment. In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise.

13. The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises [that are residents] of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents’ participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10).

Some countries disagree with the approach taken in the second sentence of paragraph 13 of the OECD Commentary which states that paragraph 1 of Article 7 does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law.

Paragraph 2

9. This paragraph reproduces Article 7, paragraph 2, of the OECD Model Convention. When last considered by the former Group of Experts a member from a developed country pointed out that his country was having some problems with inconsistent determination of the profits properly attributable to a permanent establishment, especially with regard to “turn-key” contracts. Under a turnkey contract a contractor agrees to construct a

factory or similar facility and make it ready for operation; when the facility is ready for operation, it is handed over to the purchaser, who can then begin operations. The international tax problems occur when the facility is to be constructed in one country by a contractor resident in another country. The actual construction activities carried on in one country clearly constitute a permanent establishment within that country if of sufficiently long duration. Turnkey contracts, however, often involve components other than normal construction activities, including the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, are sometimes completed before construction activities actually start (and hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment is situated.

10. The question thus arose how much of the total profits of the turnkey contract is properly attributable to the permanent establishment and taxable in the country in which it is situated. A member from a developed country said that he knew of instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was his view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits included items of income dealt with separately in other articles of the Convention and were taxable in that country accordingly.

11. The Group recognized that the problem was a complex and potentially controversial one involving many interrelated issues, such as source of income rules and the definition of permanent establishment and the concept of profits of an enterprise. The Group acknowledged that the problem might be considered in the course of bilateral negotiations, but it agreed upon no amendment to address it.

12. When the United Nations Model Convention was revised in 1999, some members of the former Group of Experts were of the view that the last part of paragraph 2 was too narrow, as they considered that it refers only to transactions between the permanent establishment and the home office, and does not take into account transactions between the permanent establishment and, for example, other permanent establishments of the same enterprise. For this purpose, Contracting States may consider the alternative clarification:

There shall in each Contracting State be attributed to that permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions.

13. Although the point in controversy relating to the allocation of profits between different permanent establishments as opposed to allocation between a permanent establishment and its head office was not in doubt, it was generally accepted that the concern of the former Group of Experts should be clearly noted.

14. As observed in paragraph 14 of the Commentary on Article 7 of the 2008 OECD Model Convention, paragraph 2 as presently worded: “contains the central directive on which the allocation of profits to a permanent establishment is intended to be based.” As stated in the Article, this is of course subject to the provisions of paragraph 3 of the Article. Paragraph 14 of the OECD Commentary continues:

The paragraph incorporates the view that was generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with the rest of the enterprise, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the “arm’s length” principle discussed in the Commentary on Article 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of business accountancy.

Since the arm’s length principle also extends to the attribution of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise, the existing paragraph 2 should be construed to make it applicable to such situations. Therefore, where an enterprise of a Contracting State carries on its business activities in the other Contracting State through a permanent establishment situated therein, it would be necessary to attribute to such permanent establishment the profits which it could be in a position to make if it were a distinct enterprise engaged in the same or similar activities under the same or similar conditions and operating at arm’s length, and dealing wholly independently with the enterprise of which it is a permanent establishment or the other permanent establishments of that enterprise.

15. The determination of the profits attributable to a specific permanent establishment is an instance where the Commentary in the 2008 OECD Model Convention refers to the 2008 Permanent Establishments Report. Given the comments in paragraph 1 above the Committee considers that the following part of the Commentary on paragraph 2 of Article 7 of the 2005 OECD Model Convention is applicable to paragraph 2 of Article 7 of the United Nations Model Convention:

12. In the great majority of cases, trading accounts of the permanent establishment—which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches—will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts [...]. But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures *in vacuo*; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce.

12.1 This raises the question as to what extent such accounts should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. In that respect, accounts could not be regarded as prepared symmetrically unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. However, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. This would be the case if, for example, a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal.

12.2 In this respect, it should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment [...].

13. Even where a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with the arm's length principle [...]. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this principle, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.

14. In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting from the figure so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then

new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market.

15. Many States consider that there is a realisation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are realised. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the realisation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of realisation depends on each country's domestic law.

15.1 Where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually realised until a subsequent commercial year, there will be inevitably a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. A serious problem is inherent in the time lag, especially when a permanent establishment transfers fixed assets or—in the event that it is wound up—its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases, it is up to the head office country to seek, on a case by case basis, a bilateral solution with the outward country where there is serious risk of overtaxation.

15.2 Another significant problem concerning the transfer of assets, such as bad loans, arises in relation to international banking. Debts may be transferred, for supervisory and financing purposes, from branch to head office or from branch to branch within a single bank. Such transfers should not be recognised where it cannot be reasonably considered that they take place for valid commercial reasons or that

they would have taken place between independent enterprises, for instance where they are undertaken solely for tax purposes with the aim of maximising the tax relief available to the bank. In such cases, the transfers would not have been expected to take place between wholly independent enterprises and therefore would not have affected the amount of profits which such an independent enterprise might have been expected to make in independent dealing with the enterprise of which it is a permanent establishment.

15.3 However, there may exist a commercial market for the transfer of such loans from one bank to another and the circumstances of an internal transfer may be similar to those which might have been expected to have taken place between independent banks. An instance of such a transfer might be a case where a bank closed down a particular foreign branch and had therefore to transfer the debts concerned either back to its head office or to another branch. Another example might be the opening of a new branch in a given country and the subsequent transfer to it, solely for commercial reasons, of all loans previously granted to residents of that country by the head office or other branches. Any such transfer should be treated (to the extent that it is recognised for tax purposes at all) as taking place at the open market value of the debt at the date of the transfer. Some relief has to be taken into account in computing the profits of the permanent establishment since, between separate entities, the value of the debt at the date of transfer would have been taken into account in deciding on the price to be charged and principles of sound accounting require that the book value of the asset should be varied to take into account market values.

15.4 Where loans which have gone bad are transferred, in order that full, but not excessive, relief for such a loss be granted, it is important that the two jurisdictions concerned reach an agreement for a mutually consistent basis for granting relief. In such cases, account should be taken of whether the transfer value, at the date of the internal transfer, was the result of mistaken judgment as to the debtor's solvency or whether the value at that date reflected an appropriate judgment of the debtor's position at that time. In the former case, it might be appropriate for the country of the transferring branch to limit relief to the actual loss suffered by the bank as a whole and for the receiving country not to tax the subsequent apparent gain. Where, however, the loan was transferred for commercial reasons from one part of the bank to another and did, after a certain time, improve in value, then the transferring branch should normally be given relief on

the basis of the actual value at the time of the transfer. The position is somewhat different where the receiving entity is the head office of a bank in a credit country because normally the credit country will tax the bank on its worldwide profits and will therefore give relief by reference to the total loss suffered in respect of the loan between the time the loan was made and the time it was finally disposed of. In such a case, the transferring branch should receive relief for the period during which the loan was in the hands of that branch by reference to the principles above. The country of the head office will then give relief from double taxation by granting a credit for the tax borne by the branch in the host country.

Paragraph 3

16. The first sentence of paragraph 3 of Article 7 reproduces with minor drafting differences the entire text of Article 7, paragraph 3, of the 2008 OECD Model Convention. The rest of the paragraph consists of additional provisions formulated by the former Group of Experts in 1980. These provisions stem from a proposal by members from developing countries, who felt that it would be helpful to include all the necessary definitions and clarifications in the text, with a view, in particular, to assisting developing countries not represented in the Group. Some of those members also felt that provisions prohibiting the deduction of certain expenses should be included in the text of a bilateral tax treaty to make it clear that taxpayers were fully informed about their fiscal obligations. In the course of the discussion it was pointed out that the additions to the OECD text would ensure that the permanent establishment would be able to deduct interest, royalties and other expenses incurred by the head office on behalf of the establishment. The Group agreed that if billings by the head office included the full costs, both direct and indirect, then there should not be a further allocation of the executive and administrative expenses of the head office, since that would produce a duplication of such charges on the transfer between the head office and the permanent establishment. It was pointed out that it was important to determine how the price was fixed and what elements of cost it included. Where an international wholesale price was used, it would normally include indirect costs. There was general agreement within the Group that any duplication of costs and expenses should be prevented.

17. The business profits of an enterprise of a Contracting State are exigible to tax in that State alone unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. The profits and gains of the business would be worked out by deducting all

expenses related to the business activity, other than capital expenditures which are currently not deductible or expenses of a personal or non-business nature which cannot be attributed to the business of the enterprise. Normally, many countries while considering the question of deductibility of business expenses apply the criteria of such expenditure being wholly, exclusively and necessarily for the purposes of the business. The basic objective in this regard is to ensure that the expenditure claimed as a deduction in determining the taxable profits is relevant, referable and necessary for carrying out the business operations. There has to exist a nexus between the expenditure and the business activity so that the expenditure incurred is justified by business expediency, necessity or efficiency. After it has been determined that an item is deductible under the foregoing criteria, then it should be considered whether there are specific legislative provisions placing a monetary or other ceiling on the deduction of business expenditure, otherwise a claim for deductibility of expenditure will have to be considered in its entirety, without considering the reasonableness of the amount or its impact on the profitability of business operations.

18. The Committee considers that the following part of the Commentary on paragraph 3 of Article 7 of the 2008 OECD Model Convention is applicable to the first part of the corresponding paragraph of Article 7 of the United Nations Model Convention:

27. This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

28. It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2

required that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise, whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element.

29. In fact, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made.

30. Also, paragraph 3 only determines which expenses should be attributed to the permanent establishment for purposes of determining the profits attributable to that permanent establishment. It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the rules of Article 24 on Non-discrimination (in particular, paragraphs 3 and 4 of that Article).

Despite the above comments, the Committee of Experts notes that some countries may wish to point out in the treaty text that they allow only those deductions that are permitted by their domestic laws.

31. In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate and independent enterprise principles of paragraph 2. Whilst in general independent enterprises in their dealings with each other will seek to realise a profit

and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these particular circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprises principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of its business, would have charged to a third party at an arm's length price, *i.e.* by normally including in the sale price an appropriate profit.

32. On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to realise a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationalise the overall costs of the enterprise or to increase in a general way its sales.

33. Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph 2 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. But there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material *e.g.* in the case of machinery, the depreciation costs that relate to its use by each of these parts. It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment (subparagraph 4 d) of Article 5) so that no question of attribution of profits arises in such circumstances.

34. In the case of intangible rights, the rules concerning the relations between enterprises of the same group (*e.g.* payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate “ownership” of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate between the various parts of the enterprise the actual costs of the creation or acquisition of such intangible rights as well as the costs subsequently incurred with respect to these intangible rights, without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (*e.g.* the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate, to a compensatory charge.

35. The area of services is the one in which difficulties may arise in determining whether in a particular case a service should be charged between the various parts of a single enterprise at its actual cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. The trade of the enterprise, or part of it, may consist of the provision of such services and there may be a standard charge for their provision. In such a case it will usually be appropriate to charge a service at the same rate as is charged to the outside customer.

36. Where the main activity of a permanent establishment is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise, the host country may require that a profit margin be included in the amount of the costs. As far as possible, the host country should then try to avoid schematic solutions and rely on the value of these services in the given circumstances of each case.

37. However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise.

38. The treatment of services performed in the course of the general management of an enterprise raises the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skillful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company had been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some notional figure for "profits of management". In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management.

39. It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in

the Article is designed to prevent this. Nevertheless; it follows from what is said in paragraph 38 above that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office.

40. It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated.

41. The treatment of interest charges raises particular issues. First, there might be amounts which, under the name of interest, are charged by a head office to its permanent establishment with respect to internal “loans” by the former to the latter. Except for financial enterprises such as banks, it is generally agreed that such internal “interest” need not be recognised. This is because:

- From the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is really a formal act incompatible with the true legal nature of a permanent establishment.
- From the economic standpoint, internal debts and receivables may prove to be non-existent, since if an enterprise is solely or predominantly equity funded it ought not to be allowed to deduct interest charges that it has manifestly not had to pay. Whilst, admittedly, symmetrical charges and returns will not distort the enterprise’s overall profits, partial results may well be arbitrarily changed.

42. For these reasons, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special situation of banks, as mentioned below.

43. A different issue, however, is that of the deduction of interest on debts actually incurred by the enterprise. Such debts may relate in whole or in part to the activities of the permanent establishment; indeed, loans contracted by an enterprise will serve either the head office, the permanent establishment or both. The question that arises

in relation to these debts is how to determine the part of the interest that should be deducted in computing the profits attributable to the permanent establishment.

44. The approach suggested [...] before 1994, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustment may need to be made to reflect economic reality, in particular the fact that an independent enterprise would normally be expected to have a certain level of “free” capital.

Consequently, the Committee of Experts considers it preferable to look for a practical solution. This would take into account a capital structure appropriate to both the organization and the functions performed taking into account the need to recognize that a distinct, separate and independent enterprise should be expected to have adequate funding.

Paragraph 4

19. This paragraph reproduces Article 7, paragraph 4, of the 2008 OECD Model Convention. The Committee considers that the following part of the Commentary on paragraph 4 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7 of the United Nations Model Convention:

52. It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm’s length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained

from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the Article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear.

54. The essential character of a method [for apportioning] total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits [...]. [T]he criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say *in vacuo* that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high-cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. [...] [T]he general aim of any method [for

apportioning] total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result.

55. The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws.

Paragraph 5

20. This paragraph reproduces Article 7, paragraph 6, of the 2008 OECD Model Convention. The Committee considers that the following part of the Commentary on paragraph 6 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7 of the United Nations Model Convention:

58. This paragraph is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favourable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment.

Paragraph 6

21. This paragraph reproduces Article 7, paragraph 7, of the 2008 OECD Model Convention. The Committee considers that the following part

of the Commentary on paragraph 7 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7 of the United Nations Model Convention:

59. Although it has not been found necessary in the Convention to define the term “profits”, it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD member countries.

60. This interpretation of the term “profits”, however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, *e.g.* dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

61. To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noted that some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph [4] of Article 12 and paragraph 2 of Article 21).

62. It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of this Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this Article will be applicable to business profits which do not belong to categories of income covered by the special Articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph [4] of Article 12 and paragraph 2 of Article 21, fall within this Article [...]. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as business profits, in conformity with the tax laws of the Contracting States.

63. It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term “profits” with a view to clarifying the distinction between this term and *e.g.* the concept of dividends. It may in particular be found appropriate to do so

where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term “profits” includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits.

22. It is important to note that in the United Nations Model Convention, payments “for the use of, or the right to use, industrial, commercial or scientific equipment” are treated differently than under the OECD Model Convention. They remain within the definition of “royalties” in paragraph 3 of Article 12 and accordingly by reason of paragraph 6 of Article 7 continue to fall under the provisions of Article 12, rather than those of Article 7.

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

A. GENERAL CONSIDERATIONS

1. Two alternative versions are given for Article 8 of the United Nations Model Convention, namely Article 8 (alternative A) and Article 8 (alternative B). Article 8 (alternative A) reproduces Article 8 of the OECD Model Convention. Article 8 (alternative B) introduces substantive changes to Article 8 (alternative A), dealing separately with profits from the operation of aircraft and profits from the operation of ships in paragraphs 1 and 2, respectively. The remaining paragraphs (3, 4 and 5) reproduce paragraphs 2, 3 and 4 of Article 8 (alternative A) with a minor adjustment in paragraph 5.

2. With regard to the taxation of profits from the operation of ships in international traffic, many countries support the position taken in Article 8 (alternative A). In their view, shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend; taxation at the place of effective management was also preferable from the viewpoint of the various tax administrations. They argued that if every country taxed a portion of the profits of a shipping line, computed according to its own rules, the sum of those portions might well exceed the total income of

the enterprise. Consequently, that would constitute a serious problem, especially because taxes in developing countries could be excessively high, and the total profits of shipping enterprises were frequently quite modest.

3. Other countries asserted that they were not in a position to forgo even the limited revenue to be derived from taxing foreign shipping enterprises as long as their own shipping industries were not more fully developed. They recognized, however, that considerable difficulties were involved in determining a taxable profit in such a situation and allocating the profit to the various countries concerned in the course of the operation of ships in international traffic.

4. Since no consensus could be reached on a provision concerning the taxation of shipping profits, the use of two alternatives in the Model Convention is proposed and the question of such taxation should be left to bilateral negotiations.

5. Although the texts of Article 8 (alternatives A and B) both refer to the “place of effective management of the enterprise”, some countries may wish to refer instead to the “State of residence of the enterprise”.

6. Although there was a consensus to recommend Articles 8 (alternatives A and B) as alternatives, some countries who could not agree to Article 8 (alternative A) also could not agree to Article 8 (alternative B) because of the phrase “more than casual”. They argued that some countries might wish to tax either all shipping profits or all airline profits, and acceptance of Article 8 (alternative B) might thus lead to a revenue loss, considering the limited number of shipping companies or airlines whose effective management was situated in those countries. Again, in such cases taxation should be left to bilateral negotiations.

7. Depending on the frequency or volume of cross-border traffic, countries may, during bilateral negotiations, wish to extend the provisions of Article 8 to cover rail or road transport.

8. Some countries consider that the activity of transport carried out in inland waters, by definition, cannot be considered international transport and, by virtue of that, the fiscal or tax power should be attributed exclusively to the source country in which the activities are carried out. Since Article 8 deals with “Shipping, inland waterways transport and air transport”, obviously all three modes of transport dealt with in this Article involve problems of double taxation. Income derived from inland waterways transport is also subject to double taxation if a river or lake used for commercial

transportation flows from more than one country with the headquarters of the establishment in one country and traffic originating in more than one country. Hence, it is possible that inland waterways transport would give rise to problems of double taxation.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 8
(ALTERNATIVES A AND B)

Paragraph 1 of Article 8 (alternative A)

9. This paragraph, which reproduces Article 8, paragraph 1, of the OECD Model Convention, has the objective of ensuring that profits from the operation of ships or aircraft in international traffic will be taxed in one State alone. The paragraph's effect is that these profits are wholly exempt from tax at source and are taxed exclusively in the State in which the place of effective management of the enterprise engaged in international traffic is situated. It provides an independent operative rule for these activities and is not qualified by Articles 5 and 7 relating to business profits governed by the permanent establishment rule. The exemption from tax in the source country is predicated largely on the premise that the income of these enterprises is earned on the high seas, that exposure to the tax laws of numerous countries is likely to result in double taxation or at best in difficult allocation problems, and that exemption in places other than the home country ensures that the enterprises will not be taxed in foreign countries if their overall operations turn out to be unprofitable. Considerations relating to international air traffic are similar. Since a number of countries with water boundaries do not have resident shipping companies but do have ports used to a significant extent by ships from other countries, they have traditionally disagreed with the principle of such an exemption of shipping profits and would argue in favour of alternative B.

10. The Commentary on the OECD Model Convention notes that the place of effective management may be situated in a country different from the country of residence of an enterprise operating ships or aircraft and that "[...] some States therefore prefer to confer the exclusive taxing right on the State of residence". The Commentary suggests that States may, in bilateral negotiations, substitute a rule on the following lines: "Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State." The Commentary continues:

3. Some other States, on the other hand, prefer to use a combination of the residence criterion and the place of effective management

criterion by giving the primary right to tax to the State in which the place of effective management is situated while the State of residence eliminates double taxation in accordance with Article 23, so long as the former State is able to tax the total profits of the enterprise, and by giving the primary right to tax to the State of residence when the State of effective management is not able to tax total profits. States wishing to follow that principle are free to substitute a rule on the following lines:

Profits of an enterprise of a Contracting State from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the other Contracting State, shall be taxable only in the first-mentioned State. However, where the place of effective management of the enterprise is situated in the other State and that other State imposes tax on the whole of the profits of the enterprise from the operation of ships or aircraft, the profits from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the first-mentioned State, may be taxed in that other State.

4. The profits covered consist in the first place of the profits obtained by the enterprise from the carriage of passengers or cargo. With this definition, however, the provision would be unduly restrictive, in view of the development of shipping and air transport, and for practical considerations also. The provision therefore covers other classes of profits as well, i.e. those which by reason of their nature or their close relationship with the profits directly obtained from transport may all be placed in a single category. Some of these classes of profits are mentioned in the following paragraphs [quoted paragraph 4 is taken from the Commentary on Article 8 as it read in the 2003 version of the OECD Model Convention].

11. Applying the principles set out above, the Commentary on the 2003 OECD Model Convention deals with a number of activities in relation to the extent to which paragraph 1 will apply when those activities are carried on by an enterprise engaged in the operation of ships or aircraft in international traffic. The Commentary notes as follows:

5. Profits obtained by leasing a ship or aircraft on charter fully equipped, manned and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. However, Article [12], and not Article 8, applies to profits from leasing a ship or aircraft on a bare boat charter basis

except when it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft.

6. The principle that the taxing right should be left to one Contracting State alone makes it unnecessary to devise detailed rules, e.g. for defining the profits covered, this being rather a question of applying general principles of interpretation.

7. Shipping and air transport enterprises—particularly the latter—often engage in additional activities more or less closely connected with the direct operation of ships and aircraft. Although it would be out of the question to list here all the auxiliary activities which could properly be brought under the provision, nevertheless a few examples may usefully be given.

8. The provision applies, *inter alia*, to the following activities:

- a) the sale of passage tickets on behalf of other enterprises;
- b) the operation of a bus service connecting a town with its airport;
- c) advertising and commercial propaganda;
- d) transportation of goods by truck connecting a depot with a port or airport.

9. If an enterprise engaged in international transport undertakes to see to it that, in connection with such transport, goods are delivered directly to the consignee in the other Contracting State, such inland transportation is considered to fall within the scope of the international operation of ships or aircraft and, therefore, is covered by the provisions of this Article.

10. Recently, “containerisation” has come to play an increasing role in the field of international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers which is supplementary or incidental to its international operation of ships or aircraft fall within the scope of this Article.

11. On the other hand, the provision does not cover a clearly separate activity such as the keeping of a hotel as a separate business; the profits from such an establishment are in any case easily determinable. In certain cases, however, circumstances are such that the provision must apply even to a hotel business e.g. the keeping of a hotel for no other purpose than to provide transit passengers with night accommodation, the cost of such a service being included in the price of the passage ticket. In such a case, the hotel can be regarded as a kind of waiting room.

12. There is another activity which is excluded from the field of application of the provision, namely a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.

13. It may be agreed bilaterally that profits from the operation of a vessel engaged in fishing, dredging or hauling activities on the high seas be treated as income falling under this Article.

14. Investment income of shipping, inland waterways or air transport enterprises (e.g. income from stocks, bonds, shares or loans) is to be subjected to the treatment ordinarily applied to this class of income [...].

Paragraph 1 of Article 8 (alternative B)

12. This paragraph reproduces Article 8, paragraph 1, of the OECD Model Convention, with the deletion of the words “ships or”. Thus the paragraph does not apply to the taxation of profits from the operation of ships in international traffic but does apply to the taxation of profits from the operation of aircraft in international traffic. Hence the Commentary on paragraph 1 of Article 8 (alternative A) is relevant in so far as aircraft are concerned.

Paragraph 2 of Article 8 (alternative B)

13. This paragraph allows profits from the operation of ships in international traffic to be taxed in the source country if operations in that country are “more than casual”. It also provides an independent operative rule for the shipping business and is not qualified by Articles 5 and 7 relating to business profits governed by the permanent establishment rule. It covers both regular or frequent shipping visits and irregular or isolated visits, provided the latter were planned and not merely fortuitous. The phrase “more than casual” means a scheduled or planned visit of a ship to a particular country to pick up freight or passengers.

14. The overall net profits should, in general, be determined by the authorities of the country in which the place of effective management of the enterprise is situated (or country of residence). The final conditions of the determination might be decided in bilateral negotiations. In the course of such negotiations, it might be specified, for example, whether the net profits are to be determined before the deduction of special allowances or incentives which could not be assimilated to depreciation allowances but could be considered rather as subsidies to the enterprise. It might also be specified in the

course of the bilateral negotiations that direct subsidies paid to the enterprise by a Government should be included in net profits. The method for the recognition of any losses incurred during prior years, for the purpose of the determination of net profits, might also be worked out in the negotiations. In order to implement that approach, the country of residence would furnish a certificate indicating the net shipping profits of the enterprise and the amounts of any special items, including prior-year losses, which in accordance with the decisions reached in the negotiations were to be included in, or excluded from, the determination of the net profits to be apportioned or otherwise specially treated in that determination. The allocation of profits to be taxed might be based on some proportional factor specified in the bilateral negotiations, preferably the factor of outgoing freight receipts (determined on a uniform basis with or without the deduction of commissions). The percentage reduction in the tax computed on the basis of the allocated profits is intended to achieve a sharing of revenues that would reflect the managerial and capital inputs originating in the country of residence.

*Paragraph 2 of Article 8 (alternative A) and
paragraph 3 of Article 8 (alternative B)*

15. Each of these paragraphs reproduces Article 8, paragraph 2, of the OECD Model Convention. The paragraphs apply not only to inland waterways transport between two or more countries but also to inland waterways transport effected by an enterprise of one country between two points in another country. Countries are free to settle any specific tax problem which may occur with regard to inland waterways transport, particularly between adjacent countries, through bilateral negotiations.

16. The rules set out in paragraphs 8 to 10 above relating to taxing rights and profits covered apply equally to this paragraph.

Enterprises not exclusively engaged in shipping, inland waterways transport and air transport.

17. With regard to enterprises not exclusively engaged in shipping, inland waterways transport or air transport, the Commentary on Article 8, paragraph 2, of the OECD Model Convention observes:

18. It follows from the wording of paragraphs 1 and 2 that enterprises not exclusively engaged in shipping, inland waterways transport or air transport nevertheless come within the provisions of these paragraphs as regards profits arising to them from the operation of ships, boats or aircraft belonging to them.

19. If such an enterprise has in a foreign country permanent establishments exclusively concerned with the operation of its ships or aircraft, there is no reason to treat such establishments differently from the permanent establishments of enterprises engaged exclusively in shipping, inland waterways transport or air transport.

20. Nor does any difficulty arise in applying the provisions of paragraphs 1 and 2 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping, inland waterways transport or air transport. If its goods are carried in its own ships to a permanent establishment belonging to it in a foreign country, it is right to say that none of the profit obtained by the enterprise through acting as its own carrier can properly be taxed in the State where the permanent establishment is situated. The same must be true even if the permanent establishment maintains installations for operating the ships or aircraft (*e.g.* consignment wharves) or incurs other costs in connection with the carriage of the enterprise's goods (*e.g.* staff costs). In this case, even though certain functions related to the operation of ships and aircraft in international traffic may be performed by the permanent establishment, the profits attributable to these functions are taxable exclusively in the State where the place of effective management of the enterprise is situated. Any expenses, or part thereof, incurred in performing such functions must be deducted in computing that part of the profit that is not taxable in the State where the permanent establishment is located and will not, therefore, reduce the part of the profits attributable to the permanent establishment which may be taxed in that State pursuant to Article 7.

21. Where ships or aircraft are operated in international traffic, the application of the Article to the profits arising from such operation will not be affected by the fact that the ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise; thus, even if such profits could be attributed to the permanent establishment under Article 7, they will only be taxable in the State in which the place of effective management of the enterprise is situated [...].

Paragraph 3 of Article 8 (alternative A) and paragraph 4 of Article 8 (alternative B)

18. Each of these paragraphs, which reproduce Article 8, paragraph 3, of the OECD Model Convention, refers to the case in which the place of effective management of the enterprise concerned is aboard a ship or a boat. As noted in the Commentary on the OECD Model Convention:

22. [...] In this case tax will only be charged by the State where the home harbour of the ship or boat is situated. It is provided that if the home harbour cannot be determined, tax will be charged only in the Contracting State of which the operator of the ship or boat is a resident.

Paragraph 4 of Article 8 (alternative A) and paragraph 5 of Article 8 (alternative B)

19. Paragraph 4 of Article 8 (alternative A) reproduces Article 8, paragraph 4, of the OECD Model Convention. Paragraph 5 of Article 8 (alternative B) also reproduces the latter paragraph, with one adjustment, namely, the replacement of the phrase “paragraph 1” by the words “paragraphs 1 and 2”. As the Commentary on the OECD Model Convention observes:

23. Various forms of international co-operation exist in shipping or air transport. In this field international co-operation is secured through pooling agreements or other conventions of a similar kind which lay down certain rules for apportioning the receipts (or profits) from the joint business.

24. In order to clarify the taxation position of the participant in a pool, joint business or in an international operating agency and to cope with any difficulties which may arise the Contracting States may bilaterally add the following, if they find it necessary:

... but only to so much of the profits so derived as is attributable to the participant in proportion to its share in the joint operation.

Article 9

ASSOCIATED ENTERPRISES

A. GENERAL CONSIDERATIONS

1. Article 9 of the United Nations Model Convention reproduces Article 9 of the OECD Model Convention, except for paragraph 3. As noted in paragraph 1 of the OECD Commentary, “[t]his Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm’s length terms”. It should be considered in conjunction with Article 25 on mutual agreement procedure and Article 26 on exchange of information.

2. The application of the arm's length rule to the allocation of profits between the associated enterprises presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's length principle.

3. With regard to transfer pricing of goods, technology, trademarks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's length terms, the former Group of Experts stated that the Contracting States will follow the OECD principles, which are set out in the OECD Transfer Pricing Guidelines. The former Group of Experts, in the United Nations Model Convention revised in 1999, came to the view that these conclusions represent internationally agreed principles and it recommended that the Guidelines should be followed for the application of the arm's length principle which underlies the Article.

The views expressed by the former Group of Experts have not yet been considered fully by the Committee of Experts, as indicated in the records of its annual sessions.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 9

Paragraph 1

4. Paragraph 1 provides that in cases involving associated enterprises, the tax authorities of a Contracting State may for the purpose of calculating tax liabilities rewrite the accounts of the enterprises if as a result of the special relationship between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that an adjustment should be sanctioned in such circumstances, and this paragraph calls for little comment. The provision applies only if special conditions have been made or imposed between the two enterprises. Clearly no re-writing of the accounts with a consequential adjustment should be made if the transactions between the associated enterprises have taken place on a normal open market commercial basis, in other words, at arm's length.

5. In the OECD Committee on Fiscal Affairs' Report on "Thin Capitalisation",³³ it is stated that there is an interplay between tax treaties and domestic rules on thin capitalization which is relevant to the scope of the Article. As noted in paragraph 3 of the OECD Commentary on Article 9:

³³Adopted by the Council of the OECD on 26 November 1986 and reproduced in volume II of the full-length version of the OECD Model Tax Convention at page R(4)-1.

- a) The Article does not prevent the application of national rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;
- b) The Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;
- c) The application of rules designed to deal with thin capitalisation should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and that this principle should be followed in applying existing tax treaties.

The OECD Commentary continues:

4. The question arises as to whether special procedural rules which some countries have adopted for dealing with transactions between related parties are consistent with the Convention. For instance, it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes found in domestic laws are consistent with the arm's length principle. A number of countries interpret the Article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level. Also, almost all member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24. However, in some cases the application of the national law of some countries may result in adjustments to profits at variance with the principles of the Article. Contracting States are enabled by the Article to deal with such situations by means of corresponding adjustments (see below) and under mutual agreement procedures.

Paragraph 2

6. In the words of the OECD Commentary, "The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in

the hands of different persons), insofar as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B.” The OECD Commentary observes that “[p]aragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation”.³⁴

However, according to the OECD Commentary,

6. [...] an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm’s length. In other words, the paragraph may not be invoked and should not be applied where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm’s length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount.

7. The paragraph does not specify the method by which an adjustment is to be made. OECD member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm’s length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of Article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23, in respect of tax paid by its associate enterprise in State A.

8. It is not the purpose of the paragraph to deal with what might be called “secondary adjustments”. Suppose that an upward revision of taxable profits of enterprise X in State A has been made in

³⁴Paragraph 5 of the OECD Commentary on Article 9.

accordance with the principle laid down in paragraph 1 and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if arm's length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y) and that in those circumstances there could have been other tax consequences (*e.g.* the operation of a withholding tax) depending upon the type of income concerned and the provisions of the Article dealing with such income.

9. These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case. It should be noted that nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

10. The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended—in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment [...].

11. If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented; the Commentary on that Article contains a number of considerations applicable to adjustments of the profits of associated enterprises

carried out on the basis of the present Article (following, in particular, adjustment of transfer prices) and to the corresponding adjustments which must then be made in pursuance of paragraph 2 thereof [...].

7. The view has been expressed that a correlative adjustment under paragraph 2 could be very costly to a developing country which may consider not including paragraph 2 in its treaties. However, paragraph 2 is an essential aspect of Article 9 and failure to provide a correlative adjustment will result in double taxation, which is contrary to the purpose of the Convention. A country should closely examine the primary adjustment under paragraph 1 before deciding what correlative adjustment is appropriate to reflect the primary adjustment. Some countries take the view that it may be desirable to eliminate the obligation that a State may have to make a correlative adjustment when the other Contracting State has previously adjusted the transfer prices. This approach can be achieved by changing the word “shall” to “may”. Contracting States may, during bilateral negotiations, use the word that is convenient. However, there is no consensus on this point and the language of paragraph 2 remains unchanged.

Paragraph 3

8. The United Nations Model Convention was amended in 1999 by the insertion of paragraph 3. Paragraph 2 of Article 9 requires a country to make an “appropriate adjustment” (a correlative adjustment) to reflect a change in the transfer price made by a country under Article 9, paragraph 1. The new paragraph 3 provides that the provisions of paragraph 2 shall not apply where the judicial, administrative or other legal proceedings have resulted in a final ruling that, by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises is liable to penalty with respect to fraud, gross negligence or wilful default. In other words, in case a final order has been passed in a judicial, administrative or other legal proceeding pointing out that in relation to the adjustment of profits under paragraph 1 one of the enterprises is subject to a penalty for fraud, gross negligence or wilful default, there would be no obligation to make the correlative adjustment under paragraph 2. This approach means that a taxpayer may be subject to non-tax and tax penalties. Some countries may consider such double penalties as too harsh, but it should be borne in mind that cases involving the levy of such penalties are likely to be exceptional and there would be no application of this provision in a routine manner.

Article 10

DIVIDENDS

A. GENERAL CONSIDERATIONS

1. Article 10 of the United Nations Model Convention reproduces the provisions of Article 10 of the OECD Model Convention with the exception of paragraph 2, which contains substantive differences and paragraphs 4 and 5 which refer to independent personal services from a fixed base. Article 10 deals with the taxation of dividends received by a resident of a Contracting State from sources in the other Contracting State. Paragraph 1 provides that dividends may be taxed in the country of residence, and paragraph 2 provides that dividends may be taxed in the country of source, but at a limited tax rate. The term “dividends” is defined in paragraph 3 as generally including distributions of corporate profits to shareholders. As the OECD Commentary observes in paragraph 3: “From the shareholders’ standpoint, dividends are income from the capital which they have made available to the company as its shareholders.” Paragraph 4 provides that paragraphs 1 and 2 do not apply to dividends that are attributable to a permanent establishment of the recipient in the source country, and paragraph 5 generally precludes a Contracting State from taxing dividends paid by a company resident in the other State unless the shareholder is a resident of the taxing State or the dividends are attributable to a permanent establishment of the recipient in that State.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 10

Paragraph 1

2. This paragraph, which reproduces Article 10, paragraph 1, of the OECD Model Convention, provides that dividends may be taxed in the State of the beneficiary’s residence. It does not, however, provide that dividends may be taxed exclusively in that State and therefore leaves open the possibility of taxation by the State of which the company paying the dividends is a resident, that is, the State in which the dividends originate (source country). When the United Nations Model Convention was first considered, many members of the former Group of Experts from developing countries felt that as a matter of principle dividends should be taxed only by the source country. According to them, if both the country of residence and the source country were given the right to tax, the country of residence should grant a full tax

credit regardless of the amount of foreign tax to be absorbed and, in appropriate cases, a tax-sparing credit. One of those members emphasized that there was no necessity for a developing country to waive or reduce its withholding tax on dividends, especially if it offered tax incentives and other concessions. However, the former Group of Experts reached a consensus that dividends may be taxed by the State of the beneficiary's residence. Current practice in developing/developed country treaties generally reflects this consensus. Double taxation is eliminated or reduced through a combination of exemption or tax credit in the residence country and reduced withholding rates in the source country.

3. According to the Commentary on Article 10, paragraph 1, of the OECD Model Convention,

7. [...] The term “paid” has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom.

8. The Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State. It does not, therefore, apply to dividends paid by a company which is a resident of a third State or to dividends paid by a company which is a resident of a Contracting State which are attributable to a permanent establishment which an enterprise of that State has in the other Contracting State [...].

Paragraph 2

4. This paragraph reproduces Article 10, paragraph 2, of the OECD Model Convention with certain changes which will be explained hereunder.

5. The OECD Model Convention restricts the tax in the source country to 5 per cent in subparagraph *a*) for direct investment dividends and 15 per cent in subparagraph *b*) for portfolio investment dividends, but the United Nations Model Convention leaves these percentages to be established through bilateral negotiations.

6. Also, the minimum ownership necessary for direct investment dividends is reduced in subparagraph *a*) from 25 per cent to 10 per cent. However, the 10 per cent threshold which determines the level of shareholding qualifying as a direct investment is illustrative only. When it last considered this issue, the former Group of Experts decided to replace “25 per cent” by “10 per cent” in subparagraph *a*) as the minimum capital required

for direct investment dividend status because in some developing countries non-residents are limited to a 50 per cent share ownership, and 10 per cent is a significant portion of such permitted ownership.

7. The former Group of Experts was unable to reach a consensus on the maximum tax rates to be permitted in the source country. Members from the developing countries, who basically preferred the principle of the taxation of dividends exclusively in the source country, considered that the rates prescribed by the OECD Model Convention would entail too large a loss of revenue for the source country. Also, although they accepted the principle of taxation in the beneficiary's country of residence, they believed that any reduction in withholding taxes in the source country should benefit the foreign investor rather than the treasury of the beneficiary's country of residence, as may happen under the traditional tax-credit method if the reduction lowers the cumulative tax rate of the source country below the rate of the beneficiary's country of residence.

8. The former Group of Experts suggested some considerations that might guide countries in negotiations on the rates for source country taxation of direct investment dividends. If the developed (residence) country uses a credit system, treaty negotiations could appropriately seek a withholding tax rate at source that would, in combination with the basic corporate tax rate of the source country, produce a combined effective rate not exceeding the tax rate in the residence country. The parties' negotiating positions may also be affected by whether the residence country allows credit for taxes spared by the source country under tax incentive programmes. If the developed country uses an exemption system for double taxation relief, it could, in bilateral negotiations, seek a limitation on withholding rates on the grounds that (a) the exemption itself stresses the concept of not taxing inter-corporate dividends, and a limitation of the withholding rate at source would be in keeping with that concept, and (b) the exemption and resulting departure from tax neutrality with domestic investment are of benefit to the international investor, and a limitation of the withholding rate at source, which would also benefit the investor, would be in keeping with this aspect of the exemption.

9. Both the source country and the country of residence should be able to tax dividends on portfolio investment shares, although the relatively small amount of portfolio investment and its distinctly lesser importance compared with direct investment might make the issues concerning its tax treatment less intense in some cases. The former Group of Experts decided not to recommend a maximum rate because source countries may have varying views on the importance of portfolio investment and on the figures to be inserted.

10. In 1999, it was noted that recent developed/developing country treaty practice indicates a range of direct investment and portfolio investment withholding tax rates. Traditionally, dividend withholding rates in the developed/developing country treaties have been higher than those in treaties between developed countries. Thus, while the OECD direct and portfolio investment rates are 5 per cent and 15 per cent, developed/developing country treaty rates have traditionally ranged between 5 per cent and 15 per cent for direct investment dividends and 15 per cent and 25 per cent for portfolio dividends. Some developing countries have taken the position that short-term loss of revenue occasioned by low withholding rates is justified by the increased foreign investment in the medium and long terms. Thus, several modern developed/developing country treaties contain the OECD Model rates for direct investment, and a few treaties provide for even lower rates.

11. Also, several special features in developed/developing country treaties have appeared: (a) the tax rates may not be the same for both countries, with higher rates allowed to the developing country; (b) tax rates may not be limited at all; (c) reduced rates may apply only to income from new investment; (d) the lowest rates or exemption may apply only to preferred types of investments (e.g. “industrial undertakings” or “pioneer investments”); and (e) dividends may qualify for reduced rates only if the shares have been held for a specified period. In treaties of countries that have adopted an imputation system of corporation taxation (i.e. integration of company tax into the shareholder’s company tax or individual income tax) instead of the classical system of taxation (i.e. separate taxation of shareholder and corporation), specific provisions may ensure that the advanced credits and exemptions granted to domestic shareholders are extended to shareholders resident in the other Contracting State.

12. Although the rates are fixed either partly or wholly for reasons connected with the general balance of the particular bilateral tax treaty, the following technical factors are often considered in fixing the rate:

- (a) the corporate tax system of the country of source (e.g. the extent to which the country follows an integrated or classical system) and the total burden of tax on distributed corporate profits resulting from the system;
- (b) the extent to which the country of residence can credit the tax on the dividends and the underlying profits against its own tax and the total tax burden imposed on the taxpayer, after relief in both countries;
- (c) the extent to which matching credit is given in the country of residence for tax spared in the country of source;

- (d) the achievement from the source country's point of view of a satisfactory balance between raising revenue and attracting foreign investment.

13. The Commentary on the OECD Model Convention contains the following passages:

11. If a partnership is treated as a body corporate under the domestic laws applying to it, the two Contracting States may agree to modify subparagraph *a*) of paragraph 2 in a way to give the benefits of the reduced rate provided for parent companies also to such partnership.

12. The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words "paid ... to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

12.1 Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"³⁵ concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

³⁵Reproduced in Volume II of the full-length version of the OECD Model Tax Convention at page R(6)-1.

12.2 Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all member countries). States which wish to make this more explicit are free to do so during bilateral negotiations.

13. The tax rates fixed by the Article for the tax in the State of source are maximum rates. The States may agree, in bilateral negotiations, on lower rates or even on taxation exclusively in the State of the beneficiary's residence. The reduction of rates provided for in paragraph 2 refers solely to the taxation of dividends and not to the taxation of the profits of the company paying the dividends.

13.1 Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as regards domestic and foreign investments by these entities, some States provide bilaterally that income, including dividends, derived by such an entity resident of the other State shall be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18.

13.2 Similarly, some States refrain from levying tax on dividends paid to other States and some of their wholly-owned entities, at least to the extent that such dividends are derived from activities of a governmental nature. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 6.38 and 6.39 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. States wishing to do so may confirm or clarify, in their bilateral conventions, the scope of these exemptions or grant such an exemption in cases where it would not otherwise be available. This may be done by adding to the Article an additional paragraph drafted along the following lines:

Notwithstanding the provisions of paragraph 2, dividends referred to in paragraph 1 shall be taxable only in the Contracting State of which the recipient is a resident if the beneficial owner of the dividends is that State or a political subdivision or local authority thereof.

14. The two Contracting States may also, during bilateral negotiations, agree to [lower the holding percentage required for direct

investment dividends]. A lower percentage is, for instance, justified in cases where the state of residence of the parent company, in accordance with its domestic law, grants exemption to such a company for dividends derived from a holding of less than 25 per cent in a non-resident subsidiary.

15. In subparagraph *a)* of paragraph 2, the term “capital” is used in [...] [defining the minimum ownership required for direct investment dividends]. The use of this term in this context implies that, for the purposes of subparagraph *a)*, it should be used in the sense in which it is used for the purposes of distribution to the shareholder (in the particular case, the parent company).

- a)* As a general rule, therefore, the term “capital” in subparagraph *a)* should be understood as it is understood in company law. Other elements, in particular the reserves, are not to be taken into account.
- b)* Capital, as understood in company law, should be indicated in terms of par value of all shares which in the majority of cases will be shown as capital in the company’s balance sheet.
- c)* No account need be taken of differences due to the different classes of shares issued (ordinary shares, preference shares, plural voting shares, non-voting shares, bearer shares, registered shares etc.), as such differences relate more to the nature of the shareholder’s right than to the extent of his ownership of the capital.
- d)* When a loan or other contribution to the company does not, strictly speaking, come as capital under company law but when on the basis of internal law or practice (“thin capitalisation”, or assimilation of a loan to share capital), the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as “capital” within the meaning of subparagraph *a)*.
- e)* In the case of bodies which do not have capital within the meaning of company law, capital for the purpose of subparagraph *a)* is to be taken as meaning the total of all contributions to the body which are taken into account for the purpose of distributing profits.

In bilateral negotiations, Contracting States may depart from the criterion of “capital” used in subparagraph *a)* of paragraph 2 and use instead the criterion of “voting power”.

16. Subparagraph *a)* of paragraph 2 does not require that the company receiving the dividends must have owned at least [10] per cent

of the capital for a relatively long time before the date of the distribution. This means that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which paragraph 2 applies, *i.e.* in most cases the situation existing at the time when the dividends become legally available to the shareholders. The primary reason for this resides in the desire to have a provision which is applicable as broadly as possible. To require the parent company to have possessed the minimum holding for a certain time before the distribution of the profits could involve extensive inquiries. Internal laws of certain OECD member countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received. In view of this, Contracting States may include a similar condition in their conventions.

17. The reduction envisaged in subparagraph *a)* of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than [10] per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph *a)* a provision along the following lines:

provided that this holding was not acquired primarily for the purpose of taking advantage of this provision.

18. Paragraph 2 lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment.

19. The paragraph does not settle procedural questions. Each State should be able to use the procedure provided in its own laws. It can either forthwith limit its tax to the rates given in the Article or tax in full and make a refund [...]. Specific questions arise with triangular cases (see paragraph 71 of the Commentary on Article 24).

20. It does not specify whether or not the relief in the State of source should be conditional upon the dividends being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

21. The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the dividends. This question is dealt with in Articles 23 A and 23 B.

22. Attention is drawn generally to the following case: the beneficial owner of the dividends arising in a Contracting State is a company resident of the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the dividends the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this Article, in order to define the treatment applicable to such companies.

Paragraph 3

14. This paragraph reproduces Article 10, paragraph 3, of the OECD Model Convention, the Commentary on which reads as follows:

23. In view of the great differences between the laws of OECD member countries, it is impossible to define “dividends” fully and exhaustively. Consequently, the definition merely mentions examples which are to be found in the majority of the member countries’ laws and which, in any case, are not treated differently in them. The enumeration is followed up by a general formula. In the course of the revision of the 1963 Draft Convention, a thorough study has been undertaken to find a solution that does not refer to domestic laws. This study has led to the conclusion that, in view of the still remaining dissimilarities between member countries in the field of company law and taxation law, it did not appear to be possible to work out a definition of the concept of dividends that would be independent of domestic laws. It is open to the Contracting States, through bilateral negotiations, to make allowance for peculiarities of their laws and to agree to bring under the definition of “dividends” other payments by companies falling under the Article.

24. The notion of dividends basically concerns distributions by companies within the meaning of subparagraph *b)* of paragraph 1 of Article 3. Therefore the definition relates, in the first instance, to distributions of profits the title to which is constituted by shares that is holdings in a company limited by shares (joint stock company). The definition assimilates to shares all securities issued by companies which carry a right to participate in the companies’ profits without being debt claims; such are, for example, “jouissance” shares or

“jouissance” rights, founders’ shares or other rights participating in profits. In bilateral conventions, of course, this enumeration may be adapted to the legal situation in the Contracting States concerned. This may be necessary, in particular, as regards income from “jouissance” shares and founders’ shares. On the other hand, debt-claims participating in profits do not come into this category [...]; likewise interest on convertible debentures is not a dividend.

25. Article 10 deals not only with dividends as such but also with interest on loans in so far as the lender effectively shares the risks run by the company, *i.e.* when repayment depends largely on the success or otherwise of the enterprise’s business. Articles 10 and 11 do not therefore prevent the treatment of this type of interest as dividends under the national rules on thin capitalisation applied in the borrower’s country. The question whether the contributor of the loan shares the risks run by the enterprise must be determined in each individual case in the light of all the circumstances, as for example the following:

- the loan very heavily outweighs any other contribution to the enterprise’s capital (or was taken out to replace a substantial portion of capital which has been lost) and is substantially unmatched by redeemable assets;
- the creditor will share in any profits of the company;
- the repayment of the loan is subordinated to claims of other creditors or to the payment of dividends;
- the level or payment of interest would depend on the profits of the company;
- the loan contract contains no fixed provisions for repayment by a definite date.

26. The laws of many of the States put participations in a *société à responsabilité limitée* (limited liability company) on the same footing as shares. Likewise, distributions of profits by cooperative societies are generally regarded as dividends.

27. Distributions of profits by partnerships are not dividends within the meaning of the definition, unless the partnerships are subject, in the State where their place of effective management is situated, to a fiscal treatment substantially similar to that applied to companies limited by shares (for instance, in Belgium, Portugal and Spain, also in France as regards distributions to *commanditaires* in the *sociétés en commandite simple*). On the other hand, clarification in bilateral conventions may be necessary in cases where the taxation law of a Contracting State gives the owner of holdings in a company a right

to opt, under certain conditions, for being taxed as a partner of a partnership, or, vice versa, gives the partner of a partnership the right to opt for taxation as the owner of holdings in a company.

28. Payments regarded as dividends may include not only distributions of profits decided by annual general meetings of shareholders, but also other benefits in money or money's worth, such as bonus shares, bonuses, profits on a liquidation and disguised distributions of profits. The reliefs provided in the Article apply so long as the State of which the paying company is a resident taxes such benefits as dividends. It is immaterial whether any such benefits are paid out of current profits made by the company or are derived, for example, from reserves, *i.e.* profits of previous financial years. Normally, distributions by a company which have the effect of reducing the membership rights, for instance, payments constituting a reimbursement of capital in any form whatever, are not regarded as dividends.

29. The benefits to which a holding in a company confer entitlement are, as a general rule, available solely to the shareholders themselves. Should, however, certain of such benefits be made available to persons who are not shareholders within the meaning of company law, they may constitute dividends if:

- the legal relations between such persons and the company are assimilated to a holding in a company (“concealed holdings”) and
- the persons receiving such benefits are closely connected with a shareholder; this is the case, for example, where the recipient is a relative of the shareholder or is a company belonging to the same group as the company owning the shares.

30. When the shareholder and the person receiving such benefits are residents of two different States with which the State of source has concluded conventions, differences of views may arise as to which of these conventions is applicable. A similar problem may arise when the State of source has concluded a convention with one of the States but not with the other. This, however, is a conflict which may affect other types of income and the solution to it can be found only through an arrangement under the mutual agreement procedure.

Paragraph 4

15. This paragraph, which makes paragraphs 1 and 2 inapplicable to dividends on shares that are effectively connected with a permanent establishment or fixed base of the recipient in the source country, reproduces

Article 10, paragraph 4, of the OECD Model Convention except the United Nations Model Convention refers to a company performing independent personal services from a fixed base. The OECD Commentary notes that paragraph 4 does not adopt a force of attraction rule, allowing dividends to be taxed as business profits if the recipient has a permanent establishment or fixed base in the source country, regardless of whether the shareholding is connected with the permanent establishment. Rather, the paragraph only permits dividends to be taxed as business profits “[...] if they are paid in respect of holdings forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment [...]”.³⁶

The OECD Commentary also notes:

32. It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a shareholding be “effectively connected” to such a location requires that the shareholding be genuinely connected to that business.

Paragraph 5

16. This paragraph, which bars a Contracting State from taxing dividends paid by a company resident in the other State merely because the company derives income or profits in the taxing State, reproduces Article 10, paragraph 5, of the OECD Model Convention except for the reference in the United Nations Model Convention to “fixed base”. The OECD Commentary reads as follows:

33. The Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other State. Certain States, however, tax not only dividends paid by companies resident therein but even distributions by non-resident companies of profits arising within their territory. Each State, of course, is entitled to tax profits arising in its territory which are made by non-resident companies, to the extent provided in the Convention (in particular in Article 7). The shareholders of such companies should not be taxed as well at any rate, unless they are residents of the State and so naturally subject to its fiscal sovereignty.

³⁶Paragraph 31 of the OECD Commentary on Article 10.

34. Paragraph 5 rules out the extraterritorial taxation of dividends, *i.e.* the practice by which States tax dividends distributed by a non-resident company solely because the corporate profits from which the distributions are made originated in their territory (for example, realised through a permanent establishment situated therein). There is, of course, no question of extraterritorial taxation when the country of source of the corporate profits taxes the dividends because they are paid to a shareholder who is a resident of that State or to a permanent establishment [or fixed base] situated in that State.

35. Moreover, it can be argued that such a provision does not aim at, or cannot result in, preventing a State from subjecting the dividends to a withholding tax when distributed by foreign companies if they are cashed in its territory. Indeed, in such a case, the criterion for tax liability is the fact of the payment of the dividends, and not the origin of the corporate profits allotted for distribution. But if the person cashing the dividends in a Contracting State is a resident of the other Contracting State (of which the distributing company is a resident), he may under Article 21 obtain exemption from, or refund of, the withholding tax of the first-mentioned State. Similarly, if the beneficiary of the dividends is a resident of a third State which had concluded a double taxation convention with the State where the dividends are cashed, he may, under Article 21 of that convention, obtain exemption from, or refund of, the withholding tax of the last-mentioned State.

36. Paragraph 5 further provides that non-resident companies are not to be subjected to special taxes on undistributed profits.

37. It might be argued that where the taxpayer's country of residence, pursuant to its controlled foreign companies legislation or other rules with similar effect seeks to tax profits which have not been distributed, it is acting contrary to the provisions of paragraph 5. However it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under such legislation or rules. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.

38. The application of such legislation or rules may, however, complicate the application of Article 23. If the income were attributed to the taxpayer then each item of the income would have to be treated under the relevant provisions of the Convention (business profits, interest, royalties). If the amount is treated as a deemed dividend then it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear

whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 or as “other income” within the meaning of Article 21. Under some of these legislation or rules the taxable amount is treated as a dividend with the result that an exemption provided for by a tax convention, *e.g.* an affiliation exemption is also extended to it. It is doubtful whether the Convention requires this to be done. If the country of residence considers that this is not the case it may face the allegation that it is obstructing the normal operation of the affiliation exemption by taxing the dividend (in the form of “deemed dividend”) in advance.

39. Where dividends are actually distributed by the base company, the provisions of a bilateral convention regarding dividends have to be applied in the normal way because there is dividend income within the meaning of the convention. Thus, the country of the base company may subject the dividend to a withholding tax. The country of residence of the shareholder will apply the normal methods for the elimination of double taxation (*i.e.* tax credit or tax exemption is granted). This implies that the withholding tax on the dividend should be credited in the shareholder’s country of residence, even if the distributed profit (the dividend) has been taxed years before under controlled foreign companies legislation or other rules with similar effect. However, the obligation to give credit in that case remains doubtful. Generally the dividend as such is exempted from tax (as it was already taxed under the relevant legislation or rules and one might argue that there is no basis for a tax credit. On the other hand, the purpose of the treaty would be frustrated if the crediting of taxes could be avoided by simply anticipating the dividend taxation under counteracting legislation. The general principle set out above would suggest that the credit should be granted, though the details may depend on the technicalities of the relevant legislation or rules and the system for crediting foreign taxes against domestic tax, as well as on the particularities of the case (*e.g.* time lapsed since the taxation of the “deemed dividend”). However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot fully be safeguarded by tax authorities.

17. It may be relevant to point out that certain countries’ laws seek to avoid or mitigate economic double taxation, that is, the simultaneous taxation of the company’s profits at the level of the company and of dividends at the level of the shareholder. For a detailed consideration of this matter, it may be instructive to refer to paragraphs 40 to 67 in the Commentary on Article 10 of the OECD Model Convention.

Branch profits taxes

18. The inclusion of a branch profits tax provision in a revised United Nations Model Convention was discussed at the 1987 and 1991 meetings of the former Group of Experts. The issue was further discussed in the 1997 meeting (Eighth Meeting) of the former Group of Experts and it was considered that because only a few countries had a branch tax, the paragraph might be better placed in the commentaries and not in the main text. It would be left to the Contracting States, if they so desire, during the course of bilateral negotiations to incorporate the provisions relating to the branch profits tax in their bilateral tax treaties. Developing countries were generally not opposed to the principle of branch profits taxation, even if they did not impose a branch profits tax.

19. Some members, while citing the justification of branch profits taxation as a means of achieving rough parity in source country taxation whether business in that country is conducted through a subsidiary corporation or a branch, maintained that the principle should be followed logically throughout the Convention. Thus, in this view, contrary to paragraph 3 of Article 7 of the United Nations Model Convention, all expenses of the permanent establishment must be deductible as if the permanent establishment were a distinct and separate enterprise dealing wholly independently with the head office.

20. Another member from a developed country noted that his country imposed the tax in two separate parts: (i) a tax analogous to a dividend withholding tax was imposed on the “dividend equivalent amount” of a branch that was approximately the amount that would likely have been distributed as dividends if the branch were a subsidiary; and (ii) a second tax, analogous to a withholding tax on interest paid by a subsidiary resident in that country to its foreign parent, was imposed on the excess of the amount of interest deducted by the branch in computing its taxable income over the amount of interest actually paid by the branch. The principal purpose of that system was to minimize the effect of tax considerations on the foreign investor’s decision whether to operate in the country in branch or subsidiary form.

21. If one or both of the Contracting States impose branch profits taxes, they may include in the Convention a provision such as the following:

Notwithstanding any other provision of this Convention, where a company which is a resident of a Contracting State has a permanent establishment in the other Contracting State, the profits taxable under Article 7, paragraph 1, may be subject to an additional tax in that other State, in accordance with its laws, but the additional charge shall not exceed ___ per cent of the amount of those profits.

22. The suggested provision does not recommend a maximum branch profits rate. The most common practice is to use the direct investment dividend rate (e.g. the tax rate in paragraph 2(a)). At the 1991 meeting of the former Group of Experts there was agreement among the supporters of branch profits taxation that, in view of the principles enunciated in support of the system, the rate of tax on branch profits should be the same as that on dividends from direct investments. However, in several treaties the branch profits tax rate was the rate for portfolio investment dividends (typically a higher rate) and in some treaties the branch tax rate was lower than the direct investment dividend rate. Although a branch profits tax is on business profits, the provision may be included in Article 10, rather than in Article 7, because the tax is intended to be analogous to a tax on dividends.

23. The provision allows the branch profits tax to be imposed only on profits taxable under Article 7, paragraph 1, on account of the permanent establishment. Many treaties further limit the tax base to such profits “after deducting therefrom income tax and other taxes on income imposed thereon in that other State”. Other treaties do not contain this clause because the concept is included under domestic law.

24. At the former Group of Experts 1991 meeting, attention was drawn to the fact that a branch profits tax provision could potentially conflict with a treaty’s non-discrimination clause. Since a branch profits tax is usually a second level of tax on profits of foreign corporations that is not imposed on domestic corporations carrying on the same activities, it could be viewed, as a technical matter, as prohibited by Article 24 (Non-discrimination). However, countries imposing the tax do so as an analogue to the dividend withholding tax paid on dividends from a subsidiary to its foreign parent, and they therefore consider it appropriate to include in the non-discrimination Article an explicit exception allowing imposition of the branch tax. The non-discrimination Article in several treaties with branch profits tax provisions contains the following paragraph:

Nothing in this Article shall be construed as preventing either Contracting State from imposing a tax as described in paragraph ____ [branch profits tax provision] of Article 10 (Dividends).

However, the branch profits tax provision suggested above makes this provision unnecessary because it applies “notwithstanding any other provision of this Convention” and thus takes precedence over other treaty provisions, including Article 24 (Non-discrimination).

25. Some members of the former Group of Experts pointed out that there are many artificial devices entered into by persons to take advantage of the

provisions of Article 10 through, inter alia, creation or assignment of shares or other rights in respect of which a dividend is paid. While substance over form rules, abuse of rights principle or any similar doctrine could be used to counter such arrangements, Contracting States, which may want to specifically address the issue, may include a clause on the following lines in their bilateral tax treaties during negotiations, namely:

The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.

Article 11

INTEREST

A. GENERAL CONSIDERATIONS

1. Article 11 of the United Nations Model Convention reproduces the provisions of Article 11 of the OECD Model Convention with the exception of paragraphs 2 and 4, in which substantive changes have been made and with respect to paragraphs 4 and 5 which refer to independent personal services from a fixed base.

2. Interest, which, like dividends, constitutes income from movable capital may be paid to individual savers who have deposits with banks or hold savings certificates, to individual investors who have purchased bonds, to individual suppliers or trading companies selling on a deferred payment basis, to financial institutions which have granted loans or to institutional investors which hold bonds or debentures. Interest may also be paid on loans between associated enterprises.

3. At the domestic level, interest is usually deductible in calculating profits. Any tax on interest is paid by the beneficiary unless a special contract provides that it should be paid by the payer of the interest. Contrary to what occurs in the case of dividends, interest is not liable to taxation in the hands of both the beneficiary and the payer. If the latter is obliged to withhold a certain portion of the interest as a tax, the amount withheld represents an advance on the tax to which the beneficiary will be liable on his aggregate income or profits for the fiscal year, and the beneficiary can deduct this amount from the tax due from him and obtain reimbursement of any sum by

which the amount withheld exceeds the tax finally payable. This mechanism prevents the beneficiary from being taxed twice on the same interest.

4. At the international level, when the beneficiary of the interest is a resident of one State and the payer of the interest is a resident of another, the interest is subject to taxation in both countries. This double taxation may considerably reduce the net amount of interest received by the beneficiary or, if the payer has agreed to bear the cost of the tax deductible at the source, increase the financial burden on the payer.

5. The Commentary on the OECD Model Convention notes that, although this double taxation could be eliminated by barring the source country or the residence country from taxing the interest,

3. A formula reserving the exclusive taxation of interest to one State, whether the State of the beneficiary's residence or the State of source, could not be sure of receiving general approval. Therefore a compromise solution was adopted. It provides that interest may be taxed in the State of residence, but leaves to the State of source the right to impose a tax if its laws so provide, it being implicit in this right that the State of source is free to give up all taxation on interest paid to non-residents. Its exercise of this right will however be limited by a ceiling which its tax cannot exceed [...]. The sacrifice that the latter would accept in such conditions will be matched by a relief to be given by the State of residence, in order to take into account the tax levied in the State of source (see Article 23 A or 23 B).

4. Certain countries do not allow interest paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the interest is paid by a resident of a Contracting State to a resident of the other State is dealt with in paragraph 4 of Article 24.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 11

Paragraph 1

6. This paragraph reproduces Article 11, paragraph 1, of the OECD Model Convention, the Commentary on which reads as follows:

5. Paragraph 1 lays down the principle that interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in the latter. In doing so, it does not stipulate an

exclusive right to tax in favour of the State of residence. The term “paid” has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom.

6. The Article deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to interest arising in a third State or to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State [...].

Paragraph 2

7. This paragraph reproduces Article 11, paragraph 2, of the OECD Model Convention with one substantive change. The OECD Model Convention provides that the tax in the country of source “shall not exceed 10 per cent of the gross amount of the interest”, but the United Nations Model Convention leaves this percentage to be established through bilateral negotiations.

8. When this Article was considered by the former Group of Experts, members from developing countries took the view that the source country should have the exclusive, or at least the primary, right to tax interest. According to that view, it is incumbent on the residence country to prevent double taxation of that income through exemption, credit or other relief measures. These members reasoned that interest should be taxed where it was earned, that is, where the capital was put to use. Some members from developed countries felt that the home country of the investor should have the exclusive right to tax interest, since in their view that would promote the mobility of capital and give the right to tax to the country that is best equipped to consider the characteristics of the taxpayer. They also pointed out that an exemption of foreign interest from the tax of the investor’s home country might not be in the best interests of the developing countries because it could induce investors to place their capital in the developing country with the lowest tax rate.

9. The members from developing countries agreed to the solution of taxation by both the country of residence and the source country embodied in Article 11, paragraphs 1 and 2, of the OECD Model Convention but found the ceiling of 10 per cent of the gross amount of the interest mentioned in paragraph 2 unacceptable. Since the former Group of Experts was unable to reach a consensus on an alternative ceiling, the matter was left to bilateral negotiations.

10. The decision not to recommend a maximum withholding rate can be justified under current treaty practice. The withholding rates for interest

adopted in developed/developing country tax treaties range more widely than those for dividends—between complete exemption and 25 per cent. However, some developing countries have reduced the interest withholding rate to attract foreign investment; several of them have adopted rates at or below the OECD rate of 10 per cent.

11. A precise level of withholding tax for a source country should take into account several factors, including the following: the fact that the capital originated in the residence country; the possibility that a high source rate might cause lenders to pass the cost of the tax on to the borrowers, which would mean that the source country would increase its revenue at the expense of its own residents rather than the foreign lenders; the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment; the fact that a lowering of the withholding rate has revenue and foreign exchange consequences for the source country; and the main direction of interest flows (e.g. from developing to developed countries).

12. In negotiations on bilateral treaties with a general positive rate for interest withholding, a lower ceiling or even exemption has sometimes been agreed upon for interest in one or more of the following categories:

- (a) Interest paid to Governments or government agencies;
- (b) Interest guaranteed by Governments or government agencies;
- (c) Interest paid to central banks;
- (d) Interest paid to banks or other financial institutions;
- (e) Interest on long-term loans;
- (f) Interest on loans to finance special equipment or public works; or
- (g) Interest on other government-approved types of investment (e.g. export finance).

With respect to bank loans and loans from financial institutions, a major justification for the reduced rate is the high costs associated with these loans, particularly the lender's cost of funds. The withholding tax, because it is a gross basis tax, has a high effective tax rate. If the effective rate is higher than the general tax rate in the lender's country of residence, the borrower is often required to bear the tax through a gross-up feature in the loan agreement. In that case, the withholding tax amounts to an additional tax on residents of the source State. One way to deal with this is to allow the lender to elect to treat such income as business profits under Article 7, but this approach raises computation and administrative issues for banks and tax administrators.

13. A similar justification exists for reduced rates on interest from credit sales. The supplier in such cases often merely passes on to the customer, without

additional charge, the price he has had to pay to a bank or export finance agency to finance the credit. For a person selling equipment on credit, the interest is more an element of the sales price than income from invested capital.

14. In addition, long-term credits correspond to investments that should be profitable enough to be repaid in instalments over a period. In the latter case, interest must be paid out of earnings at the same time as instalments of credit are repaid out of capital. Consequently, any excessive fiscal burden on such interest must be passed on to the book value of the capital goods purchased on credit, with the result that the fiscal charge levied on the interest might, in the last analysis, diminish the amount of tax payable on the profits made by the user of the capital goods.

15. At the former Group of Experts 1991 meeting, some members argued that interest income received by government agencies should be exempted from source country taxation because exemption would facilitate the financing of development projects, especially in developing countries, by eliminating tax considerations from negotiations over interest rates. Some members from developing countries asserted that the financing of such projects would be enhanced even further if the interest income was also exempt from tax in the lender's country of residence.

16. The predominant treaty practice is to exempt governmental interest from source country tax, but there is a wide range of practice on the details. In some instances interest income is exempted if paid by a government or paid to a government; in other instances only interest paid to a government is exempt. Also, the definition of "government" varies to include, e.g. local authorities, agencies, instrumentalities, central banks, and financial institutions owned by the government.

17. The former Group of Experts observed that long-term credits often call for special guarantees because of the difficulty of long-term political, economic and monetary forecasting. Moreover, most developed countries, in order to ensure full employment in their capital goods industries or public works enterprises, have adopted various measures to encourage long-term credits, including credit insurance or interest-rate reductions by government agencies. These measures may take the form of direct loans by government agencies tied to loans by private banks or private credit facilities or interest terms more favourable than those obtainable on the money market. These measures are not likely to persist if the preferences are effectively cancelled out or reduced by excessive taxation in the debtor's country. Thus, not only should interest on loans made by a government be exempted, but an

argument exists for exempting interest on long-term loans made by private banks where such loans are guaranteed or refinanced by a government or a government agency.

18. The Commentary on the OECD Model Convention contains the following passages:

9. The requirement of beneficial ownership was introduced in paragraph 2 of Article 11 to clarify the meaning of the words “paid to a resident” as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term “beneficial owner” is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

10. Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled “Double Taxation Conventions and the Use of Conduit Companies”³⁷ concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical

³⁷Reproduced in Volume II of the full-length version of the OECD Model Tax Convention at page R(6)-1.

matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

11. Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all member countries). States which wish to make this more explicit are free to do so during bilateral negotiations.

12. The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment. Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law [...].

13. It does not specify whether or not the relief in the State of source should be conditional upon the interest being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

14. The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the interest. This question is dealt with in Articles 23 A and 23 B.

Paragraph 3

19. This paragraph reproduces Article 11, paragraph 3, of the OECD Model Convention, the Commentary on which reads as follows:

18. Paragraph 3 specifies the meaning to be attached to the term "interest" for the application of the taxation treatment defined by the Article. The term designates, in general, income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits. The term "debt claims of every kind" obviously embraces cash deposits and security in the form of money, as well as government securities, and bonds and debentures, although the three latter are specially mentioned because of their importance and of certain peculiarities that they may present. It is recognised, on the one hand, that mortgage interest comes within

the category of income from movable capital (*revenus de capitaux mobiliers*), even though certain countries assimilate it to income from immovable property. On the other hand, debt claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest.

19. Interest on participating bonds should not normally be considered as a dividend, and neither should interest on convertible bonds until such time as the bonds are actually converted into shares. However, the interest on such bonds should be considered as a dividend if the loan effectively shares the risks run by the debtor company [...]. In situations of presumed thin capitalisation, it is sometimes difficult to distinguish between dividends and interest and in order to avoid any possibility of overlap between the categories of income dealt with under Article 10 and Article 11 respectively, it should be noted that the term "interest" as used in Article 11 does not include items of income which are dealt with in Article 10.

20. As regards, more particularly, government securities, and bonds and debentures, the text specifies that premiums or prizes attaching thereto constitute interest. Generally speaking, what constitutes interest yielded by a loan security, and may properly be taxed as such in the State of source, is all that the institution issuing the loan pays over and above the amount paid by the subscriber, that is to say, the interest accruing plus any premium paid at redemption or at issue. It follows that when a bond or debenture has been issued at a premium, the excess of the amount paid by the subscriber over that repaid to him may constitute negative interest which should be deducted from the interest that is taxable. On the other hand, any profit or loss which a holder of such a security realises by the sale thereof to another person does not enter into the concept of interest. Such profit or loss may, depending on the case, constitute either a business profit or a loss, a capital gain or a loss, or income falling under Article 21.

21. Moreover, the definition of interest in the first sentence of paragraph 3 is, in principle, exhaustive. It has seemed preferable not to include a subsidiary reference to domestic laws in the text; this is justified by the following considerations:

- a) the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws;
- b) the formula employed offers greater security from the legal point of view and ensures that conventions would be unaffected by future changes in any country's domestic laws;

- c) in the Model Convention references to domestic laws should as far as possible be avoided.

It nevertheless remains understood that in a bilateral convention two Contracting States may widen the formula employed so as to include in it any income which is taxed as interest under either of their domestic laws but which is not covered by the definition and in these circumstances may find it preferable to make reference to their domestic laws.

21.1 The definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kinds of non-traditional financial instruments where there is no underlying debt (for example, interest rate swaps). However, the definition will apply to the extent that a loan is considered to exist under a “substance over form” rule, an “abuse of rights” principle, or any similar doctrine.

19.1. Furthermore, in a number of countries, certain non-traditional financial arrangements are assimilated to debt relations under domestic tax law, although their legal form is not a loan. The definition of interest in paragraph 3 applies to payments made under such arrangements.

19.2. The definition applies, for instance, to Islamic financial instruments where the economic reality of the contract underlying the instrument is a loan (even if the legal form thereof is not). This may be the case, for example, of *murabaha*, *istisna'a*, certain forms of *mudaraba* and *musharaka* (i.e., profit-sharing deposits and diminishing *musharaka*) and *ijara* (where assimilated to finance lease), as well as *sukuk* based on such instruments.³⁸

19.3. Countries that do not deal specifically in their domestic law with the above-mentioned instruments and generally follow an economic-substance-based approach for tax purposes may, nevertheless, apply the definition of interest to payments made under those instruments. Alternatively, such countries, as well as those following a purely legal approach for tax purposes, may wish to refer expressly to such instruments in the definition of interest in the treaty. This may be done by inserting the following after the first sentence:

The term also includes income from arrangements such as Islamic financial instruments where the substance of the underlying contract can be assimilated to a loan.

³⁸The Committee has decided to include more details regarding these instruments in the next version of the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries.

19.4. It is clear that the definition does not apply to Islamic financial instruments the economic substance of which cannot be considered as a loan.

19.5. The OECD Commentary then continues:

22. The second sentence of paragraph 3 excludes from the definition of interest penalty charges for late payment but Contracting States are free to omit this sentence and treat penalty charges as interest in their bilateral conventions. Penalty charges, which may be payable under the contract, or by customs or by virtue of a judgement, consist either of payments calculated or else of fixed sums; in certain cases they may combine both forms of payment. Even if they are determined *pro rata temporis* they constitute not so much income from capital as a special form of compensation for the loss suffered by the creditor through the debtor's delay in meeting his obligations. Moreover, considerations of legal security and practical convenience make it advisable to place all penalty charges of this kind, in whatever form they be paid, on the same footing for the purposes of their taxation treatment. On the other hand, two Contracting States may exclude from the application of Article 11 any kinds of interest which they intend to be treated as dividends.

23. Finally, the question arises whether annuities ought to be assimilated to interest; it is considered that they ought not to be. On the one hand, annuities granted in consideration of past employment are referred to in Article 18 and are subject to the rules governing pensions. On the other hand, although it is true that instalments of purchased annuities include an interest element on the purchase capital as well as return of capital, such instalments thus constituting "*fruits civilis*" which accrue from day to day, it would be difficult for many countries to make a distinction between the element representing income from capital and the element representing a return of capital in order merely to tax the income element under the same category as income from movable capital. Taxation laws often contain special provisions classifying annuities in the category of salaries, wages and pensions, and taxing them accordingly.

Paragraph 4

20. This paragraph, which provides that paragraphs 1 and 2 do not apply to some interest if the recipient has a permanent establishment or fixed base in the source country, reproduces Article 11, paragraph 4, of the OECD Model Convention, with two modifications. First, the United Nations Model Convention refers to a fixed base as well as a permanent establishment.

Secondly, the OECD version only applies if the obligation on which the interest is paid is effectively connected with the permanent establishment or fixed base. Since the United Nations Model Convention, unlike the OECD Model Convention, adopts a limited force of attraction rule in Article 7, defining the income that may be taxed as business profits, a conforming change is made in Article 11, paragraph 4, of the United Nations Model Convention. This modification makes paragraphs 1 and 2 of Article 11 inapplicable if the debt claim is effectively connected with the permanent establishment or fixed base or with business activities in the source country of the same or similar kind as those effected through the permanent establishment.

Paragraph 5

21. This paragraph reproduces Article 11, paragraph 5, of the OECD Model Convention, which specifies that interest is from sources in the residence country of the payer, except that the United Nations version refers to a fixed base as well as a permanent establishment. The first sentence of paragraph 5 was amended in 1999 in line with the OECD Model Convention. However, in the course of discussion, the former Group of Experts agreed that countries might substitute a rule that would identify the source of interest as the State in which the loan giving rise to the interest was used. Where, in bilateral negotiations, the two parties differ on the appropriate rule, a possible solution would be a rule which, in general, would accept the place of residence of the payer as the source of interest; but where the loan was used in the State having a “place of use” rule, the interest would be deemed to arise in that State. The OECD Commentary on Article 11, paragraph 5, reads as follows:

26. This paragraph lays down the principle that the State of source of the interest is the State of which the payer of the interest is a resident. It provides, however, for an exception to this rule in the case of interest-bearing loans which have an obvious economic link with a permanent establishment owned in the other Contracting State by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, the paragraph determines that the source of the interest is in the Contracting State in which the permanent establishment is situated, leaving aside the place of residence of the owner of the permanent establishment, even when he resides in a third State.

27. In the absence of an economic link between the loan on which the interest arises and the permanent establishment, the State where the latter is situated cannot on that account be regarded as the State where the interest arises; it is not entitled to tax such interest, not even within the limits of a “taxable quota” proportional to the importance

of the permanent establishment. Such a practice would be incompatible with paragraph 5. Moreover, any departure from the rule fixed in the first sentence of paragraph 5 is justified only where the economic link between the loan and the permanent establishment is sufficiently clear-cut. In this connection, a number of possible cases may be distinguished:

- a)* The management of the permanent establishment has contracted a loan which it uses for the specific requirements of the permanent establishment; it shows it among its liabilities and pays the interest thereon directly to the creditor.
- b)* The head office of the enterprise has contracted a loan the proceeds of which are used solely for the purposes of a permanent establishment situated in another country. The interest is serviced by the head office but is ultimately borne by the permanent establishment.
- c)* The loan is contracted by the head office of the enterprise and its proceeds are used for several permanent establishments situated in different countries.

In cases *a)* and *b)* the conditions laid down in the second sentence of paragraph 5 are fulfilled, and the State where the permanent establishment is situated is to be regarded as the State where the interest arises. Case *c)*, however, falls outside the provisions of paragraph 5, the text of which precludes the attribution of more than one source to the same loan. Such a solution, moreover, would give rise to considerable administrative complications and make it impossible for lenders to calculate in advance the taxation that interest would attract. It is, however, open to two Contracting States to restrict the application of the final provision in paragraph 5 to case *a)* or to extend it to case *c)*.

28. Paragraph 5 provides no solution for the case, which it excludes from its provisions, where both the beneficiary and the payer are indeed residents of the Contracting States, but the loan was borrowed for the requirements of a permanent establishment owned by the payer in a third State and the interest is borne by that establishment. As paragraph 5 now stands, therefore, only its first sentence will apply in such a case. The interest will be deemed to arise in the Contracting State of which the payer is a resident and not in the third State in whose territory is situated the permanent establishment for the account of which the loan was effected and by which the interest is payable. Thus the interest will be taxed both in the Contracting State of which the payer is a resident and in the Contracting State of which the beneficiary is a resident. But, although double taxation will

be avoided between these two States by the arrangements provided in the Article, it will not be avoided between them and the third State if the latter taxes the interest on the loan at the source when it is borne by the permanent establishment in its territory.

29. It has been decided not to deal with that case in the Convention. The Contracting State of the payer's residence does not, therefore, have to relinquish its tax at the source in favour of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne. If this were not the case and the third State did not subject the interest borne by the permanent establishment to source taxation, there could be attempts to avoid source taxation in the Contracting State through the use of a permanent establishment situated in such a third State. States for which this is not a concern and that wish to address the issue described in the paragraph above may do so by agreeing to use, in their bilateral convention, the alternative formulation of paragraph 5 suggested in paragraph 30 below. The risk of double taxation just referred to could also be avoided through a multilateral convention. Also, if in the case described in paragraph 28, the State of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States together with, where appropriate, the State of the beneficiary's residence, from concerting measures to avoid the double taxation that would result from such claims using, where necessary, the mutual agreement procedure (as envisaged in paragraph 3 of Article 25).

30. As mentioned in paragraph 29, any such double taxation could be avoided either through a multilateral convention or if the State of the beneficiary's residence and the State of the payer's residence agreed to word the second sentence of paragraph 5 in the following way, which would have the effect of ensuring that paragraphs 1 and 2 of the Article did not apply to the interest, which would then typically fall under Article 7 or 21:

Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident a permanent establishment [or a fixed base] in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment [or fixed base] is situated.

31. If two Contracting States agree in bilateral negotiations to reserve to the State where the beneficiary of the income resides the exclusive right to tax such income, then ipso facto there is no value in inserting in the convention which fixes their relations that provision in paragraph 5 which defines the State of source of such income. But it is equally obvious that double taxation would not be fully avoided in such a case if the payer of the interest owned, in a third State which charged its tax at the source on the interest, a permanent establishment for the account of which the loan had been borrowed and which bore the interest payable on it. The case would then be just the same as is contemplated [...] above.

Paragraph 6

22. This paragraph reproduces Article 11, paragraph 6, of the OECD Model Convention, the Commentary on which reads as follows:

32. The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of interest in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the Article apply only to that last-mentioned amount and that the excess part of the interest shall remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention.

33. It is clear from the text that for this clause to apply the interest held excessive must be due to a special relationship between the payer and the beneficial owner or between both of them and some other person. There may be cited as examples cases where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.

34. On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest.

35. With regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under paragraph 6 of Article 11 it would be necessary to as a minimum to remove the limiting phrase “having regard to the debt-claim for which it is paid”. If greater clarity of intent is felt appropriate, a phrase such as “for whatever reason” might be added after “exceeds”. Either of these alternative versions would apply where some or all of an interest payment is excessive because the amount of the loan or the terms relating to it (including the rate of interest) are not what would have been agreed upon in the absence of the special relationship. Nevertheless, this paragraph can affect not only the recipient but also the payer of excessive interest and if the law of the State of source permits, the excess amount can be disallowed as a deduction, due regard being had to other applicable provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the interest, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 6, as long as they do not alter its general purport.

36. Should the principles and rules of their respective laws oblige the two Contracting States to apply different Articles of the Convention for the purpose of taxing the excess, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty.

23. When this issue was last considered, some members of the former Group of Experts pointed out that there are many artificial devices entered into by persons to take advantage of the provisions of Article 11 through, *inter alia*, creation or assignment of debt claims in respect of which interest is charged. While substance over form rules, abuse of rights principle or any similar doctrine could be used to counter such arrangements, Contracting States which may want to specifically address the issue may include a clause on the following lines in their bilateral tax treaties during negotiations, namely:

The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the

creation or assignment of the debt claim in respect of which the interest is paid to take advantage of this Article by means of that creation or assignment.

Article 12

ROYALTIES

A. GENERAL CONSIDERATIONS

1. Article 12 of the United Nations Model Convention reproduces Article 12 of the OECD Model Convention, with the following exceptions: first, substantive differences appear in paragraphs 1 and 3; second, paragraphs 2 and 5 do not appear in the OECD Model Convention with the result that the paragraph numbers in the United Nations Model Convention differ from those in the OECD Model Convention; and third, a drafting adjustment is made in paragraph 4.

2. When the user of a patent or similar property is resident in one country and pays royalties to the owner of the property who is resident in another country, the amount paid by the user is generally subject to withholding tax in his country, the source country. The source country tax is imposed on the gross payments, with no allowance for any related expenses incurred by the owner. Without recognition of expenses, the owner's after-tax profit may in some cases be only a small percentage of gross royalties. Consequently, the owner may take the withholding tax in the source country into account in fixing the amount of the royalty, so that the user and the source country will pay more for the use of the patent or similar property than they would if the withholding tax levied by the source country were lower and took into account the expenses incurred by the owner. A manufacturing enterprise or an inventor may have spent substantial sums on the development of the property generating the royalties, because the work of research and testing involves considerable capital outlays and does not always yield successful results. The problem of determining the appropriate tax rate to be applied by the source country to gross royalty payments is therefore complex, especially since the user may make a lump sum payment for the use of the patent or similar property, in addition to regular royalty payments.

3. The Commentary on Article 12 of the OECD Model Convention includes the following preliminary remarks:

1. In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from

a letting. The letting may be granted in connection with an enterprise (e.g. the use of literary copyright granted by a publisher or the use of a patent granted by the inventor) or quite independently of any activity of the grantor (e.g. use of a patent granted by the inventor's heirs).

2. Certain countries do not allow royalties paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the royalties are paid by a resident of a Contracting State to a resident of the other State is dealt with in paragraph 4 of Article 24.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 12

Paragraphs 1 and 2

4. Paragraph 1 omits the word "only" found in the corresponding provision of the OECD Model Convention, which provides that "royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State". Paragraph 2 is an addition flowing logically from the premise underlying paragraph 1, which is that royalties may be taxable in the source country as well as the residence country. By providing for taxing rights in respect of royalties to be shared between the State of residence and the State of source, the United Nations Model Convention departs from the principle of exclusive residence State's right to tax provided in the OECD Model Convention. In this context, it should be noted that several member States of OECD have recorded reservations to the exclusive residence State taxation of royalties provided by Article 12 of the OECD Model Convention.

5. The Commentary on the OECD Model Convention contains the following relevant passages:

4. The requirement of beneficial ownership was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries. It makes plain that the State of source is not obliged to give up taxing rights over royalty income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance.

4.1 Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"³⁹ concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties.

4.2 Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, in those cases where the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all member countries). States which wish to make this more explicit are free to do so during bilateral negotiations.

6. During discussion by the former Group of Experts in 1999, members from developing countries argued that, in order to facilitate the conclusion of tax treaties between those countries and developed countries, the primary right to tax royalties should be given to the country where the income arose, that is, the source country. Patents and processes might be licensed to devel-

³⁹Reproduced in Volume II of the full-length version of the OECD Model Tax Convention, at page R(6)-1.

oping countries after they had been fully exploited elsewhere and, according to these members, after the expenses incurred in connection with their development had already been largely recouped.

7. Members from developed countries responded that it would be unrealistic to assume that enterprises selected the oldest patents for licensing to developing countries. Normally, an enterprise would license its patents to foreign subsidiaries and therefore select the most up-to-date inventions, in the hope of expanding existing markets or opening up new ones. Patents are not merchandise but instruments for promoting industrial production. Several members from developed countries held as a matter of principle that the country of residence of the owner of a patent or similar property should have the exclusive or primary right to tax royalties paid thereon.

8. Since the former Group of Experts reached no consensus on a particular rate for the withholding tax to be charged on royalties on a gross basis, the rate should be established through bilateral negotiations. The following considerations might be taken into account in negotiations:

- First, the country of source should recognize both current expenses allocable to the royalty and expenditure incurred in the development of the property whose use gave rise to the royalty. It should be considered that the costs of developing the property are also allocable to profits derived from other royalties or activities, past or future, associated with these expenditures and that expenditure not directly incurred in the development of that property might nevertheless have contributed significantly to that development;
- Second, if an expense ratio is agreed upon in fixing a gross rate in the source country, the country of the recipient, if following a credit method, should also use that expense ratio in applying its credit, whenever feasible. Therefore, that matter should be considered under Article 23 A or 23 B.

9. Other factors might influence the determination of the withholding tax on gross royalties, including the developing countries' need to earn revenue and conserve foreign exchange; the fact that royalty payments flow almost entirely from developing countries to developed countries; the extent of assistance that developed countries should, for a variety of reasons, extend to developing countries; and the special importance of providing such assistance in the context of royalty payments; the desirability of preventing a shift of the tax burden to the licensees in the licensing arrangement; the ability that taxation at source confers on a developing country to make selective

judgements by which, through reduced taxation or exemption, it could encourage those licensing arrangements if they were considered desirable for its development; the lessening of the risks of tax evasion resulting from taxation at the source; the fact that the country of the licensor supplies the facilities and activities necessary for the development of the patent and thus undertakes the risks associated with the patent; the desirability of obtaining and encouraging a flow of technology to developing countries; the desirability of expanding the field of activity of the licensor in the utilization of the research; the benefits that developed countries obtain from world development in general; the relative importance of revenue sacrifice; the relation of the royalty decision to other decisions in the negotiations.

10. Income from film rentals should not be treated as industrial and commercial profits but should be dealt with in the context of royalties. The tax would thus be levied on a gross basis but expenses would be taken into account in fixing the withholding rate. With regard to expenses, there are factors that could be regarded as peculiarly relevant to film rentals. As a general rule, the expenses of film producers might be much higher and the profits lower than in the case of industrial royalties. On the other hand, because a considerable part of film expenses represents high salaries paid to actors and other participants who may be taxed solely by the country of residence, and not by the source country, these expenses might not justify any great reduction of the withholding tax at source. However, it could be said that the amounts involved are nevertheless real costs for the producer and should be taken into account, while at the same time all countries involved should join in efforts to make sure that such income does not escape tax. Further, while the write-off of expenses in the country of residence does not mean that the expenses should not be taken into account at source, at some point old films could present a different expense situation.

11. Some members of the former Group of Experts expressed the view that because copyright royalties represent cultural efforts, they should be exempted from taxation by the source country. Other members, however, argued that tax would be levied by the residence country, and the reduction at source would not benefit the author. Other members favoured exempting copyright royalties at the source, not necessarily for cultural reasons, but because the country of residence is in a better position to evaluate the expenses and personal circumstances of the creator of the royalties, including the period over which the books or other copyrighted items had been created; a reduction of the source country tax could be supported in some cases by the fact that the tax was too high to be absorbed by the tax credit of the residence country. However, source countries might not be willing to accept that approach to the problem. Furthermore, if the person dealing with

the source country might be the publisher and not the author, arguments supporting the exemption of the author's income because of his personal situation obviously do not apply to the publisher.

Paragraph 3

12. This paragraph reproduces Article 12, paragraph 2, of the OECD Model Convention, but does not incorporate the 1992 amendment thereto which eliminates equipment rental from this Article. Also, paragraph 3 of Article 12 includes payments for tapes and royalties which are not included in the corresponding provision of the OECD Model Convention. The following portions of the OECD Commentary are relevant (the bracketed paragraphs being portions of the Commentary that highlight differences between the United Nations Model Convention and the OECD Model Convention):

8. Paragraph 2 contains a definition of the term "royalties". These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and information concerning industrial, commercial or scientific experience. The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. The definition covers both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying or infringing the right.

8.4 As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, [equipment renting and] the provision of information.

10. Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as business profits and, in consequence, subjected to the provisions of Articles 7 and 9.

11. In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 is referring to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how. The words "payments ... for information concerning industrial, commercial or scientific experience" are used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. It generally corresponds to

undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer.

Some members of the Committee of Experts are of the view that there is no ground to limit the scope of information of an industrial, commercial or scientific nature to that arising from previous experience. The OECD Commentary then continues:

11.1 In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognised that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof.

11.2 This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Payments made under the latter contracts generally fall under Article 7 or in the case of the United Nations Model Convention Article 14.

11.3 The need to distinguish these two types of payments, *i.e.* payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

- Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.
- In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.
- In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other

hand, a contract for the performance of services would, in the majority of cases, involve a very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services.

11.4 Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

- payments obtained as consideration for after-sales service,
- payments for services rendered by a seller to the purchaser under a warranty,
- payments for pure technical assistance,
- payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information (a payment for the confidential list of customers to which the payee has provided a particular product or service would, however, constitute a payment for know-how as it would relate to the commercial experience of the payee in dealing with these customers),
- payments for an opinion given by an engineer, an advocate or an accountant, and
- payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with non-confidential information in response to frequently asked questions or common problems that arise frequently.

11.5 In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection.

11.6 In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then the treatment applicable to the principal part should generally be applied to the whole amount of the consideration.

12. Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. In 1992, the Commentary was amended to describe the principles by which such classification should be made. Paragraphs 12 to 17 were further amended in 2000 to refine the analysis by which business profits are distinguished from royalties in computer software transactions. In most cases, the revised analysis will not result in a different outcome.

12.1 Software may be described as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-Rom. It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware.

12.2 The character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer programs are a form of intellectual property. Research into the

practices of OECD member countries has established that all but one protects rights in computer programs either explicitly or implicitly under copyright law. Although the term “computer software” is commonly used to describe both the program—in which the intellectual property rights (copyright) subsist—and the medium on which it is embodied, the copyright law of most OECD member countries recognises a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program. Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.

13. The transferee’s rights will in most cases consist of partial rights or complete rights in the underlying copyright (see paragraphs 13.1 and 15 below), or they may be (or be equivalent to) partial or complete rights in a copy of the program (the “program copy”), whether or not such copy is embodied in a material medium or provided electronically (see paragraphs 14 to 14.2 below). In unusual cases, the transaction may represent a transfer of “know-how” or secret formula (paragraph 14.3).

13.1 Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (*i.e.* to exploit the rights that would otherwise be the sole prerogative of the copyright holder). It should be noted that where a software payment is properly to be regarded as a royalty there may be difficulties in applying the copyright provisions of the Article to software payments since paragraph 2 requires that software be classified as a literary, artistic or scientific work. None of these categories seems

entirely apt. The copyright laws of many countries deal with this problem by specifically classifying software as a literary or scientific work. For other countries treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of the copyrights or refers specifically to software.

14. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7.

14.1 The method of transferring the computer program to the transferee is not relevant. For example, it does not matter whether the transferee acquires a computer disk containing a copy of the program or directly receives a copy on the hard disk of her computer via a modem connection. It is also of no relevance that there may be restrictions on the use to which the transferee can put the software.

14.2 The ease of reproducing computer programs has resulted in distribution arrangements in which the transferee obtains rights to make multiple copies of the program for operation only within its own business. Such arrangements are commonly referred to as "site

licences”, “enterprise licences”, or “network licences”. Although these arrangements permit the making of multiple copies of the program, such rights are generally limited to those necessary for the purpose of enabling the operation of the program on the licensee’s computers or network, and reproduction for any other purpose is not permitted under the license. Payments under such arrangements will in most cases be dealt with as business profits in accordance with Article 7.

14.3 Another type of transaction involving the transfer of computer software is the more unusual case where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. In these cases, the payments may be characterised as royalties to the extent that they represent consideration for the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience which cannot be separately copyrighted. This contrasts with the ordinary case in which a program copy is acquired for operation by the end user.

14.4 Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation.

15. Where consideration is paid for the transfer of the full ownership of the rights in the copyright, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there is a transfer of rights involving:

- exclusive right of use of the copyright during a specific period or in a limited geographical area;
- additional consideration related to usage;
- consideration in the form of a substantial lump sum payment.

16. Each case will depend on its particular facts but in general if the payment is in consideration for the transfer of rights that constitute a distinct and specific property (which is more likely in the case of geographically-limited than time-limited rights), such payments are likely to be business profits within Article 7 (or 14 in the case of the United Nations Model Convention) or a capital gain within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most countries, by the fact that the payments are related to a contingency.

17. Software payments may be made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods set out in paragraph 11 above for dealing with similar problems in relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part.

17.1 The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made.

17.2 Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, *e.g.* because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright

(such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of "royalties".

17.3 This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (*i.e.* to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer.

17.4 By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, *i.e.* the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content.

Some members of the Committee of Experts are of the view that the payments referred to in paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 of the OECD Commentary extracted above may constitute royalties. The OECD Commentary then continues:

18. The suggestions made above regarding mixed contracts could also be applied in regard to certain performances by artists and, in particular, in regard to an orchestral concert given by a conductor or a recital given by a musician. The fee for the musical performance, together with that paid for any simultaneous radio broadcasting thereof, seems to fall to be treated under Article 17. Where, whether under the same contract or under a separate one, the musical performance is recorded and the artist has stipulated that he be paid royalties on the sale or public playing of the records, then so much of the payment received by him as consists of such royalties falls to be treated under Article 12 where, however, the copyright in a sound recording, because of either the relevant copyright law or the terms of contract, belongs to a person with whom the artist has contractually agreed to provide his services (*i.e.* a musical performance during the recording), or to a third party, the payments made under such a contract fall under Articles 7 [or Article 14 of the United Nations Model Convention] (*e.g.* if the performance takes place outside the State of source of the payment) or 17 rather than under this Article, even if these payments are contingent on the sale of the recordings.

19. It is further pointed out that variable or fixed payments for the working of mineral deposits, sources or other natural resources are governed by Article 6 and do not, therefore, fall within the present Article.

13. Paragraph 2 of Article 12 of the OECD Model Convention (corresponding to paragraph 3 of Article 12 of the United Nations Model Convention) was amended by deleting the words “or the use of, or the right to use, industrial, commercial or scientific equipment” by the Report entitled “The Revision of the Model Convention” adopted by the Council of the OECD on 23 July 1992. However, a number of OECD member countries have entered reservations on this point.

14. When the former Group of Experts considered this issue, it addressed the problems of distinguishing royalties from types of income properly subject to other articles of the Convention. A member from a developed country asserted that the problem was that the “royalties” definition makes an imperfect distinction between revenues that constituted royalties in the strict sense and payments received for brain-work and technical services, such as surveys of any kind (engineering, geological research etc.). The member also mentioned the problem of distinguishing between royalties akin to income from capital and payments received for services. Given the broad definition of “information concerning industrial, commercial or scientific experience”, some countries tend to regard the provision of brain-work and

technical services as the provision of “information concerning industrial, commercial or scientific experience” and to regard payment for such information as royalties.

15. In order to avoid those difficulties, this member proposed that the definition of royalties be restricted by excluding payments received for “information concerning industrial, commercial or scientific experience”. The member also suggested that a protocol should be annexed to the treaty making it clear that such payments should be deemed to be profits of an enterprise to which Article 7 would apply and that payments received for studies or surveys of a scientific or technical nature, such as geological surveys, or for consultant or supervisory services, should also be deemed to be business profits subject to Article 7. The effect of these provisions would be that the source country could not tax such payments unless the enterprise had a permanent establishment in that country and that taxes should only be imposed on the net income element of such payments attributable to that permanent establishment.

16. Some members from developing countries interpreted the phrase “information concerning industrial, commercial or scientific experience” to mean specialized knowledge, having intrinsic property value relating to industrial, commercial, or managerial processes, conveyed in the form of instructions, advice, teaching or formulas, plans or models, permitting the use or application of experience gathered on a particular subject. They also pointed out that the definition of the term royalties could be broadened through bilateral negotiations to include gains derived from the alienation of any such right or property that were contingent on the productivity, use or disposition thereof. The former Group of Experts agreed that literary copyrights could be interpreted to include copyrights relating to international news.

Paragraph 4

17. This paragraph reproduces with modifications Article 12, paragraph 3, of the OECD Model Convention, which states that paragraph 1 does not apply to royalties beneficially owned by a person having a permanent establishment⁴⁰ in the source country if the right or property from which the royalties derive is effectively connected with the permanent establishment.⁴¹ The former Group of Experts decided to modify paragraph 3 of the OECD Model Convention by introducing a limited force of attraction principle.

⁴⁰Or a fixed base; see Article 14 of the United Nations Model Convention.

⁴¹See footnote above.

In addition to royalties excluded from the application of paragraph 1 by paragraph 3 of the OECD Article, paragraph 4 of the United Nations Model Convention excludes royalties which are received in connection with business activities described in subparagraph (c) of paragraph 1 of Article 7 (business activities of the same or similar kind as those of a permanent establishment in the source country), even if the business activities are not carried on through a permanent establishment or a fixed base. The United Nations Model Convention also modifies the paragraph to refer to paragraph 2 as well as paragraph 1.

Paragraph 5

18. This paragraph, which provides that royalties are considered income from sources in the residence country of the payer of the royalties, is an innovation of the United Nations Model Convention, not found in Article 12 of the OECD Model Convention.

19. As in the case of interest, some members suggested that some countries may wish to substitute a rule that would identify the source of a royalty as the State in which the property or right giving rise to the royalty (the patent etc.) is used. Where, in bilateral negotiations, the two parties differ on the appropriate rule, a possible solution would be a rule which, in general, would accept the payer's place of residence as the source of royalty; but where the right or property for which the royalty was paid was used in the State having a place of use rule, the royalty would be deemed to arise in that State.

Paragraph 6

20. This paragraph reproduces Article 12, paragraph 4, of the OECD Model Convention, the Commentary on which reads as follows:

22. The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of royalties in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the Article apply only to that last-mentioned amount and that the excess part of the royalty shall remain taxable according to the laws of the two Contracting States due regard being had to the other provisions of the Convention. The paragraph permits only the adjustment of the

amount of royalties and not the reclassification of the royalties in such a way as to give it a different character, *e.g.* a contribution to equity capital. For such an adjustment to be possible under paragraph 4 of Article 12 it would be necessary as a minimum to remove the limiting phrase “having regard to the use, right or information for which they are paid”. If greater clarity of intent is felt appropriate, a phrase such as “for whatever reason” might be added after “exceeds”.

23. It is clear from the text that for this clause to apply the payment held excessive must be due to a special relationship between the payer and the beneficial owner or between both of them and some other person. There may be cited as examples cases where royalties are paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.

24. On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the royalty.

25. With regard to the taxation treatment to be applied to the excess part of the royalty, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purpose of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases required, to the excess part of the royalties there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 4, as long as they do not alter its general purport.

26. Should the principles and rules of their respective laws oblige the two Contracting States to apply different Articles of the Convention for the purpose of taxing the excess, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty.

21. When this issue was last considered by the former Group of Experts, some members pointed out that there are artificial devices entered into by persons to take advantage of the provisions of Article 12 through, *inter alia*, creation or assignment of agreements for the use, right or information with

respect to intangible assets for which royalties are charged. While substance over form rules, abuse of rights principles or any similar doctrine could be used to counter such arrangements, Contracting States which may want to specifically address the issue may include a clause on the following lines in their bilateral tax treaties:

The provisions of this Article shall not apply if it was the main purpose, or one of the main purposes, of any persons concerned with the creation or the assignment of the rights in respect of which the royalties are paid to take advantage of this Article by means of that creation or assignment.

Article 13

CAPITAL GAINS

A. GENERAL CONSIDERATIONS

1. Article 13 of the United Nations Model Convention consists of the first three paragraphs of Article 13 of the OECD Model Convention. Paragraph 4 broadly corresponds with paragraph 4 of the OECD Model Convention and paragraph 5 is a distinct provision in the United Nations Model Convention. Paragraph 6 is the same as paragraph 5 of the OECD Model Convention but adjusted to take into account the insertion of the additional paragraph.

2. The text of this Article resulted from a compromise which the former Group of Experts felt would be most acceptable to both developed and developing countries. Some members from developed countries advocated the use of Article 13 of the OECD Model Convention, which (1) allows the source country to tax capital gains from the alienation of immovable property and from movable property that is a part of a permanent establishment or pertains to a fixed base for performing independent personal services, (2) permits gains from the alienation of ships and aircraft to be taxed only in the State of effective management of the relevant enterprises, and (3) reserves to the residence country the right to tax gains on the alienation of other types of property. Most members from developing countries advocated the right of the source country to levy a tax in situations in which the OECD reserves that right to the country of residence.

3. Concerning the taxation of capital gains in both developed and developing countries, the following remarks from the preliminary remarks in the Commentary on Article 13 of the OECD Model Convention are pertinent:

1. A comparison of the tax laws of the OECD member countries shows that the taxation of capital gains varies considerably from country to country:

- in some countries capital gains are not deemed to be taxable income;
- in other countries capital gains accrued to an enterprise are taxed, but capital gains made by an individual outside the course of his trade or business are not taxed;
- even where capital gains made by an individual outside the course of his trade or business are taxed, such taxation often applies only in specified cases, e.g. profits from the sale of immovable property or speculative gains (where an asset was bought to be resold).

2. Moreover, the taxes on capital gains vary from country to country. In some OECD member countries, capital gains are taxed as ordinary income and therefore added to the income from other sources. This applies especially to the capital gains made by the alienation of assets of an enterprise. In a number of OECD member countries, however, capital gains are subjected to special taxes, such as taxes on profits from the alienation of immovable property, or general capital gains taxes, or taxes on capital appreciation (increment taxes). Such taxes are levied on each capital gain or on the sum of the capital gains accrued during a year, mostly at special rates, which do not take into account the other income (or losses) of the taxpayer. It does not seem necessary to describe all those taxes.

3. The Article does not deal with the above-mentioned questions. It is left to the domestic law of each Contracting State to decide whether capital gains should be taxed and, if they are taxable, how they are to be taxed. The Article can in no way be construed as giving a State the right to tax capital gains if such right is not provided for in its domestic law. The Article does not specify to what kind of tax it applies. It is understood that the Article must apply to all kinds of taxes levied by a Contracting State on capital gains. The wording of Article 2 is large enough to achieve this aim and to include also special taxes on capital gains.

4. The OECD Commentary on Article 13 contains the following general remarks:

4. It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom. The right

to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such gain is a capital gain or a business profit. Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question.

5. The Article does not give a detailed definition of capital gains. This is not necessary for the reasons mentioned above. The words “alienation of property” are used to cover in particular capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.

6. Most States taxing capital gains do so when an alienation of capital assets takes place. Some of them, however, tax only so-called realised capital gains. Under certain circumstances, though there is an alienation no realised capital gain is recognised for tax purposes (e.g. when the alienation proceeds are used for acquiring new assets). Whether or not there is a realisation has to be determined according to the applicable domestic tax law. No particular problems arise when the State which has the right to tax does not exercise it at the time the alienation takes place.

7. As a rule, appreciation in value not associated with the alienation of a capital asset is not taxed, since, as long as the owner still holds the asset in question, the capital gain exists only on paper. There are, however, tax laws under which capital appreciation and revaluation of business assets are taxed even if there is no alienation.

8. Special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated. This may be the case if the value of a capital asset has increased in such a manner that the owner proceeds to the revaluation of this asset in his books. Such revaluation of assets in the books may also occur in the case of a depreciation of the national currency. A number of States levy special taxes on such book profits, amounts put into reserve, an increase in the paid-up capital and other revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset. These taxes on capital appreciation (increment taxes) are covered by the Convention according to Article 2.

9. Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the Article or to lay down special rules. The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment [or pertaining to a fixed base], the prior right to tax belongs to the State where such property is situated. Special attention must be drawn, however, to the cases dealt with in paragraphs 13 to 17 below.

10. In some States the transfer of an asset from a permanent establishment situated in the territory of such State to a permanent establishment or the head office of the same enterprise situated in another State is assimilated to an alienation of property. The Article does not prevent these States from taxing profits or gains deemed to arise in connection with such a transfer, provided, however, that such taxation is in accordance with Article 7.

11. The Article does not distinguish as to the origin of the capital gain. Therefore all capital gains, those accruing over a long term, parallel to a steady improvement in economic conditions, as well as those accruing in a very short period (speculative gains) are covered. Also capital gains which are due to depreciation of the national currency are covered. It is, of course, left to each State to decide whether or not such gains should be taxed.

12. The Article does not specify how to compute a capital gain, this being left to the domestic law applicable. As a rule, capital gains are calculated by deducting the cost from the selling price. To arrive at cost all expenses incidental to the purchase and all expenditure for improvements are added to the purchase price. In some cases the cost after deduction of the depreciation allowances already given is taken into account. Some tax laws prescribe another base instead of cost, *e.g.* the value previously reported by the alienator of the asset for capital tax purposes.

13. Special problems may arise when the basis for the taxation of capital gains is not uniform in the two Contracting States. The capital gain from the alienation of an asset computed in one State according to the rules mentioned in paragraph 12 above, may not necessarily coincide with the capital gain computed in the other State under the accounting rules used there. This may occur when one State has the

right to tax capital gains because it is the State of situs while the other State has the right to tax because the enterprise is a resident of that other State.

14. The following example may illustrate this problem: an enterprise of State A bought immovable property situated in State B. The enterprise may have entered depreciation allowances in the books kept in State A. If such immovable property is sold at a price which is above cost, a capital gain may be realised and, in addition, the depreciation allowances granted earlier may be recovered. State B, in which the immovable property is situated and where no books are kept, does not have to take into account, when taxing the income from the immovable property, the depreciation allowances booked in State A. Neither can State B substitute the value of the immovable property shown in the books kept in State A for the cost at the time of the alienation. State B cannot, therefore, tax the depreciation allowances realised in addition to the capital gain as mentioned in paragraph 12 above.

15. On the other hand, State A of which the alienator is a resident, cannot be obliged in all cases to exempt such book profits fully from its taxes under paragraph 1 of the Article and Article 23 A (there will be hardly any problems for States applying the tax credit method). To the extent that such book profits are due to the realisation of the depreciation allowances previously claimed in State A and which had reduced the income or profits taxable in such State A, that State cannot be prevented from taxing such book profits [...].

16. Further problems may arise in connection with profits due to changes of the rate of exchange between the currencies of State A and State B. After the devaluation of the currency of State A, enterprises of such State A may, or may have to, increase the book value of the assets situated outside the territory of State A. Apart from any devaluation of the currency of a State, the usual fluctuations of the rate of exchange may give rise to so-called currency gains or losses. Take for example an enterprise of State A having bought and sold immovable property situated in State B. If the cost and the selling price, both expressed in the currency of State B, are equal, there will be no capital gain in State B. When the value of the currency of State B has risen between the purchase and the sale of the asset in relation to the currency of State A, in the currency of that State a profit will accrue to such enterprise. If the value of the currency of State B has fallen in the meantime, the alienator will sustain a loss which will not be recognised in State B. Such currency gains or losses may also arise in connection with claims and debts contracted in a foreign currency.

If the balance sheet of a permanent establishment situated in State B of an enterprise of State A shows claims and debts expressed in the currency of State B, the books of the permanent establishment do not show any gain or loss when repayments are made. Changes of the rate of exchange may be reflected, however, in the accounts of the head office. If the value of the currency of State B has risen (fallen) between the time the claim has originated and its repayment, the enterprise, as a whole will realise a gain (sustain a loss). This is true also with respect to debts if between the time they have originated and their repayment, the currency of State B has fallen (risen) in value.

17. The provisions of the Article do not settle all questions regarding the taxation of such currency gains. Such gains are in most cases not connected with an alienation of the asset; they may often not even be determined in the State on which the right to tax capital gains is conferred by the Article. Accordingly, the question, as a rule, is not whether the State in which a permanent establishment is situated has a right to tax, but whether the State of which the taxpayer is a resident must, if applying the exemption method, refrain from taxing such currency gains which, in many cases, cannot be shown but in the books kept in the head office. The answer to that latter question depends not only on the Article but also on Article 7 and on Article 23 A. If in a given case differing opinions of two States should result in an actual double taxation, the case should be settled under the mutual agreement procedure provided for by Article 25.

18. Moreover the question arises which Article should apply when there is paid for property sold an annuity during the lifetime of the alienator and not a fixed price. Are such annuity payments, as far as they exceed costs, to be dealt with as a gain from the alienation of the property or as "income not dealt with" according to Article 21? Both opinions may be supported by arguments of equivalent weight, and it seems difficult to give one rule on the matter. In addition such problems are rare in practice, so it therefore seems unnecessary to establish a rule for insertion in the Convention. It may be left to Contracting States who may be involved in such a question to adopt a solution in the mutual agreement procedure provided for by Article 25.

19. The Article is not intended to apply to prizes in a lottery or to premiums and prizes attaching to bonds or debentures.

20. The Article deals first with the gains which may be taxed in the State where the alienated property is situated. For all other capital gains, paragraph [6] gives the right to tax to the State of which the alienator is a resident.

21. As capital gains are not taxed by all States, it may be considered reasonable to avoid only actual double taxation of capital gains. Therefore, Contracting States are free to supplement their bilateral convention in such a way that a State has to forego its right to tax conferred on it by the domestic laws only if the other State on which the right to tax is conferred by the Convention makes use thereof. In such a case, paragraph [6] of the Article should be supplemented accordingly. Besides, a modification of Article 23 A as suggested in [...] the Commentary on Article 23 A is needed.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 13

Paragraph 1

5. This paragraph reproduces Article 13, paragraph 1, of the OECD Model Convention, the Commentary on which is as follows:

22. Paragraph 1 states that gains from the alienation of immovable property may be taxed in the State in which it is situated. This rule corresponds to the provisions of Article 6 and of paragraph 1 of Article 22. It applies also to immovable property forming part of the assets of an enterprise [or used for performing independent personal services]. For the definition of immovable property paragraph 1 refers to Article 6. Paragraph 1 of Article 13 deals only with gains which a resident of a Contracting State derives from the alienation of immovable property situated in the other Contracting State. It does not, therefore, apply to gains derived from the alienation of immovable property situated in the Contracting State of which the alienator is a resident in the meaning of Article 4 or situated in a third State; the provisions of paragraph 5 [paragraph 6 of the United Nations text] shall apply to such gains (and not, as was mentioned in this Commentary before 2002, those of paragraph 1 of Article 21.

23. The rules of paragraph 1 are supplemented by those of paragraph 4, which applies to gains from the alienation of all or part of the shares in a company holding immovable property [...].

Paragraph 2

6. This paragraph reproduces Article 13, paragraph 2, of the OECD Model Convention, the Commentary on which reads as follows:

24. Paragraph 2 deals with movable property forming part of the business property of a permanent establishment of an enterprise [or pertaining to a fixed base used for performing independent personal services]. The term “movable property” means all property other than immovable property which is dealt with in paragraph 1. It includes also incorporeal property, such as goodwill, licences, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment [or fixed base] is situated, which corresponds to the rules for business profits [and for income from independent personal services] (Article[s] 7 [and 14]).

25. The paragraph makes clear that its rules apply when movable property of a permanent establishment [or fixed base] is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) [or the fixed base as such] is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment. The rules of Article 7 should then apply *mutatis mutandis* without express reference thereto. For the transfer of an asset from a permanent establishment in one State to a permanent establishment (or the head office) in another State, see paragraph 10 above.

26. On the other hand, paragraph 2 may not always be applicable to capital gains from the alienation of a participation in an enterprise. The provision applies only to property which was owned by the alienator, either wholly or jointly with another person. Under the laws of some countries, capital assets of a partnership are considered to be owned by the partners. Under some other laws, however, partnerships and other associations are treated as body corporate for tax purposes, distinct from their partners (members), which means that participations in such entities are dealt with in the same way as shares in a company. Capital gains from the alienation of such participations, like capital gains from the alienation of shares, are therefore taxable only in the State of residence of the alienator. Contracting States may agree bilaterally on special rules governing the taxation of capital gains from the alienation of a participation in a partnership.

27. Certain States consider that all capital gains arising from sources in their territory should be subject to their taxes according to their domestic laws, if the alienator has a permanent establishment within their territory. Paragraph 2 is not based on such a conception which is sometimes referred to as “the force of attraction of the permanent establishment”. The paragraph merely provides that gains

from the alienation of movable property forming part of the business property of a permanent establishment [or of movable property pertaining to a fixed base used for performing independent personal services] may be taxed in the State where the permanent establishment [or the fixed base] is situated. The gains from the alienation of all other movable property are taxable only in the State of residence of the alienator as provided in paragraph [6]. The foregoing explanations accord with those in the Commentary on Article 7.

Paragraph 3

7. This paragraph reproduces Article 13, paragraph 3, of the OECD Model Convention, the Commentary on which is as follows:

28. An exception from the rule of paragraph 2 is provided for ships and aircraft operated in international traffic and for boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, aircraft and boats. Normally, gains from the alienation of such assets are taxable only in the State in which the place of effective management of the enterprise operating such ships, aircraft and boats is situated. This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 22. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of such enterprise is aboard a ship or a boat. Contracting States which would prefer to confer the exclusive taxing right on the State of residence or to use a combination of the residence criterion and the place of effective management criterion are free, in bilateral conventions, to substitute for paragraph 3 a provision corresponding to those proposed in [...] the Commentary on Article 8.

Paragraph 4

8. This paragraph, which broadly corresponds to paragraph 4 of the OECD Model Convention, allows a Contracting State to tax a gain on an alienation of shares of a company or on an alienation of interests in other entities the property of which consists principally of immovable property situated in that State. It is designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of a company to hold such property, it is necessary to tax the sale of shares in such a company. This is especially so where ownership of the shares carries the right to occupy the property. In order to achieve its objective, paragraph 4 would have to

apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State. In 1999, the former Group of Experts decided to amend paragraph 4 to expand its scope to include interests in partnerships, trusts and estates which own immovable property. It also decided to exclude from its scope such entities whose property consists directly or indirectly principally of immovable property used by them in their business activities. However, this exclusion will not apply to an immovable property management company, partnership, trust or estate. In order to fulfil its purpose, paragraph 4 must apply whether the company, partnership, trust or estate owns the immovable property directly or indirectly, such as, through one or more interposed entities. Contracting States may agree in bilateral negotiations that paragraph 4 also applies to gains from the alienation of other corporate interests or rights forming part of a substantial participation in a company. For the purpose of this paragraph, the term “principally” in relation to the ownership of an immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by such company, partnership, trust or estate.

Paragraph 5

9. Some countries hold the view that a Contracting State should be able to tax a gain on the alienation of shares of a company resident in that State, whether the alienation occurs within or outside that State. However, it is recognized that for administrative reasons the right to tax should be limited to the alienation of shares of a company in the capital of which the alienator at any time during the 12-month period preceding the alienation, held, directly or indirectly, a substantial participation. In this context, “12-month period” means the period beginning with the date which is one calendar year earlier than the date of the alienation and ending at the time of the alienation. The determination of what is a substantial participation is left to bilateral negotiations, in the course of which an agreed percentage can be determined.

10. This paragraph provides for taxation of a gain on the alienation of shares as contemplated in the paragraph above but excludes gains from the alienation of shares to which paragraph 4 of Article 13 of the Convention applies. The wording clearly stipulates that a gain on the alienation of any number of shares may be taxed in the State in which the company is a resident as long as the shareholding is substantial at any time during the 12-month period preceding the alienation. A substantial shareholding is determined according to the percentage shareholding decided in the relevant bilateral negotiations. Consequently, even if a substantial shareholding is alienated

through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12-month period.

11. It will be up to the law of the State imposing the tax to determine which transactions give rise to a gain on the alienation of shares and how to determine the level of holdings of the alienator, in particular, how to determine an interest held indirectly. An indirect holding in this context may include ownership by related persons that is imputed to the alienator. Anti-avoidance rules of the law of the State imposing the tax may also be relevant in determining the level of the alienator's direct or indirect holdings. The treaty text itself or associated documents could alternatively expand on the meaning of these concepts.

12. The question of laying down a concessionary rate of tax (compared with the normal domestic rate) on gains arising on alienation of shares, other than the shares referred to in paragraph 4, that is, not being shares of companies principally owning immovable property, has also been considered. Since the gains arising on alienation of shares being taxed in a concessionary manner is likely to encourage investment in shares, promote foreign direct investment and portfolio investment, and thereby give impetus to the industrialization of the country, countries may consider discussing this matter during bilateral negotiations and making necessary provision in the bilateral tax treaties.

13. It is costly to tax gains from the alienation of quoted shares. In addition, developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares. Countries that wish to do so may include in their bilateral tax treaties the following:

Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, excluding shares in which there is substantial and regular trading on a recognized stock exchange, may be taxed in that other State if the alienator, at any time during the 12-month period preceding such alienation, held directly or indirectly at least ____ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.

The treaty text itself or associated documents could expand on the meaning of the phrases "substantial and regular trading" and "recognized stock exchange".

14. Some countries might consider that the Contracting State in which a company is resident should be allowed to tax the alienation of its shares only

if a substantial portion of the company's assets are situated in that State and in bilateral negotiations might seek to include such a limitation.

15. Other countries engaged in bilateral negotiations might seek to have paragraph 5 omitted entirely, where they take the view that taxation in the source State of capital gains in these situations may create economic double taxation in the corporate chain, thus hampering foreign direct investment. This consideration is, in particular, relevant for countries that apply a participation exemption not only to dividends received from a substantial shareholding, but also to capital gains made on shares in relation to such substantial holdings.

16. If countries choose not to tax the gains derived in the course of corporate reorganizations, they are of course also free to do so.

Paragraph 6

17. This paragraph reproduces Article 13, paragraph 5, of the OECD Model Convention with a drafting adjustment replacing the words “in paragraphs 1, 2, 3 and 4” with “in paragraphs 1, 2, 3, 4 and 5”. The Commentary on Article 13, paragraph 5, of the OECD Model Convention is therefore relevant, *mutatis mutandis*, to paragraph 6. That Commentary reads as follows:

29. As regards gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3[, 4] and [5], paragraph [6] provides that they are taxable only in the State of which the alienator is a resident [...].

30. The Article does not contain special rules for gains from the alienation of shares in a company (other than shares of a company dealt with in paragraph[s] 4 [and 5]) or of securities, bonds, debentures and the like. Such gains are, therefore, taxable only in the State of which the alienator is a resident.

31. If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price and the par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated profits and not as a capital gain. The Article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in Article 10: such taxation is permitted because such difference is covered by the definition of the term “dividends” contained in paragraph 3 of Article 10 and interpreted in paragraph 28 of the

Commentary relating thereto. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with Article 11 (see also paragraphs 20 and 21 of the Commentary on Article 11).

32. There is a need to distinguish the capital gain that may be derived from the alienation of shares acquired upon the exercise of a stock-option granted to an employee or member of a board of directors from the benefit derived from the stock-option that is covered by Articles 15 or 16. The principles on which that distinction is based are discussed in paragraphs 12.2 to 12.5 of the Commentary on Article 15 and paragraph 3.1 of the Commentary on Article 16 [of the OECD Model Convention].

18. However, as indicated in paragraph 2 above, most members from developing countries suggested the following alternative to Article 13, paragraph 5, of the OECD Model Convention:

5. Gains from the alienation of any property other than those gains mentioned in paragraphs 1, 2, 3 and 4 may be taxed in the Contracting State in which they arise according to the law of that State.

This alternative is equivalent to saying that either or both States may tax according to their own laws and that the State of residence will eliminate double taxation under Article 23. Countries choosing this alternative may wish through bilateral negotiations to clarify which particular source rules will apply to establish where a gain shall be considered to arise.

Article 14

INDEPENDENT PERSONAL SERVICES

1. Article 14 of the United Nations Model Convention reproduces in paragraph 1, subparagraph (a) and paragraph 2 the essential provisions of Article 14 of the OECD Model Convention (1997 version). The whole of Article 14 and the Commentary thereon were deleted from the OECD Model Convention on 29 April 2000. Paragraph 1, subparagraph (b), allows the country of source to tax in one situation in addition to the one contained in Article 14, paragraph 1, of the 1997 OECD Model Convention. More completely, while the former OECD Model Convention allowed the source

country to tax income from independent personal services only if the income was attributable to a fixed base of the taxpayer, the United Nations Model Convention also allows taxation at source if the taxpayer is present in that country for more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned.

2. In the discussion of Article 14, some members from developing countries expressed the view that taxation by the source country should not be restricted by the criteria of existence of a fixed base and length of stay and that the source of income should be the only criterion. Some members from developed countries, on the other hand, felt that the exportation of skills, like the exportation of tangible goods, should not give rise to taxation in the country of destination unless the person concerned has a fixed base in that country comparable to a permanent establishment. They therefore supported the fixed base criterion, although they also accepted that taxation in the source country is justified by continued presence in that country of the person rendering the service. Some members from developing countries also expressed support for the fixed base criterion. Other members from developing countries expressed preference for the criterion based on length of stay.

3. In developing the 1980 Model, several members from developing countries had proposed a third criterion, namely, the amount of remuneration. Under that criterion, remuneration for independent personal services could be taxed by the source country if it exceeded a specified amount, regardless of the existence of a fixed base or the length of stay in that country.

4. As a compromise, the 1980 Model included three alternative criteria found in subparagraphs (a)–(c) of paragraph 1, the satisfaction of any one of which would give the source country the right to tax the income derived from the performance of personal activities by an individual who is a resident of the other State. However, in 1999, the former Group of Experts decided to omit the third criterion, namely, the amount of remuneration, specified in subparagraph (c), retaining subparagraphs (a) and (b).

5. Subparagraph (a), which reproduces the sole criterion in the OECD Model Convention, provides that the income may be taxed if the individual has a fixed base regularly available to him for performing his activities. Though the presence of a fixed base gives the right to tax, the amount of income that is subject to tax is limited to that which is attributable to the fixed base.

6. Subparagraph (b) as amended in 1999, extends the source country's right to tax by providing that the source country may tax if the

individual is present in the country for a period or periods aggregating at least 183 days in any twelve-month period commencing or ending in the fiscal year concerned, even if there is no fixed base. Only income derived from activities exercised in that country, however, may be taxed. Prior to the amendment, the requirement of minimum stay in the Contracting State was a “period or periods amounting to or exceeding in the aggregate 183 days in the fiscal year concerned”. A member from a developed country, however, expressed a preference for retaining the previous wording for technical reasons. By virtue of the amendment, the provisions of Article 14, paragraph 1, subparagraph (b), have been brought on a par with those of Article 15, paragraph 2, subparagraph (a), relating to the minimum period of stay in the other Contracting State.

7. Prior to its deletion, subparagraph (c) provided a further criterion for source country tax when neither of the two conditions specified in subparagraphs (a) and (b) is met. It was provided that if the remuneration for the services performed in the source country exceeds a certain amount (to be determined in bilateral negotiations), the source country may tax, but only if the remuneration is received from a resident of the source country or from a permanent establishment or fixed base of a resident of any other country which is situated in that country.

8. It was observed that any monetary ceiling limit fixed in this behalf becomes meaningless over a period of time due to inflation and would only have the effect of limiting the amount of potentially valuable services that the country will be able to import. Moreover, the provision to this effect appeared only in 6 per cent of the existing bilateral tax treaties finalized between 1980 and 1997. It was, accordingly, decided to delete subparagraph (c) of paragraph 1 of Article 14.

9. The former Group of experts discussed the relationship between Article 14 and subparagraph 3(b) of Article 5. It was generally agreed that remuneration paid directly to an individual for the performance of activity in an independent capacity was subject to the provisions of Article 14. Payments to an enterprise in respect of the furnishing by that enterprise of the activities of employees or other personnel are subject to Articles 5 and 7. The remuneration paid by the enterprise to the individual who performed the activities is subject either to Article 14 (if he is an independent contractor engaged by the enterprise to perform the activities) or Article 15 (if he is an employee of the enterprise). If the parties believe that further clarification of the relationship between Article 14 and Articles 5 and 7 is needed, they may make such clarification in the course of negotiations.

10. Since Article 14 of the United Nations Model Convention contains all the essential provisions of Article 14 of the 1997 OECD Model Convention, the former OECD Commentary on that Article is relevant. That Commentary reads as follows:

1. The Article is concerned with what are commonly known as professional services and with other activities of an independent character. This excludes industrial and commercial activities and also professional services performed in employment, *e.g.* a physician serving as a medical officer in a factory. It should, however, be observed that the Article does not concern independent activities of artistes and sportsmen, these being covered by Article 17.

2. The meaning of the term “professional services” is illustrated by some examples of typical liberal professions. The enumeration has an explanatory character only and is not exhaustive. Difficulties of interpretation which might arise in special cases may be solved by mutual agreement between the competent authorities of the Contracting States concerned.

3. The provisions of the Article are similar to those for business profits and rest in fact on the same principles as those of Article 7. The provisions of Article 7 and the Commentary thereon could therefore be used as guidance for interpreting and applying Article 14. Thus the principles laid down in Article 7 for instance as regards allocation of profits between head office and permanent establishment could be applied also in apportioning income between the State of residence of a person performing independent personal services and the State where such services are performed from a fixed base. Equally, expenses incurred for the purposes of a fixed base, including executive and general expenses, should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment [...]. Also in other respects Article 7 and the Commentary thereon could be of assistance for the interpretation of Article 14, *e.g.* in determining whether computer software payments should be classified as commercial income within Article 7 or 14 or as royalties within Article 12.

4. Even if Articles 7 and 14 are based on the same principles, it was thought that the concept of permanent establishment should be reserved for commercial and industrial activities. The term “fixed base” has therefore been used. It has not been thought appropriate to try to define it, but it would cover, for instance, a physician’s consulting room or the office of an architect or a lawyer. A person performing independent personal services would probably not as a rule have premises

of this kind in any other State than of his residence. But if there is in another State a centre of activity of a fixed or a permanent character, then that State should be entitled to tax the person's activities.

11. Some countries interpret Article 14 differently from the interpretation delineated in paragraphs 9 and 10 above. These countries may, therefore, wish to clarify their positions and agree on these aspects bilaterally, if not already dealt with.

Article 15

DEPENDENT PERSONAL SERVICES

1. Article 15 of the United Nations Model Convention reproduces Article 15 of the OECD Model Convention. The only differences are that the heading of the OECD Article now reads "INCOME FROM EMPLOYMENT" and the reference to "fixed base" in paragraph 2, subparagraph c) has been taken out. These changes stem from the elimination of Article 14 from the OECD Model Convention in 2000. The Commentary on Article 15 of the OECD Model Convention reads as follows:

1. Paragraph 1 establishes the general rule as to the taxation of income from employment (other than pensions), namely, that such income is taxable in the State where the employment is actually exercised. The issue of whether or not services are provided in the exercise of an employment may sometimes give rise to difficulties which are discussed in paragraphs 8.1 ff. Employment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid. One consequence of this would be that a resident of a Contracting State who derived remuneration, in respect of an employment, from sources in the other State could not be taxed in that other State in respect of that remuneration merely because the results of this work were exploited in that other State.

2. The general rule is subject to exception only in the case of pensions (Article 18) and of remuneration and pensions in respect of government service (Article 19). Non-employment remuneration of members of boards of directors of companies is the subject of Article 16.

2.1 Member countries have generally understood the term "salaries, wages and other similar remuneration" to include benefits in kind received in respect of an employment (e.g. stock-options, the use of a residence or automobile, health or life insurance coverage and club memberships).

2.2 The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee.

3. Paragraph 2 contains, however, a general exception to the rule in paragraph 1. This exception covers all individuals rendering [dependent personal] services in the course of an employment (sales representatives, construction workers, engineers, etc.), to the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or artistes and sportsmen.

4. The three conditions prescribed in this paragraph must be satisfied for the remuneration to qualify for the exemption. The first condition is that the exemption is limited to the 183 day period. It is further stipulated that this time period may not be exceeded “in any twelve month period commencing or ending in the fiscal year concerned”. This contrasts with the 1963 Draft Convention and the 1977 Model Convention which provided that the 183 day period⁴² should not be exceeded “in the fiscal year concerned”, a formulation that created difficulties [in cases] where the fiscal years of the Contracting States did not coincide and which opened up opportunities in the sense that operations were sometimes organised in such a way that, for example, workers stayed in the State concerned for the last 5 1/2 months of one year and the first 5 1/2 months of the following year. The present wording of subparagraph 2 a) does away with such opportunities for tax avoidance. In applying that wording, all possible periods of twelve consecutive months must be considered, even periods which overlap others to a certain extent. For instance, if an employee is present in a State during 150 days between 1 April 01 and 31 March 02 but is present there during 210 days between 1 August 01 and 31 July 02, the employee will have been present for a period exceeding 183 days during the second 12 month period identified above even though he did not meet the minimum presence test during the first period considered and that first period partly overlaps the second.

5. Although various formulas have been used by member countries to calculate the 183 day period, there is only one way which is consistent with the wording of this paragraph: the “days of physical presence” method. The application of this method is straightforward

⁴²The same change was made in 1999 in the United Nations Model Convention.

as the individual is either present in a country or he is not. The presence could also relatively easily be documented by the taxpayer when evidence is required by the tax authorities. Under this method the following days are included in the calculation: part of a day, day of arrival, day of departure and all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the exemption) and death or sickness in the family. However, days spent in the State of activity in transit in the course of a trip between two points outside the State of activity should be excluded from the computation. It follows from these principles that any entire day spent outside the State of activity, whether for holidays, business trips, or any other reason, should not be taken into account. A day during any part of which, however brief, the taxpayer is present in a State counts as a day of presence in that State for purposes of computing the 183 day period.

5.1 Days during which the taxpayer is a resident of the source State should not, however, be taken into account in the calculation. Subparagraph *a*) has to be read in the context of the first part of paragraph 2, which refers to “remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State”, which does not apply to a person who resides and works in the same State. The words “the recipient is present”, found in subparagraph *a*), refer to the recipient of such remuneration and, during a period of residence in the source State, a person cannot be said to be the recipient of remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State. The following examples illustrate this conclusion:

- Example 1: From January 01 to December 01, X lives in, and is a resident of, State S. On 1 January 02, X is hired by an employer who is a resident of State R and moves to State R where he becomes a resident. X is subsequently sent to State S by his employer from 15 to 31 March 02. In that case, X is present in State S for 292 days between 1 April 01 and 31 March 02 but since he is a resident of State S between 1 April 01 and 31 December 01, this first period is not taken into account for purposes of the calculation of the periods referred to in subparagraph *a*).
- Example 2: From 15 to 31 October 01, Y, a resident of State R, is present in State S to prepare the expansion in that country of the

business of ACO, also a resident of State R. On 1 May 02, Y moves to State S where she becomes a resident and works as the manager of a newly created subsidiary of ACO resident of State S. In that case, Y is present in State S for 184 days between 15 October 01 and 14 October 02 but since she is a resident of State S between 1 May and 14 October 02, this last period is not taken into account for purposes of the calculation of the periods referred to in subparagraph *a*).

6. The second condition is that the employer paying the remuneration must not be a resident of the State in which the employment is exercised. Some member countries may, however, consider that it is inappropriate to extend the exception of paragraph 2 to cases where the employer is not a resident of the State of residence of the employee, as there might then be administrative difficulties in determining the employment income of the employee or in enforcing withholding obligations on the employer. Contracting States that share this view are free to adopt bilaterally the following alternative wording of subparagraph 2 *b*):

b) the remuneration is paid by, or on behalf of, an employer who is a resident of the first-mentioned State, and

6.1 The application of the second condition in the case of fiscally transparent partnerships presents difficulties since such partnerships cannot qualify as a resident of a Contracting State under Article 4 (see paragraph 8.2 of the Commentary on Article 4). While it is clear that such a partnership could qualify as an “employer” (especially under the domestic law definitions of the term in some countries, *e.g.* where an employer is defined as a person liable for a wage tax), the application of the condition at the level of the partnership regardless of the situation of the partners would therefore render the condition totally meaningless.

6.2 The object and purpose of subparagraphs *b*) and *c*) of paragraph 2 are to avoid the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as he neither is a resident nor has a permanent establishment therein. These subparagraphs can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given State may be considered to constitute an excessive administrative burden where the employer neither resides nor has a permanent establishment in that State. In order to achieve a meaningful interpretation of subparagraph *b*) that would accord with

its context and its object, it should therefore be considered that, in the case of fiscally transparent partnerships, that subparagraph applies at the level of the partners. Thus, the concepts of “employer” and “resident”, as found in subparagraph *b*), are applied at the level of the partners rather than at the level of a fiscally transparent partnership. This approach is consistent with that under which other provisions of tax conventions must be applied at the partners’ rather than at the partnership’s level. While this interpretation could create difficulties where the partners reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners who own the majority of the interests in the partnership reside (*i.e.* the State in which the greatest part of the deduction will be claimed).

Some members of the Committee of Experts disagree with the proposition in paragraph 6.2 of the OECD Commentary extracted above that the concepts of “employer” and “resident” in subparagraph (*b*) are applied at the level of partners. They dispute the stated rationale for this approach, *i.e.* that in cases of fiscally transparent partnerships, provisions of tax conventions must be applied at the partners’ level. They are of the view that a special rule is required in a convention to provide such a result.

7. Under the third condition, if the employer has a permanent establishment [or a fixed base if he performs professional services or other activities of an independent character] in the State in which the employment is exercised, the exemption is given on condition that the remuneration is not borne by that permanent establishment [or a fixed base which he has in that State]. The phrase “borne by” must be interpreted in the light of the underlying purpose of subparagraph *c*) of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration that could give rise to a deduction, having regard to the principles of Article 7 and the nature of the remuneration, in computing the profits of a permanent establishment situated in the State in which the employment is exercised.

7.1 The fact that the employer has, or has not, actually claimed a deduction for the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether any deduction otherwise available with respect to that remuneration should be taken into account in determining the profits attributable to the permanent establishment. That test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding

not to claim a deduction to which he was entitled. The test would also be met where the remuneration is not deductible merely because of its nature (*e.g.* where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment.

8. There is a direct relationship between the principles underlying the exception of paragraph 2 and Article 7. Article 7 is based on the principle that an enterprise of a Contracting State should not be subjected to tax in the other State unless its business presence in that other State has reached a level sufficient to constitute a permanent establishment. The exception of paragraph 2 of Article 15 extends that principle to the taxation of the employees of such an enterprise where the activities of these employees are carried on in the other State for a relatively short period. Subparagraphs *b)* and *c)* make it clear that the exception is not intended to apply where the employment services are rendered to an enterprise the profits of which are subjected to tax in a State either because it is carried on by a resident of that State or because it has a permanent establishment therein to which the services are attributable.

8.1 It may be difficult, in certain cases, to determine whether the services rendered in a State by an individual resident of another State, and provided to an enterprise of the first State (or that has a permanent establishment in that State), constitute employment services, to which Article 15 applies, or services rendered by a separate enterprise, to which Article 7 applies or, more generally, whether the exception applies. While the Commentary previously dealt with cases where arrangements were structured for the main purpose of obtaining the benefits of the exception of paragraph 2 of Article 15, it was found that similar issues could arise in many other cases that did not involve tax-motivated transactions and the Commentary was amended to provide a more comprehensive discussion of these questions.

8.2 In some States, a formal contractual relationship would not be questioned for tax purposes unless there were some evidence of manipulation and these States, as a matter of domestic law, would consider that employment services are only rendered where there is a formal employment relationship.

8.3 If States where this is the case are concerned that such approach could result in granting the benefits of the exception provided for in paragraph 2 in unintended situations (*e.g.* in so-called “hiring-out of labour” cases), they are free to adopt bilaterally a provision drafted along the following lines:

Paragraph 2 of this Article shall not apply to remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and paid by, or on behalf of, an employer who is not a resident of that other State if:

- a) the recipient renders services in the course of that employment to a person other than the employer and that person, directly or indirectly, supervises, directs or controls the manner in which those services are performed; and
- b) those services constitute an integral part of the business activities carried on by that person.

8.4 In many States, however, various legislative or jurisprudential rules and criteria (*e.g.* substance over form rules) have been developed for the purpose of distinguishing cases where services rendered by an individual to an enterprise should be considered to be rendered in an employment relationship (contract of service) from cases where such services should be considered to be rendered under a contract for the provision of services between two separate enterprises (contract for services). That distinction keeps its importance when applying the provisions of Article 15, in particular those of subparagraphs 2 b) and c). Subject to the limit described in paragraph 8.11 and unless the context of a particular convention requires otherwise, it is a matter of domestic law of the State of source to determine whether services rendered by an individual in that State are provided in an employment relationship and that determination will govern how that State applies the Convention.

8.5 In some cases, services rendered by an individual to an enterprise may be considered to be employment services for purposes of domestic tax law even though these services are provided under a formal contract for services between, on the one hand, the enterprise that acquires the services, and, on the other hand, either the individual himself or another enterprise by which the individual is formally employed or with which the individual has concluded another formal contract for services.

8.6 In such cases, the relevant domestic law may ignore the way in which the services are characterised in the formal contracts. It may prefer to focus primarily on the nature of the services rendered by the individual and their integration into the business carried on by the enterprise that acquires the services to conclude that there is an employment relationship between the individual and that enterprise.

8.7 Since the concept of employment to which Article 15 refers is to be determined according to the domestic law of the State that applies

the Convention (subject to the limit described in paragraph 8.11 and unless the context of a particular convention requires otherwise), it follows that a State which considers such services to be employment services will apply Article 15 accordingly. It will, therefore, logically conclude that the enterprise to which the services are rendered is in an employment relationship with the individual so as to constitute his employer for purposes of subparagraph 2 *b*) and *c*). That conclusion is consistent with the object and purpose of paragraph 2 of Article 15 since, in that case, the employment services may be said to be rendered to a resident of the State where the services are performed.

8.8 As mentioned in paragraph 8.2, even where the domestic law of the State that applies the Convention does not offer the possibility of questioning a formal contractual relationship and therefore does not allow the State to consider that services rendered to a local enterprise by an individual who is formally employed by a non-resident are rendered in an employment relationship (contract of service) with that local enterprise, it is possible for that State to deny the application of the exception of paragraph 2 in abusive cases.

8.9 The various approaches that are available to States that want to deal with such abusive cases are discussed in the section “Improper use of the Convention” in the Commentary on Article 1. As explained in paragraph 9.4 of that Commentary, it is agreed that States do not have to grant the benefits of a tax convention where arrangements that constitute an abuse of the Convention have been entered into. As noted in paragraphs 9.5 of that Commentary, however, it should not be lightly assumed that this is the case (see also paragraph 22.2 of that Commentary).

8.10 The approach described in the previous paragraphs therefore allows the State in which the activities are exercised to reject the application of paragraph 2 in abusive cases and in cases where, under that State’s domestic law concept of employment, services rendered to a local enterprise by an individual who is formally employed by a non-resident are rendered in an employment relationship (contract of service) with that local enterprise. This approach ensures that relief of double taxation will be provided in the State of residence of the individual even if that State does not, under its own domestic law, consider that there is an employment relationship between the individual and the enterprise to which the services are provided. Indeed, as long as the State of residence acknowledges that the concept of employment in the domestic tax law of the State of source or the existence of arrangements that constitute an abuse of the Convention allows that

State to tax the employment income of an individual in accordance with the Convention, it must grant relief for double taxation pursuant to the obligations incorporated in Articles 23 A and 23 B (see paragraphs 32.1 to 32.7 of the Commentary on these articles). The mutual agreement procedure provided by paragraph 1 of Article 25 will be available to address cases where the State of residence does not agree that the other State has correctly applied the approach described above and, therefore, does not consider that the other State has taxed the relevant income in accordance with the Convention.

8.11 The conclusion that, under domestic law, a formal contractual relationship should be disregarded must, however, be arrived at on the basis of objective criteria. For instance, a State could not argue that services are deemed, under its domestic law, to constitute employment services where, under the relevant facts and circumstances, it clearly appears that these services are rendered under a contract for the provision of services concluded between two separate enterprises. The relief provided under paragraph 2 of Article 15 would be rendered meaningless if States were allowed to deem services to constitute employment services in cases where there is clearly no employment relationship or to deny the quality of employer to an enterprise carried on by a non-resident where it is clear that that enterprise provides services, through its own personnel, to an enterprise carried on by a resident. Conversely, where services rendered by an individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises, that State should logically also consider that the individual is not carrying on the business of the enterprise that constitutes that individual's formal employer; this could be relevant, for example, for purposes of determining whether that enterprise has a permanent establishment at the place where the individual performs his activities.

8.12 It will not always be clear, however, whether services rendered by an individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises. Any disagreement between States as to whether this is the case should be solved having regard to the following principles and examples (using, where appropriate, the mutual agreement procedure).

8.13 The nature of the services rendered by the individual will be an important factor since it is logical to assume that an employee provides services which are an integral part of the business activities

carried on by his employer. It will therefore be important to determine whether the services rendered by the individual constitute an integral part of the business of the enterprise to which these services are provided. For that purpose, a key consideration will be which enterprise bears the responsibility or risk for the results produced by the individual's work. Clearly, however, this analysis will only be relevant if the services of an individual are rendered directly to an enterprise. Where, for example, an individual provides services to a contract manufacturer or to an enterprise to which business is outsourced, the services of that individual are not rendered to enterprises that will obtain the products or services in question.

8.14 Where a comparison of the nature of the services rendered by the individual with the business activities carried on by his formal employer and by the enterprise to which the services are provided points to an employment relationship that is different from the formal contractual relationship, the following additional factors may be relevant to determine whether this is really the case:

- who has the authority to instruct the individual regarding the manner in which the work has to be performed;
- who controls and has responsibility for the place at which the work is performed;
- the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided (see paragraph 8.15 below);
- who puts the tools and materials necessary for the work at the individual's disposal;
- who determines the number and qualifications of the individuals performing the work;
- who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered into with that individual for that purpose;
- who has the right to impose disciplinary sanctions related to the work of that individual;
- who determines the holidays and work schedule of that individual.

8.15 Where an individual who is formally an employee of one enterprise provides services to another enterprise, the financial arrangements made between the two enterprises will clearly be relevant, although not necessarily conclusive, for the purposes of determining

whether the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided. For instance, if the fees charged by the enterprise that formally employs the individual represent the remuneration, employment benefits and other employment costs of that individual for the services that he provided to the other enterprise, with no profit element or with a profit element that is computed as a percentage of that remuneration, benefits and other employment costs, this would be indicative that the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided. That should not be considered to be the case, however, if the fee charged for the services bears no relationship to the remuneration of the individual or if that remuneration is only one of many factors taken into account in the fee charged for what is really a contract for services (e.g. where a consulting firm charges a client on the basis of an hourly fee for the time spent by one of its employee to perform a particular contract and that fee takes account of the various costs of the enterprise), provided that this is in conformity with the arm's length principle if the two enterprises are associated. It is important to note, however, that the question of whether the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided is only one of the subsidiary factors that are relevant in determining whether services rendered by that individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises.

8.16 Example 1: Aco, a company resident of State A, concludes a contract with Bco, a company resident of State B, for the provision of training services. Aco is specialised in training people in the use of various computer software and Bco wishes to train its personnel to use recently acquired software. X, an employee of Aco who is a resident of State A, is sent to Bco's offices in State B to provide training courses as part of the contract.

8.17 In that case, State B could not argue that X is in an employment relationship with Bco or that Aco is not the employer of X for purposes of the convention between States A and B. X is formally an employee of Aco whose own services, when viewed in light of the factors in paragraphs 8.13 and 8.14, form an integral part of the business activities of Aco. The services that he renders to Bco are rendered on behalf of Aco under the contract concluded between the two enterprises. Thus, provided that X is not present in State B for more

than 183 days during any relevant twelve month period and that Aco does not have in State B a permanent establishment which bears the cost of X's remuneration, the exception of paragraph 2 of Article 15 will apply to X's remuneration.

8.18 Example 2: Cco, a company resident of State C, is the parent company of a group of companies that includes Dco, a company resident of State D. Cco has developed a new worldwide marketing strategy for the products of the group. In order to ensure that the strategy is well understood and followed by Dco, which sells the group's products, Cco sends X, one of its employees who has worked on the development of the strategy, to work in Dco's headquarters for four months in order to advise Dco with respect to its marketing and to ensure that Dco's communications department understands and complies with the worldwide marketing strategy.

8.19 In that case, Cco's business includes the management of the worldwide marketing activities of the group and X's own services are an integral part of that business activity. While it could be argued that an employee could have been easily hired by Dco to perform the function of advising the company with respect to its marketing, it is clear that such function is frequently performed by a consultant, especially where specialised knowledge is required for a relatively short period of time. Also, the function of monitoring the compliance with the group's worldwide marketing strategy belongs to the business of Cco rather than to that of Dco. The exception of paragraph 2 of Article 15 should therefore apply provided that the other conditions for that exception are satisfied.

8.20 Example 3: A multinational owns and operates hotels worldwide through a number of subsidiaries. Eco, one of these subsidiaries, is a resident of State E where it owns and operates a hotel. X is an employee of Eco who works in this hotel. Fco, another subsidiary of the group, owns and operates a hotel in State F where there is a shortage of employees with foreign language skills. For that reason, X is sent to work for five months at the reception desk of Fco's hotel. Fco pays the travel expenses of X, who remains formally employed and paid by Eco, and pays Eco a management fee based on X's remuneration, social contributions and other employment benefits for the relevant period.

8.21 In that case, working at the reception desk of the hotel in State F, when examined in light of the factors in paragraphs 8.13 and 8.14, may be viewed as forming an integral part of Fco's business of operating that hotel rather than of Eco's business. Under the approach described above, if, under the domestic law of State F, the services of X

are considered to have been rendered to Fco in an employment relationship, State F could then logically consider that Fco is the employer of X and the exception of paragraph 2 of Article 15 would not apply.

8.22 Example 4: Gco is a company resident of State G. It carries on the business of filling temporary business needs for highly specialised personnel. Hco is a company resident of State H which provides engineering services on building sites. In order to complete one of its contracts in State H, Hco needs an engineer for a period of five months. It contacts Gco for that purpose. Gco recruits X, an engineer resident of State X, and hires him under a five month employment contract. Under a separate contract between Gco and Hco, Gco agrees to provide the services of X to Hco during that period. Under these contracts, Gco will pay X's remuneration, social contributions, travel expenses and other employment benefits and charges.

8.23 In that case, X provides engineering services while Gco is in the business of filling short-term business needs. By their nature the services rendered by X are not an integral part of the business activities of his formal employer. These services are, however, an integral part of the business activities of Hco, an engineering firm. In light of the factors in paragraphs 8.13 and 8.14, State H could therefore consider that, under the approach described above, the exception of paragraph 2 of Article 15 would not apply with respect to the remuneration for the services of the engineer that will be rendered in that State.

8.24 Example 5: Ico is a company resident of State I specialised in providing engineering services. Ico employs a number of engineers on a full time basis. Jco, a smaller engineering firm resident of State J, needs the temporary services of an engineer to complete a contract on a construction site in State J. Ico agrees with Jco that one of Ico's engineers, who is a resident of State I momentarily not assigned to any contract concluded by Ico, will work for four months on Jco's contract under the direct supervision and control of one of Jco's senior engineers. Jco will pay Ico an amount equal to the remuneration, social contributions, travel expenses and other employment benefits of that engineer for the relevant period, together with a 5 per cent commission. Jco also agrees to indemnify Ico for any eventual claims related to the engineer's work during that period of time.

8.25 In that case, even if Ico is in the business of providing engineering services, it is clear that the work performed by the engineer on the construction site in State J is performed on behalf of Jco rather than Ico. The direct supervision and control exercised by Jco over the work of the engineer, the fact that Jco takes over the responsibility

for that work and that it bears the cost of the remuneration of the engineer for the relevant period are factors that could support the conclusion that the engineer is in an employment relationship with Jco. Under the approach described above, State J could therefore consider that the exception of paragraph 2 of Article 15 would not apply with respect to the remuneration for the services of the engineer that will be rendered in that State.

8.26 Example 6: Kco, a company resident of State K, and Lco, a company resident of State L, are part of the same multinational group of companies. A large part of the activities of that group are structured along function lines, which requires employees of different companies of the group to work together under the supervision of managers who are located in different States and employed by other companies of the group. X is a resident of State K employed by Kco; she is a senior manager in charge of supervising human resources functions within the multinational group. Since X is employed by Kco, Kco acts as a cost centre for the human resource costs of the group; periodically, these costs are charged out to each of the companies of the group on the basis of a formula that takes account of various factors such as the number of employees of each company. X is required to travel frequently to other States where other companies of the group have their offices. During the last year, X spent three months in State L in order to deal with human resources issues at Lco.

8.27 In that case, the work performed by X is part of the activities that Kco performs for its multinational group. These activities, like other activities such as corporate communication, strategy, finance and tax, treasury, information management and legal support, are often centralised within a large group of companies. The work that X performs is thus an integral part of the business of Kco. The exception of paragraph 2 of Article 15 should therefore apply to the remuneration derived by X for her work in State L provided that the other conditions for that exception are satisfied.

8.28 Where, in accordance with the above principles and examples, a State properly considers that the services rendered on its territory by an individual have been rendered in an employment relationship rather than under a contract for services concluded between two enterprises, there will be a risk that the enterprises would be required to withhold tax at source in two jurisdictions on the remuneration of that individual even though double taxation should ultimately be avoided (see paragraph 8.10 above). This compliance difficulty may be partly reduced by tax administrations making sure that their domestic rules

and practices applicable to employment are clear and well understood by employers and are easily accessible. Also, the problem can be alleviated if the State of residence allows enterprises to quickly adjust the amount of tax to be withheld to take account of any relief for double taxation that will likely be available to the employee.

9. Paragraph 3 applies to the remuneration of crews of ships or aircraft operated in international traffic, or of boats engaged in inland waterways transport, a rule which follows up to a certain extent the rule applied to the income from shipping, inland waterways transport and air transport, that is, to tax them in the Contracting State in which the place of effective management of the enterprise concerned is situated. In the Commentary on Article 8, it is indicated that Contracting States may agree to confer the right to tax such income on the State of the enterprise operating the ships, boats or aircraft. The reasons for introducing that possibility in the case of income from shipping, inland waterways and air transport operations are valid also in respect of remuneration of the crew. Accordingly Contracting States are left free to agree on a provision which gives the right to tax such remuneration to the State of the enterprise. Such a provision, as well as that of paragraph 3 of Article 15, assumes that the domestic laws of the State on which the right to tax is conferred allows it to tax the remuneration of a person in the service of the enterprise concerned, irrespective of his residence. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat. According to the domestic laws of some member countries, tax is levied on remuneration received by non-resident members of the crew in respect of employment aboard ships only if the ship has the nationality of such a State. For that reason conventions concluded between these States provide that the right to tax such remuneration is given to the State of the nationality of the ship. On the other hand many States cannot make use of such a taxation right and the provision could in such cases lead to non-taxation. However, States having that taxation principle in their domestic laws may agree bilaterally to confer the right to tax remuneration in respect of employment aboard ships on the State of the nationality of the ship.

10. It should be noted that no special rules regarding the taxation of income of frontier workers or of employees working on trucks and trains travelling between States are included as it would be more suitable for the problems created by local conditions to be solved directly between the States concerned.

11. No special provision has been made regarding remuneration derived by visiting professors or students employed with a view to their acquiring practical experience. Many conventions contain rules of some kind or other concerning such cases, the main purpose of which is to facilitate cultural relations by providing for a limited tax exemption. Sometimes, tax exemption is already provided under domestic taxation laws. The absence of specific rules should not be interpreted as constituting an obstacle to the inclusion of such rules in bilateral conventions whenever this is felt desirable.

The treatment of employee stock-options

12. The different country rules for taxing employee stock-options create particular problems which are discussed below. While many of these problems arise with respect to other forms of employee remuneration, particularly those that are based on the value of shares of the employer or a related company, they are particularly acute in the case of stock-options. This is largely due to the fact that stock-options are often taxed at a time (*e.g.* when the option is exercised or the shares sold) that is different from the time when the employment services that are remunerated through these options are rendered.

12.1 As noted in paragraph 2.2, the Article allows the State of source to tax the part of the stock-option benefit that constitutes remuneration derived from employment exercised in that State even if the tax is levied at a later time when the employee is no longer employed in that State.

12.2 While the Article applies to the employment benefit derived from a stock-option granted to an employee regardless of when that benefit is taxed, there is a need to distinguish that employment benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (*e.g.* upon cancellation or acquisition by the employer or issuer). Once the option is exercised or alienated, however, the employment benefit has been realised and any subsequent gain on the acquired shares (*i.e.* the value of the shares that accrues after exercise) will be derived by the employee in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the employee obtained from his employment, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so). Where, however, the option that has been exercised entitles the employee to acquire shares that will not irrevocably vest

until the end of a period of required employment, it will be appropriate to apply this Article to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.

12.3 The fact that the Article does not apply to a benefit derived after the exercise or alienation of the option does not imply in any way that taxation of the employment income under domestic law must occur at the time of that exercise or alienation. As already noted, the Article does not impose any restriction as to when the relevant income may be taxed by the State of source. Thus, the State of source could tax the relevant income at the time the option is granted, at the time the option is exercised (or alienated), at the time the share is sold or at any other time. The State of source, however, may only tax the benefits attributable to the option itself and not what is attributable to the subsequent holding of shares acquired upon the exercise of that option (except in the circumstances described in the last sentence of the preceding paragraph).

12.4 Since paragraph 1 must be interpreted to apply to any benefit derived from the option until it has been exercised, sold or otherwise alienated, it does not matter how such benefit, or any part thereof, is characterised for domestic tax purposes. As a result, whilst the Article will be interpreted to allow the State of source to tax the benefits accruing up to the time when the option has been exercised, sold or otherwise alienated, it will be left to that State to decide how to tax such benefits, *e.g.* as either employment income or capital gain. If the State of source decides, for example, to impose a capital gains tax on the option when the employee ceases to be a resident of that country, that tax will be allowed under the Article. The same will be true in the State of residence. For example, while that State will have sole taxation right on the increase of value of the share obtained after exercise since this will be considered to fall under Article 13 of the Convention, it may well decide to tax such increase as employment income rather than as a capital gain under its domestic law.

12.5 The benefits resulting from a stock-option granted to an employee will not, as a general rule, fall under either Article 21, which does not apply to income covered by other Articles, or Article 18, which only applies to pension and other similar remuneration, even if the option is exercised after termination of the employment or retirement.

12.6 Paragraph 1 allows the State of source to tax salaries, wages and other similar remuneration derived from employment exercised in that State. The determination of whether and to what extent an

employee stock-option is derived from employment exercised in a particular State must be done in each case on the basis of all the relevant facts and circumstances, including the contractual conditions associated with that option (*e.g.* the conditions under which the option granted may be exercised or disposed of). The following general principles should be followed for that purpose.

12.7 The first principle is that, as a general rule, an employee stock-option should not be considered to relate to any services rendered after the period of employment that is required as a condition for the employee to acquire the right to exercise that option. Thus, where a stock-option is granted to an employee on the condition that he provides employment services to the same employer (or an associated enterprise) for a period of three years, the employment benefit derived from that option should generally not be attributed to services performed after that three year period.

12.8 In applying the above principle, however, it is important to distinguish between a period of employment that is required to obtain the right to exercise an employee stock-option and a period of time that is merely a delay before such option may be exercised (a blocking period). Thus, for example, an option that is granted to an employee on the condition that he remains employed by the same employer (or an associated enterprise) during a period of three years can be considered to be derived from the services performed during these three years while an option that is granted, without any condition of subsequent employment, to an employee on a given date but which, under its terms and conditions, can only be exercised after a delay of three years, should not be considered to relate to the employment performed during these years as the benefit of such an option would accrue to its recipient even if he were to leave his employment immediately after receiving it and waited the required three years before exercising it.

12.9 It is also important to distinguish between a situation where a period of employment is required as a condition for the acquisition of the right to exercise an option, *i.e.* the vesting of the option, and a situation where an option that has already vested may be forfeited if it is not exercised before employment is terminated (or within a short period after). In the latter situation, the benefit of the option should not be considered to relate to services rendered after vesting since the employee has already obtained the benefit and could in fact realise it at any time. A condition under which the vested option may be forfeited if employment is terminated is not a condition for the

acquisition of the benefit but, rather, one under which the benefit already acquired may subsequently be lost. The following examples illustrate this distinction:

- Example 1: On 1 January of year 1, a stock-option is granted to an employee. The acquisition of the option is conditional on the employee continuing to be employed by the same employer until 1 January of year 3. The option, once this condition is met, will be exercisable from 1 January of year 3 until 1 January of year 10 (a so-called “American” option⁴³). It is further provided, however, that any option not previously exercised will be lost upon cessation of employment. In that example, the right to exercise that option has been acquired on 1 January of year 3 (*i.e.* the date of vesting) since no further period of employment is then required for the employee to obtain the right to exercise the option.
- Example 2: On 1 January of year 1, a stock-option is granted to an employee. The option is exercisable on 1 January of year 5 (a so-called “European” option). The option has been granted subject to the condition that it can only be exercised on 1 January of year 5 if employment is not terminated before that date. In that example, the right to exercise that option is not acquired until 1 January of year 5, which is the date of exercise, since employment until that date is required to acquire the right to exercise the option (*i.e.* for the option to vest).

12.10 There are cases where that first principle might not apply. One such case could be where the stock-option is granted without any condition to an employee at the time he either takes up an employment, is transferred to a new country or is given significant new responsibilities and, in each case, the option clearly relates to the new functions to be performed by the employee during a specific future period. In that case, it may be appropriate to consider that the option relates to these new functions even if the right to exercise the option is acquired before these are performed. There are also cases where an option vested technically but where that option entitles the employee to acquire shares which will not vest until the end of a period of required employment. In such cases, it may be appropriate to consider that the benefit of the option relates to the services rendered in the whole period between the grant of the option and the vesting of the shares.

⁴³Under an “American” stock-option, the right to acquire a share may be exercised during a certain period (typically a number of years) whilst under a European stock-option, that right may only be exercised at a given moment (*i.e.* on a particular date).

12.11 The second principle is that an employee stock-option should only be considered to relate to services rendered before the time when it is granted to the extent that such grant is intended to reward the provision of such services by the recipient for a specific period. This would be the case, for example, where the remuneration is demonstrably based on the employee's past performance during a certain period or is based on the employer's past financial results and is conditional on the employee having been employed by the employer or an associated enterprise during a certain period to which these financial results relate. Also, in some cases, there may be objective evidence demonstrating that during a period of past employment, there was a well-founded expectation among participants to an employee stock-option plan that part of their remuneration for that period would be provided through the plan by having stock-options granted at a later date. This evidence might include, for example, the consistent practice of an employer that has granted similar levels of stock-options over a number of years, as long as there was no indication that this practice might be discontinued. Depending on other factors, such evidence may be highly relevant for purposes of determining if and to what extent the stock-option relates to such a period of past employment.

12.12 Where a period of employment is required to obtain the right to exercise an employee's stock-option but such requirement is not applied in certain circumstances, *e.g.* where the employment is terminated by the employer or where the employee reaches retirement age, the stock-option benefit should be considered to relate only to the period of services actually performed when these circumstances have in fact occurred.

12.13 Finally, there may be situations in which some factors may suggest that an employee stock-option is rewarding past services but other factors seem to indicate that it relates to future services. In cases of doubt, it should be recognised that employee stock-options are generally provided as an incentive to future performance or as a way to retain valuable employees. Thus, employee stock-options are primarily related to future services. However, all relevant facts and circumstances will need to be taken into account before such a determination can be made and there may be cases where it can be shown that a stock-option is related to combined specific periods of previous and future services (*e.g.* options are granted on the basis of the employee having achieved specific performance targets for the previous year, but they become exercisable only if the employee remains employed for another three years).

12.14 Where, based on the preceding principles, a stock-option is considered to be derived from employment exercised in more than one State, it will be necessary to determine which part of the stock-option benefit is derived from employment exercised in each State for purposes of the application of the Article and of Articles 23 A and 23 B. In such a case, the employment benefit attributable to the stock-option should be considered to be derived from a particular country in proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment services from which the stock-option is derived has been exercised. For that purpose, the only days of employment that should be taken into account are those that are relevant for the stock-option plan, *e.g.* those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to acquire the right to exercise the option.

12.15 It is possible for member countries to depart from the case-by-case application of the above principles (in paragraphs 12.7 to 12.14) by agreeing to a specific approach in a bilateral context. For example, two countries that tax predominantly at exercise of an option may agree, as a general principle, to attribute the income from an option that relates primarily to future services to the services performed by an employee in the two States between date of grant and date of exercise. Thus, in the case of options that do not become exercisable until the employee has performed services for the employer for a specific period of time, two States could agree to an approach that attributes the income from the option to each State based on the number of days worked in each State by the employee for the employer in the period between date of grant and date of exercise. Another example would be for two countries that have similar rules for the tax treatment of employee stock-options to adopt provisions that would give to one of the Contracting States exclusive taxation rights on the employment benefit even if a minor part of the employment services to which the option relates have been rendered in the other State. Of course, member countries should be careful in adopting such approaches because they may result in double taxation or double non-taxation if part of the employment is exercised in a third State that does not apply a similar approach.

2. Although Articles 14, 15, 19 and 23 may generally be adequate to prevent double taxation of visiting teachers, some countries may wish to

include a visiting teachers article in their treaties. Reference is made to paragraphs 10 to 12 of the Commentary on Article 20 for a comprehensive treatment of this subject.

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL
MANAGERIAL OFFICIALS

1. Article 16, paragraph 1, of the United Nations Model Convention reproduces Article 16 of the OECD Model Convention.

2. Since Article 16, paragraph 1, of the United Nations Model Convention reproduces the whole of Article 16 of the OECD Model Convention, the Commentary on the latter Article, which reads as follows, is relevant:

1. This Article relates to remuneration received by a resident of a Contracting State, whether an individual or a legal person, in the capacity of a member of a board of directors of a company which is a resident of the other Contracting State. Since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company.

1.1 Member countries have generally understood the term "fees and other similar payments" to include benefits in kind received by a person in that person's capacity as a member of the board of directors of a company (e.g. stock-options the use of a residence or automobile, health or life insurance coverage and club memberships).

2. A member of the board of directors of a company often also has other functions with the company, e.g. as ordinary employee, adviser, consultant, etc. It is clear that the Article does not apply to remuneration paid to such a person on account of such other functions. [This position does not apply under the United Nations Model Convention to the extent that paragraph 2 of Article 16 applies.]

3. In some countries organs of companies exist which are similar in function to the board of directors. Contracting States are free to include in bilateral conventions such organs of companies under a provision corresponding to Article 16.

3.1 Many of the issues discussed under paragraphs 12 to 12.15 of the Commentary on Article 15 in relation to stock-options granted to employees will also arise in the case of stock-options granted to members of the board of directors of companies. To the extent that stock-options are granted to a resident of a Contracting State in that

person's capacity as a member of the board of directors of a company which is a resident of the other State, that other State will have the right to tax the part of the stock-option benefit that constitutes director's fees or a similar payment (see paragraph 1.1 above) even if the tax is levied at a later time when the person is no longer a member of that board. While the Article applies to the benefit derived from a stock-option granted to a member of the board of directors regardless of when that benefit is taxed, there is a need to distinguish that benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (*e.g.* upon cancellation or acquisition by the company or issuer). Once the option is exercised or alienated, however, the benefit taxable under this Article has been realised and any subsequent gain on the acquired shares (*i.e.* the value of the shares that accrues after exercise) will be derived by the member of the board of directors in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the director obtained in his capacity as such, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so).

3. Article 16 of the United Nations Model Convention also includes a second paragraph not in the OECD Model Convention, dealing with remuneration received by top-level managerial officials.

4. The former Group of Experts decided that where a top-level managerial position of a company resident in a Contracting State is occupied by a resident of the other Contracting State, the remuneration paid to that official should be subject to the same principle as directors' fees.

5. The term "top-level managerial position" refers to a limited group of positions that involve primary responsibility for the general direction of the affairs of the company, apart from the activities of the directors. The term covers a person acting as both a director and a top-level manager.

Article 17

ARTISTES AND SPORTSPERSONS

1. Article 17 of the United Nations Model Convention reproduces Article 17 of the OECD Model Convention with one modification. Instead

of the word “sportsman” used in the OECD Model Convention (in place of “athlete” earlier used in both the United Nations and OECD Model Conventions), it has been decided to use the gender neutral word “sportsperson”, which unlike the term “entertainer” was not followed in paragraph 1 by illustrative examples but is nevertheless likewise to be construed in a broad manner consistent with the spirit and purpose of the Article.

2. The Commentary on Article 17 of the OECD Model Convention is as follows:

1. Paragraph 1 provides that artistes and sportsmen who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are of [an independent or of a dependent] nature. This provision is an exception to the rules in Article [14] and to that in paragraph 2 of Article 15, respectively.

2. This provision makes it possible to avoid the practical difficulties which often arise in taxing artistes and sportsmen performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to [independent] activities. To achieve this it would be sufficient to amend the text of the Article so that an exception is made only to the provisions of Article [14]. In such a case, artistes and sportsmen performing in the course of an employment would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article.

3. Paragraph 1 refers to artistes and sportsmen. It is not possible to give a precise definition of “artiste”, but paragraph 1 includes examples of persons who would be regarded as such. These examples should not be considered as exhaustive. On the one hand, the term “artiste” clearly includes the stage performer, film actor, actor (including for instance a former sportsman) in a television commercial. The Article may also apply to income received from activities which involve a political, social, religious or charitable nature, if an entertainment character is present. On the other hand, it does not extend to a visiting conference speaker or to administrative or support staff (*e.g.* cameramen for a film, producers, film directors, choreographers, technical staff, road crew for a pop group etc.). In between there is a grey area where it is necessary to review the overall balance of the activities of the person concerned.

4. An individual may both direct a show and act in it, or may direct and produce a television programme or film and take a role in

it. In such cases it is necessary to look at what the individual actually does in the State where the performance takes place. If his activities in that State are predominantly of a performing nature, the Article will apply to all the resulting income he derives in that State. If, however, the performing element is a negligible part of what he does in that State, the whole of the income will fall outside the Article. In other cases an apportionment should be necessary.

5. Whilst no precise definition is given of the term “sportsmen”, it is not restricted to participants in traditional athletic events (*e.g.* runners, jumpers, swimmers). It also covers, for example, golfers, jockeys, footballers, cricketers and tennis players, as well as racing drivers.

6. The Article also applies to income from other activities which are usually regarded as of an entertainment character, such as those deriving from billiards and snooker, chess and bridge tournaments.

7. Income received by impresarios, etc. for arranging the appearance of an artiste or sportsman is outside the scope of the Article, but any income they receive on behalf of the artiste or sportsman is of course covered by it.

8. Paragraph 1 applies to income derived directly and indirectly by an individual artiste or sportsman. In some cases the income will not be paid directly to the individual or his impresario or agent. For instance, a member of an orchestra may be paid a salary rather than receive payment for each separate performance: a Contracting State where a performance takes place is entitled, under paragraph 1, to tax the proportion of the musician’s salary which corresponds to such a performance. Similarly, where an artiste or sportsman is employed by *e.g.* a one person company, the State where the performance takes place may tax an appropriate proportion of any remuneration paid to the individual. In addition, where its domestic laws “look through” such entities and treat the income as accruing directly to the individual, paragraph 1 enables that State to tax income derived from appearances in its territory and accruing in the entity for the individual’s benefit, even if the income is not actually paid as remuneration to the individual.

9. Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was no direct link between the income and a public exhibition by the performer in the country concerned. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (see paragraph 18 of the Commentary on Article 12), but in general advertising and sponsorship fees will fall outside the scope

of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State. Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article [14] or Article 15, as appropriate. Payments received in the event of the cancellation of a performance are also outside the scope of Article 17, and fall under Articles 7, [14] or 15, as the case may be.

10 The Article says nothing about how the income in question is to be computed. It is for a Contracting State's domestic law to determine the extent of any deductions for expenses. Domestic laws differ in this area, and some provide for taxation at source, at a low rate based on the gross amount paid to artistes and sportsmen. Such rules may also apply to income paid to groups or incorporated teams, troupes, etc. Some States, however, may consider that the taxation of the gross amount may be inappropriate in some circumstances even if the applicable rate is low. These States may want to give the option to the taxpayer to be taxed on a net basis. This could be done through the inclusion of a paragraph drafted along the following lines:

Where a resident of a Contracting States derives income referred to in paragraph 1 or 2 and such income is taxable in the other Contracting State on a gross basis, that person may, within [period to be determined by the Contracting States] request the other State in writing that the income be taxable on a net basis in that other State. Such request shall be allowed by that other State. In determining the taxable income of such resident in the other State, there shall be allowed as deductions those expenses deductible under the domestic laws of the other State which are incurred for the purposes of the activities exercised in the other State and which are available to a resident of the other State exercising the same or similar activities under the same or similar conditions.

11. Paragraph 1 of the Article deals with income derived by individual artistes and sportsmen from their personal activities. Paragraph 2 deals with situations where income from their activities accrues to other persons. If the income of an entertainer or sportsman accrues to another person, and the State of source does not have the statutory right to look through the person receiving the income to tax it as income of the performer, paragraph 2 provides that the portion of the income which cannot be taxed in the hands of the performer may be taxed in the hands of the person receiving the remuneration. If the person receiving the income carries on business

activities, tax may be applied by the source country even if the income is not attributable to a permanent establishment there. [If the person receiving the income is an individual, the income may be taxed even in the absence of a fixed base.] But it will not always be so. There are three main situations of this kind:

- a) The first is the management company which receives income for the appearance of, *e.g.* a group of sportsmen (which is not itself constituted as a legal entity).
- b) The second is the team, troupe, orchestra, etc. which is constituted as a legal entity. Income for performances may be paid to the entity. Individual members of the team, orchestra, etc. will be liable to tax under paragraph 1, in the State in which a performance is given, on any remuneration (or income accruing for their benefit) as a counterpart to the performance; however, if the members are paid a fixed periodic remuneration and it would be difficult to allocate a portion of that income to particular performances, member countries may decide, unilaterally or bilaterally, not to tax it. The profit element accruing from a performance to the legal entity would be liable to tax under paragraph 2.
- c) The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, *e.g.* a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries “look through” such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory. Other countries cannot do this. Where a performance takes place in such a country, paragraph 2 permits it to impose a tax on the profits diverted from the income of the artiste or sportsman to the enterprise. It may be, however, that the domestic laws of some States do not enable them to apply such a provision. Such States are free to agree to other solutions or to leave paragraph 2 out of their bilateral conventions.

11.1 The application of paragraph 2 is not restricted to situations where both the entertainer or sportsman and the other person to

whom the income accrues, *e.g.* a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer or sportsman is not a resident of that other State. Conversely, where the income of an entertainer resident in one of the Contracting States accrues to a person, *e.g.* a star-company, who is a resident of a third State with which the State of source does not have a tax convention, nothing will prevent the Contracting State from taxing that person in accordance with its domestic laws.

11.2 As a general rule it should be noted, however, that, regardless of Article 17, the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsman or the star-company in abusive cases, as is recognised in paragraph 24 of the Commentary on Article 1.

12. Where, in the cases dealt with in paragraphs 1 and 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.

13. Article 17 will ordinarily apply when the artiste or sportsman is employed by a Government and derives income from that Government [...]. Certain conventions contain provisions excluding artistes and sportsmen employed in organisations which are subsidised out of public funds from the application of Article 17.

14. Some countries may consider it appropriate to exclude from the scope of the Article events supported from public funds. Such countries are free to include a provision to achieve this but the

exemptions should be based on clearly definable and objective criteria to ensure that they are given only where intended. Such a provision might read as follows:

The provisions of paragraphs 1 and 2 shall not apply to income derived from activities performed in a Contracting State by artistes or sportsmen if the visit to that State is wholly or mainly supported by public funds of one or both of the Contracting States or political subdivisions or local authorities thereof. In such a case, the income is taxable only in the Contracting State in which the artiste or the sportsman is a resident.

3. When this issue was considered by the former Group of Experts, some members indicated that the examples given in the Commentary on Article 17, paragraph 2, of the OECD Model Convention should not be understood as limiting the field of application of taxation to the incomes mentioned in that Commentary. In fact, the wording of the Commentary would allow taxation of the enterprise in the other Contracting State, with the same limitations as those imposed for artistes or sportspersons resident in a Contracting State and carrying out activities in the other State.

4. On the other hand, members expressed the view that some countries might wish paragraph 2 to have a narrower scope.

Article 18

PENSIONS AND SOCIAL SECURITY PAYMENTS

A. GENERAL CONSIDERATIONS

1. Two alternative versions are given for Article 18 of the United Nations Model Convention, Article 18 A and Article 18 B.

2. Article 18 A, like Article 18 of the OECD Model Convention, provides that the State of residence has an exclusive right to tax pensions and other similar remuneration. It departs, however, from the OECD Article by granting to the State of source an exclusive right to tax the payments made within the framework of a public scheme which is part of the social security system of that State or a political subdivision or a local authority thereof.

3. Under Article 18 B the State of source may tax pensions and other similar remuneration and the provisions of Article 23 A or 23 B will determine whether the State of residence shall exempt such income or shall allow,

as a deduction from its own tax on such income, the tax paid in the State of source. Article 18 B allows, however, exclusive source taxation when the payments are made within the framework of a public scheme which is part of the social security system of a State or a political subdivision or a local authority thereof.

**B. COMMENTARY ON THE TWO ALTERNATIVE
VERSIONS OF ARTICLE 18**

Commentary on the paragraphs of Article 18 A

Paragraph 1

4. According to this paragraph, pensions, and other similar remuneration, paid in respect of private employment are taxable only in the State of residence of the recipient. Since this paragraph reproduces the text of Article 18 of the OECD Model Convention, the Committee considers that the following part of the OECD Commentary is applicable:

1. According to this Article, pensions paid in respect of private employment are taxable only in the State of residence of the recipient. Various policy and administrative considerations support the principle that the taxing right with respect to this type of pension, and other similar remuneration, should be left to the State of residence. For instance, the State of residence of the recipient of a pension is in a better position than any other State to take into account the recipient's overall ability to pay tax, which mostly depends on worldwide income and personal circumstances such as family responsibilities. This solution also avoids imposing on the recipient of this type of pension the administrative burden of having to comply with tax obligations in States other than that recipient's State of residence.

Scope of the Article

3. The types of payment that are covered by the Article include not only pensions directly paid to former employees but also to other beneficiaries (e.g. surviving spouses, companions or children of the employees) and other similar payments, such as annuities, paid in respect of past employment. The Article also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19. The Article only applies, however, to payments

that are in consideration of past employment; it would therefore not apply, for example, to an annuity acquired directly by the annuitant from capital that has not been funded from an employment pension scheme. The Article applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could nevertheless constitute a “pension or other similar remuneration” (the tax mismatch that could arise in such a situation is discussed below).

4. Various payments may be made to an employee following cessation of employment. Whether or not such payments fall under the Article will be determined by the nature of the payments, having regard to the facts and circumstances in which they are made, as explained in the following two paragraphs.

5. While the word “pension”, under the ordinary meaning of the word, covers only periodic payments, the words “other similar remuneration” are broad enough to cover non-periodic payments. For instance, a lump-sum payment in lieu of periodic pension payments that is made on or after cessation of employment may fall within the Article.

6. Whether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact. For example, if it is shown that the consideration for the payment is the commutation of the pension or the compensation for a reduced pension then the payment may be characterised as “other similar remuneration” falling under the Article. This would be the case where a person was entitled to elect upon retirement between the payment of a pension or a lump-sum computed either by reference to the total amount of the contributions or to the amount of pension to which that person would otherwise be entitled under the rules in force for the pension scheme. The source of the payment is an important factor; payments made from a pension scheme would normally be covered by the Article. Other factors which could assist in determining whether a payment or series of payments fall under the Article include: whether a payment is made on or after the cessation of the employment giving rise to the payment, whether the recipient continues working, whether the recipient has reached the normal age of retirement with respect to that particular type of employment, the status of other recipients who qualify for the same type of lump-sum payment and whether the recipient is simultaneously eligible for other pension benefits. Reimbursement of pension contributions (e.g. after temporary

employment) does not constitute “other similar remuneration” under Article 18. Where cases of difficulty arise in the taxation of such payments, the Contracting States should solve the matter by recourse to the provisions of Article 25.

7. Since the Article applies only to pensions and other similar remuneration that are paid in consideration for past employment, it does not cover other pensions such as those that are paid with respect to previous independent personal services. Some States, however, extend the scope of the Article to cover all types of pensions, including Government pensions; States wishing to do so are free to agree bilaterally to include provisions to that effect.

Cross-border issues related to pensions

8. The globalisation of the economy and the development of international communications and transportation have considerably increased the international mobility of individuals, both for work-related and personal reasons. This has significantly increased the importance of cross-border issues arising from the interaction of the different pension arrangements which exist in various States and which were primarily designed on the basis of purely domestic policy considerations. As these issues often affect large numbers of individuals, it is desirable to address them in tax conventions so as to remove obstacles to the international movement of persons, and employees in particular.

9. Many such issues relate to mismatches resulting from differences in the general tax policy that States adopt with respect to retirement savings. In many States, tax incentives are provided for pension contributions. Such incentives frequently take the form of a tax deferral so that the part of the income of an individual that is contributed to a pension arrangement as well as the income earned in the scheme or any pension rights that accrue to the individual are exempt from tax. Conversely, the pension benefits from these arrangements are taxable upon receipt. Other States, however, treat pension contributions like other forms of savings and neither exempt these contributions nor the return thereon; logically, therefore, they do not tax pension benefits. Between these two approaches exist a variety of systems where contributions, the return thereon, the accrual of pension rights or pension benefits are partially taxed or exempt.

10. Other issues arise from the existence of very different arrangements to provide retirement benefits. These arrangements are often classified under the following three broad categories:

- statutory social security schemes;
- occupational pension schemes;
- individual retirement schemes.

The interaction between these three categories of arrangements presents particular difficulties. These difficulties are compounded by the fact that each State may have different tax rules for the arrangements falling in each of these categories as well as by the fact that there are considerable differences in the extent to which States rely on each of these categories to ensure retirement benefits to individuals (e.g. some States provide retirement benefits almost exclusively through their social security system while others rely primarily on occupational pension schemes or individual retirement schemes).

11. The issues arising from all these differences need to be fully considered in the course of bilateral negotiations, in particular to avoid double taxation or non-taxation, and, where appropriate, addressed through specific provisions [...].

5. Many countries have adopted the approach under which, subject to specific conditions, tax on contributions to, and earnings in, pension schemes or on the accrual of pension rights is totally or partially deferred and is recovered when pension benefits are paid. Other countries, however, treat pension contributions, or some kind of them, like other forms of savings and neither exempt those contributions nor the return thereon. Those countries generally do not tax the corresponding pension benefits. Where an individual has been granted tax relief in a country that has adopted the first approach and, before the payment of all or part of the pension benefits, that individual becomes a resident of a country having adopted the second approach, the mismatch in the approaches adopted by the two countries will result in a situation where no tax will ever be payable on the relevant income. In order to avoid such unintended result, countries could include in paragraph 1 an additional sentence along the following lines:

However such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by or on behalf of a pension fund established in that other State or borne by a permanent establishment situated therein and the payment is not subject to tax in the first-mentioned State under the ordinary rules of its tax law.

6. The Committee considers that the following part of the OECD Commentary which deals with exempt pensions is also applicable to paragraph 1:

22. [S]ome States do not tax pension payments generally or otherwise exempt particular categories or parts of pension payments. In these cases, the provisions of the Article, which provides for taxation of pensions in the State of residence, may result in taxation by that State of pensions which were designed not to be taxed and the amount of which may well have been determined having regard to that exemption. This may result in undue financial hardship for the recipient of the pension.

23. To avoid the problems resulting from this type of mismatch, some States include in their treaties provisions to preserve the exempt treatment of pensions when the recipient is a resident of the other Contracting State. These provisions may be restricted to specific categories of pensions or may address the issue in a more comprehensive way. An example of that latter approach would be a provision drafted along the following lines:

Notwithstanding any provision of this Convention, any pension or other similar remuneration paid to a resident of a Contracting State in respect of past employment exercised in the other Contracting State shall be exempt from tax in the first-mentioned State if that pension or other remuneration would be exempt from tax in the other State if the recipient were a resident of that other State.

Paragraph 2

7. Under this paragraph the State of source has an exclusive right to tax pensions paid and other payments made within the framework of a public scheme which is part of the social security system of that State or a political subdivision or a local authority thereof. Countries using the credit method as the general method for relieving double taxation in their conventions are thus, as an exception to that method, obliged to exempt from tax such payments to their residents as are dealt with under paragraph 2. The exclusive right of the State of source to tax pensions paid and other payments made under a public scheme which is part of the social security system is predicated on the rationale that the payments involved are wholly or largely financed out of the tax revenues of the State of source. This is the case when there are no contributions by the prospective beneficiaries of the payments or when the contractual savings contributed under the social security scheme have to be supplemented by the tax revenues of the State of source. Such may not always be the case however when the social security system functions on the basis of the capitalization principle rather than that of the distribution principle.

8. No consensus emerged within the OECD Committee on Fiscal Affairs on the inclusion in the text of Article 18 of the OECD Model of a

provision allowing the State of source to tax payments made under its social security system. However, the OECD Commentary proposes an alternative paragraph providing for such right. The Committee considers that the following part of the OECD Commentary is applicable to paragraph 2:

28. Although the above draft provision refers to the social security [system] of each Contracting State, there are limits to what it covers. “Social security” generally refers to a system of mandatory protection that a State puts in place in order to provide its population with a minimum level of income or retirement benefits or to mitigate the financial impact of events such as unemployment, employment-related injuries, sickness or death. A common feature of social security systems is that the level of benefits is determined by the State. Payments that may be covered by the provision include retirement pensions available to the general public under a public pension scheme, old age pension payments as well as unemployment, disability, maternity, survivorship, sickness, social assistance, and family protection payments that are made by the State or by public entities constituted to administer the funds to be distributed. As there may be substantial differences in the social security systems of the Contracting States, it is important for the States that intend to use the draft provision to verify, during the course of bilateral negotiations, that they have a common understanding of what will be covered by the provision.

9. Some countries using the credit method as the general method for the elimination of double taxation of income derived by their residents may consider that the State of source should not have an exclusive right to tax social security payments. Those countries should then substitute the words “may be taxed” for the words “shall be taxable only” in paragraph 2 of their treaties.

10. The countries that wish to deal with the consequences of the privatisation of their social security system may propose to amend the provisions of paragraph 2 along the following lines in order to cover their privatised system:

Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme or a mandatory private scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Commentary on the paragraphs of Article 18 B

11. Several countries consider that pensions paid in consideration of past employment should not be taxed exclusively in the beneficiary’s State of

residence. Various policy considerations support this rule. Since pensions are in substance a form of deferred compensation for services performed in the State of source, they should be taxed at source as normal employment income would be. When tax relief is granted for pension contributions, the tax on part of the employment income is deferred until retirement and the tax so deferred should be recovered even if the individual has ceased to be a resident before all or part of the pension benefits is paid. Pension flows between some developed and developing countries may not be reciprocal and in some cases represent a relatively substantial net outflow for the developing country.

12. If the State of source does not grant any personal allowances to non-residents, the source taxation of pensions may result in excessive taxation. This issue should be discussed during negotiations. The Contracting States may agree in those cases that the State of source shall grant to a resident of the other State any personal allowances, reliefs and reductions for taxation purposes granted to its own residents in the proportion which the pensions and other similar remunerations bear to world income of the resident of the other State. A sentence drafted along the following lines may be added in paragraph 2:

The other State shall grant to a resident of the first-mentioned State any personal allowances, reliefs and reductions for taxation purposes which it grants to its own residents. Those allowances, reliefs and reductions shall be granted in the proportion which the pensions and other similar remunerations taxable in that State bear to the world income taxable in the first-mentioned State.

13. The State of source might be considered to be the State in which the fund is established, the State where the relevant work has been performed or the State where deductions have been claimed. It is fairly common for employees of transnational corporations to perform services consecutively in several different countries. In such case, taxation in the State where those services were performed or in which relief was granted would raise uncertainty and administrative difficulties for both taxpayers and tax authorities because it would create the possibility of different parts of the same pension being taxable in different States of source. It is generally agreed, therefore, that taxation of pension at source should be construed to mean taxation at the place in which the pension payments originate, not the place in which the services were performed or in which tax relief was granted.

Paragraph 1

14. This paragraph, although it recognizes the right of the State of residence of the recipient to tax pensions and other similar remuneration, leaves

open the possibility that the State of source may also be given the right to tax in certain conditions which are defined in paragraph 2. Paragraph 4 of the Commentary on paragraph 1 of Article 18 A is applicable in order to determine the scope of Article 18 B and to consider the cross-border issues related to pensions.

Paragraph 2

15. As indicated above, the State of source may tax pensions and other similar remuneration paid in consideration of past employment if the payments involved are made by a resident of that State or a permanent establishment situated therein.

16. Some countries could, however, consider that the State which has given tax relief with regard to contributions to the pension scheme or to the accrual of pension rights should have the right to tax the resultant pension. This could be the case where countries grant also tax relief with respect to contributions to or pension rights within foreign pension funds. The following provision is an example of such a provision:

However such pensions and other similar remuneration may also be taxed in the other Contracting State to the extent that they arise from contributions that have qualified for tax relief in that other State.

As already explained in paragraph 13, this approach would raise administrative difficulties, especially in the case of individuals who have worked in more than one country during their career. Such difficulties should be addressed in order to avoid situations, for example, where two countries would claim to have source taxation rights on the same pension.

Paragraph 3

17. Since paragraph 3 of Article 18 B is identical to paragraph 2 of Article 18 A, the Commentary on the latter paragraph (see above) is fully applicable to the former.

18. The OECD Model Convention in the Commentary on Article 18 under paragraphs 31 to 69 has dealt with the question of tax treatment of contributions to foreign pension schemes, the question of tax obstacles to the portability of pension rights and the question of the tax exempt treatment of investment income derived by pension funds established in the other Contracting State. Incorporation of these paragraphs in the Commentary on Article 18 in the United Nations Model Convention would send a strong positive signal to potential inward investors. Allowing recognition of cross-border

pension contributions and facilitating cross-border transfer of pension rights from a pension scheme to another will also stimulate movement of personnel to foreign countries. The Committee considers that the following part of the OECD Commentary is therefore relevant to Article 18 A and Article 18 B:

**The tax treatment of contributions to foreign pension schemes
[made by or for employees and individuals providing
independent services]**

A. *General comments*

31. It is characteristic of multinational enterprises that their staff are expected to be willing to work outside their home country from time to time. The terms of service under which staff are sent to work in other countries are of keen interest and importance to both the employer and the employee. One consideration is the pension arrangements that are made for the employee in question. Similarly, individuals who move to other countries to provide independent services are often confronted with cross-border tax issues related to the pension arrangements that they have established in their home country.

32. Individuals working abroad will often wish to continue contributing to a pension scheme (including a social security scheme that provides pension benefits) in their home country during their absence abroad. This is both because switching schemes can lead to a loss of rights and benefits, and because many practical difficulties can arise from having pension arrangements in a number of countries.

33. The tax treatment accorded to pension contributions made by or for individuals working outside their home country varies both from country to country and depending on the circumstances of the individual case. Before taking up an overseas assignment or contract, pension contributions made by or for these individuals commonly qualify for tax relief in the home country. When the individual works abroad, the contributions in some cases continue to qualify for relief. Where the individual, for example, remains resident and fully taxable in the home country, pension contributions made to a pension scheme established in the home country will generally continue to qualify for relief there. But frequently, contributions paid in the home country by an individual working abroad do not qualify for relief under the domestic laws of either the home country or the host country. Where this is the case it can become expensive, if not prohibitive, to maintain membership of a pension scheme in the

home country during a foreign assignment or contract. Paragraph 37 below suggests a provision which Member countries can, if they wish, include in bilateral treaties to provide reliefs for the pension contributions made by or for individuals working outside their home country.

34. However, some member countries may not consider that the solution to the problem lies in a treaty provision, preferring, for example, the pension scheme to be amended to secure deductibility of contributions in the host State. Other countries may be opposed to including the provision below in treaties where domestic legislation allows relief only with respect to contributions paid to residents. In such cases it may be inappropriate to include the suggested provision in a bilateral treaty.

35. The suggested provision covers contributions made to all forms of pension schemes, including individual retirement schemes as well as social security schemes. Many Member countries have entered into bilateral social security totalisation agreements which may help to partially avoid the problem with respect to contributions to social security schemes; these agreements, however, usually do not deal with the tax treatment of cross-border contributions. In the case of an occupational scheme to which both the employer and the employees contribute, the provision covers both these contributions. Also, the provision is not restricted to the issue of the deductibility of the contributions as it deals with all aspects of the tax treatment of the contributions as regards the individual who derive benefits from a pension scheme. Thus the provision deals with issues such as whether or not the employee should be taxed on the employment benefit that an employer's contribution constitutes and whether or not the investment income derived from the contributions should be taxed in the hands of the individual. It does not, however, deal with the taxation of the pension fund on its income (this issue is dealt with in paragraph 69 below). Contracting States wishing to modify the scope of the provision with respect to any of these issues may do so in their bilateral negotiations.

B. *Aim of the provision*

36. The aim of the provision is to ensure that, as far as possible, individuals are not discouraged from taking up overseas work by the tax treatment of their contributions to a home country pension scheme. The provision seeks, first, to determine the general equivalence of pension plans in the two countries and then to establish limits to the contributions to which the tax relief applies based on the limits in the laws of both countries.

C. Suggested provision

37. The following is the suggested text of the provision that could be included in bilateral conventions to deal with the problem identified above:

1. Contributions to a pension scheme established in and recognised for tax purposes in a Contracting State that are made by or on behalf of an individual who renders services in the other Contracting State shall, for the purposes of determining the individual's tax payable and the profits of an enterprise which may be taxed in that State, be treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that State, provided that:

- a) the individual was not a resident of that State, and was participating in the pension scheme, immediately before beginning to provide services in that State, and
- b) the pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognised as such for tax purposes by that State.

2. For the purposes of paragraph 1:

- a) the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the services referred to in paragraph 1; and
- b) a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State.

38. The above provision is restricted to pension schemes established in one of the two Contracting States. As it is not unusual for individuals to work in a number of different countries in succession, some States may wish to extend the scope of the provision to cover situations where an individual moves from one Contracting State to another while continuing to make contributions to a pension scheme established in a third State. Such an extension may, however, create administrative difficulties if the host State cannot have access to information concerning the pension scheme (*e.g.* through the exchange of information provisions of a tax convention concluded with the third State); it may also create a situation where relief would be given on a non-reciprocal basis because the third State would not grant similar

relief to an individual contributing to a pension scheme established in the host State. States which, notwithstanding these difficulties, want to extend the suggested provision to funds established in third States can do so by adopting an alternative version of the suggested provision drafted along the following lines:

1. Contributions made by or on behalf of an individual who renders services in a Contracting State to a pension scheme
 - a) recognised for tax purposes in the other Contracting State,
 - b) in which the individual participated immediately before beginning to provide services in the first-mentioned State,
 - c) in which the individual participated at a time when that individual was providing services in, or was a resident of, the other State, and
 - d) that is accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognised as such for tax purposes by that State, shall, for the purposes of
 - e) determining the individual's tax payable in the first-mentioned State, and
 - f) determining the profits of an enterprise which may be taxed in the first-mentioned State, be treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that first-mentioned State.
2. For the purposes of paragraph 1:
 - a) the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the services referred to in paragraph 1; and
 - b) a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State.

D. Characteristics of the suggested provision

39. The following paragraphs discuss the main characteristics of the suggested provision found in paragraph 37 above.

40. Paragraph 1 of the suggested provision lays down the characteristics of both the individual and the contributions in respect of which the provision applies. It also provides the principle that

contributions made by or on behalf of an individual rendering services in one Contracting State (the host State) to a defined pension scheme in the other Contracting State (the home State) are to be treated for tax purposes in the host State, in the same way and subject to the same conditions and limitations as contributions to domestic pension schemes of the host State.

41. Tax relief with respect to contributions to the home country pension scheme under the conditions outlined can be given by either the home country, being the country where the pension scheme is situated or by the host country, where the economic activities giving rise to the contributions are carried out.

42. A solution in which relief would be given by the home country might not be effective, since the individual might have no or little taxable income in that country. Practical considerations therefore suggest that it would be preferable for relief to be given by the host country and this is the solution adopted in the suggested provision.

43. In looking at the characteristics of the individual, paragraph 1 makes it clear that, in order to get the relief from taxation in the host State, the individual must not have been resident in the host State immediately prior to working there.

44. Paragraph 1 does not, however, limit the application of the provision to individuals who become resident in their host State. In many cases individuals working abroad who remain resident in their home State will continue to qualify for relief there, but this will not be so in all cases. The suggested provision therefore applies to non-residents working in the host State as well as to individuals who attain residence status there. In some member countries the domestic legislation may restrict deductibility to contributions borne by residents, and these member countries may wish to restrict the suggested provision to cater for this. Also, States with a special regime for non-residents (*e.g.* taxation at a special low rate) may, in bilateral negotiations, wish to agree on a provision restricted to residents.

45. In the case where individuals temporarily cease to be resident in the host country in order to join a pension scheme in a country with more relaxed rules, individual States may want a provision which would prevent the possibility of abuse. One form such a provision could take would be a nationality test which could exclude from the suggested provision individuals who are nationals of the host State.

46. As already noted, it is not unusual for individuals to work in a number of different countries in succession; for that reason the suggested provision is not limited to individuals who are residents

of the home State immediately prior to providing services in the host State. The provision covers an individual coming to the host State from a third country as it is only limited to individuals who were not resident in the host country before starting to work there. However, Article 1 restricts the scope of the Convention to residents of one or both Contracting States. An individual who is neither a resident of the host State nor of the home State where the pension scheme is established is therefore outside the scope of the Convention between the two States.

47. The suggested provision places no limits on the length of time for which an individual can work in a host State. It could be argued that, if an individual works in the host State for long enough, it in effect becomes his home country and the provision should no longer apply. Indeed, some host countries already restrict relief for contributions to foreign pension schemes to cases where the individuals are present on a temporary basis.

48. In addition, the inclusion of a time limit may be helpful in preventing the possibility of abuse outlined in paragraph 45 above. In bilateral negotiations, individual countries may find it appropriate to include a limit on the length of time for which an individual may provide services in the host State after which reliefs granted by the suggested provision would no longer apply.

49. In looking at the characteristics of the contributions, paragraph 1 provides a number of tests. It makes it clear that the provision applies only to contributions made by or on behalf of an individual to a pension scheme established in and recognised for tax purposes in the home State. The phrase “recognised for tax purposes” is further defined in subparagraph 2 *b*) of the suggested provision. The phrase “made by or on behalf of” is intended to apply to contributions that are made directly by the individual as well as to those that are made for that individual’s benefit by an employer or another party (*e.g.* a spouse). While paragraph 4 of Article 24 ensures that the employer’s contributions to a pension fund resident of the other Contracting State are deductible under the same conditions as contributions to a resident pension fund, that provision may not be sufficient to ensure the similar treatment of employer’s contributions to domestic and foreign pension funds. This will be the case, for example, where the employer’s contributions to the foreign fund are treated as a taxable benefit in the hands of the employee or where the deduction of the employer’s contributions is not dependent on the fund being a resident but, rather, on other conditions (*e.g.* registration with tax authorities or the presence of offices) which have the effect of generally excluding

foreign pension funds. For these reasons, employer's contributions are covered by the suggested provision even though paragraph 4 of Article 24 may already ensure a similar relief in some cases.

50. The second test applied to the characteristics of the contributions is that the contributions should be made to a home State scheme recognised by the competent authority of the host State as generally corresponding to a scheme recognised as such for tax purposes by the host State. This operates on the premise that only contributions to recognised schemes qualify for relief in member countries. This limitation does not, of course, necessarily secure equivalent tax treatment of contributions paid where an individual was working abroad and of contributions while working in the home country. If the host State's rules for recognising pension schemes were narrower than those of the home State, the individual could find that contributions to his home country pension scheme were less favourably treated when he was working in the host country than when working in the home country.

51. However, it would not be in accordance with the stated aim of securing, as far as possible, equivalent tax treatment of contributions to foreign schemes to give relief for contributions which do not—at least broadly—correspond to domestically recognised schemes. To do so would mean that the amount of relief in the host State would become dependent on legislation in the home State. In addition, it could be hard to defend treating individuals working side by side differently depending on whether their pension scheme was at home or abroad (and if abroad, whether it was one country rather than another). By limiting the suggested provision to schemes which generally correspond to those in the host country such difficulties are avoided.

52. The suggested provision makes it clear that it is for the competent authority of the host State to determine whether the scheme in the home State generally corresponds to recognised schemes in the host State. Individual States may wish, in bilateral negotiations, to specify expressly to which existing schemes the provision will apply or to establish what interpretation the competent authority places on the term “generally corresponding”; for example how widely it is interpreted and what tests are imposed.

53. The contributions covered by the provision are limited in payments to schemes to which the individual was participating before beginning to provide services in the host State. This means that contributions to new pension schemes which an individual joins while in the host State are excluded from the suggested provision.

54. It is, however, recognised that special rules may be needed to cover cases where new pension schemes are substituted for previous ones. For instance, in some member countries the common practice may be that, if a company employer is taken over by another company, the existing company pension scheme for its employees may be ended and a new scheme opened by the new employer. In bilateral negotiations, therefore, individual States may wish to supplement the provision to cover such substitution schemes; this could be done by adding the following sub-paragraph to paragraph 2 of the suggested provision:

- c) a pension scheme that is substituted for, but is substantially similar to, a pension scheme accepted by the competent authority of a Contracting State under subparagraph *b*) of paragraph 1 shall be deemed to be the pension scheme that was so accepted.

55. Paragraph 1 also sets out the relief to be given by the host State if the characteristics of the individual and the contributions fall within the terms of the provision. In brief, contributions must be treated for tax purposes in a way which corresponds to the manner in which they would be treated if these contributions were to a scheme established in the host State. Thus, the contributions will qualify for the same tax relief (*e.g.* be deductible), for both the individual and the employer (where the individual is employed and contributions are made by the employer) as if these contributions had been made to a scheme in the host State. Also, the same treatment has to be given as regards the taxation of an employee on the employment benefit derived from an employer's contribution to either a foreign or a local scheme (see paragraph 58 below).

56. This measure of relief does not, of course, necessarily secure equivalent tax treatment given to contributions paid when an individual is working abroad and contributions paid when he is working in the home country. Similar considerations apply here to those discussed in paragraphs 50 and 51 above. The measure does, however, ensure equivalent treatment of the contributions of co-workers. The following example is considered. The home country allows relief for pension contributions subject to a limit of 18 per cent of income. The host country allows relief subject to a limit of 20 per cent. The suggested provision in paragraph 37 would require the host country to allow relief up to its domestic limit of 20 per cent. Countries wishing to adopt the limit in the home country would need to amend the wording of the provision appropriately.

57. The amount and method of giving the relief would depend upon the domestic tax treatment of pension contributions by the host State. This would settle such questions as whether contributions qualify for relief in full, or only in part, and whether relief should be given as a deduction in computing taxable income (and if so, which income, *e.g.* in the case of an individual, only employment, [independent personal services] or business income or all income) or as a tax credit.

58. For an individual who participates in an occupational pension scheme, being assigned to work abroad may not only mean that this employee's contributions to a pension scheme in his home country cease to qualify for tax relief. It may also mean that contributions to the pension scheme by the employer are regarded as the employee's income for tax purposes. In some member countries employees are taxed on employer's contributions to domestic schemes whilst working in the home country whereas in others these contributions remain exempt. Since it applies to both employees' and employers' contribution, the suggested provision ensures that employers' contributions in the context of the employees' tax liability are accorded the same treatment that such contributions to domestic schemes would receive.

59. Subparagraph 2 *a*) defines a pension scheme for the purposes of paragraph 1. It makes it clear that, for these purposes, a pension scheme is an arrangement in which the individual who makes the payments participates in order to secure retirement benefits. These benefits must be payable in respect of services provided in the host State. All the above conditions must apply to the pension scheme before it can qualify for relief under the suggested provision.

60. Subparagraph 2 *a*) refers to the participation of the individual in the pension scheme in order to secure retirement benefits. This definition is intended to ensure that the proportion of contributions made to secure benefits other than periodic pension payments on retirement, *e.g.* a lump sum on retirement, will also qualify for relief under the provision.

61. The initial definition of a pension scheme is "an arrangement". This is a widely drawn term, the use of which is intended to encompass the various forms which pension schemes (whether social security, occupational or individual retirement schemes) may take in different member countries.

62. Subparagraph 2 *a*) sets out that participation in this scheme has to be by the individual who provides services referred to in paragraph 1 there is no reference to the identity of the recipient of the retirement benefits secured by participation in the scheme. This is

to ensure that any proportion of contributions intended to generate pension for other beneficiaries (e.g. surviving spouses, companions or children of employees) may be eligible for relief under the suggested provision.

63. The definition of a pension scheme makes no distinction between pensions paid from State-run occupational pension schemes and similar privately-run schemes. Both are covered by the scope of the provision. Social security schemes are therefore covered by the provision to the extent that contributions to such schemes can be considered to be with respect to the services provided in the host State by an individual, whether as an employee or in an independent capacity.

64. Subparagraph 2 *b*) further defines the phrase “recognised for tax purposes”. As the aim of the provision is, so far as possible, to ensure that contributions are neither more nor less favourably treated for tax purposes than they would be if the individual were resident in his home State, it is right to limit the scope of the provision to contributions which would have qualified for relief if the individual had remained in the home State. The provision seeks to achieve this aim by limiting its scope to contributions made to a scheme only if contributions to this scheme would qualify for tax relief in that State.

65. This method of attempting to achieve parity of treatment assumes that in all member countries only contributions to recognised pension schemes qualify for relief. The tax treatment of contributions to pension schemes under member countries’ tax systems may differ from this assumption. It is recognised that, in bilateral negotiations, individual countries may wish to further define the qualifying pension schemes in terms that match the respective domestic laws of the treaty partners. They may also wish to define other terms used in the provision, such as “renders services” and “provides services”.

Tax obstacles to the portability to pension rights

66. Another issue, which also relates to international labour mobility, is that of the tax consequences that may arise from the transfer of pension rights from a pension scheme established in one Contracting State to another scheme located in the other Contracting State. When an individual moves from one employer to another, it is frequent for the pension rights that this individual accumulated in the pension scheme covering the first employment to be transferred to a different scheme covering the second employment. Similar arrangements may exist to allow for the portability of pension rights to or from an individual retirement scheme.

67. Such transfers usually give rise to a payment representing the actuarial value, at the time of the transfer, of the pension rights of the individual or representing the value of the contributions and earnings that have accumulated in the scheme with respect to the individual. These payments may be made directly from the first scheme to the second one; alternatively, they may be made by requiring the individual to contribute to the new pension scheme all or part of the amount received upon withdrawing from the previous scheme. In both cases, it is frequent for tax systems to allow such transfers, when they are purely domestic, to take place on a tax-free basis.

68. Problems may arise, however, where the transfer is made from a pension scheme located in one Contracting State to a scheme located in the other State. In such a case, the Contracting State where the individual resides may consider that the payment arising upon the transfer is a taxable benefit. A similar problem arises when the payment is made from a scheme established in a State to which the relevant tax convention gives source taxing rights on pension payments arising therefrom as that State may want to apply that taxing right to any benefit derived from the scheme. Contracting States that wish to address that issue are free to include a provision drafted along the following lines:

Where pension rights or amounts have accumulated in a pension scheme established in and recognised for tax purposes in one Contracting State for the benefit of an individual who is a resident of the other Contracting State, any transfer of these rights or amounts to a pension scheme established in and recognised for tax purposes in that other State shall, in each State, be treated for tax purposes in the same way and subject to the same conditions and limitations as if it had been made from one pension scheme established in and recognised for tax purposes in that State to another pension scheme established in and recognised for tax purposes in the same State.

The above provision could be modified to also cover transfers to or from pensions funds established and recognised in third States (this, however, could raise similar concerns as those described in the preamble of paragraph 38 above).

Exemption of the income of a pension fund

69. Where, under their domestic law, two States follow the same approach of generally exempting from tax the investment income of

pension funds established in their territory, these States, in order to achieve greater neutrality with respect to the location of capital, may want to extend that exemption to the investment income that a pension fund established in one State derives from the other State. In order to do so, States sometimes include in their conventions a provision drafted along the following lines:

Notwithstanding any provision of this Convention, income arising in a Contracting State that is derived by a resident of the other Contracting State that was constituted and is operated exclusively to administer or provide pension benefits and has been accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognised as such for tax purposes by that State, shall be exempt from tax in that State.

Article 19

GOVERNMENT SERVICE

1. In 2011 the Committee of Experts made some changes in Article 19. Firstly, the words “other than a pension” were deleted in paragraph 1. Secondly, the words “Notwithstanding the provisions of paragraph 1” were added in paragraph 2. Thirdly, in paragraphs 2 and 3, the word “pension” was replaced by the words “pensions and other similar remuneration”. As a result, Article 19 of the United Nations Model Convention reproduces Article 19 of the OECD Model Convention.

2. Since Article 19 of the United Nations Model Convention incorporates all the provisions of Article 19 of the OECD Model Convention, the Committee considers that the following part of the OECD Commentary is applicable:

1. This Article applies to salaries, wages, and other similar remuneration, and pensions, in respect of government service. Similar provisions in old bilateral conventions were framed in order to conform with the rules of international courtesy and mutual respect between sovereign States. They were therefore rather limited in scope. However, the importance and scope of Article 19 has increased on account of the fact that, consequent on the growth of the public sector in many countries, governmental activities abroad have been considerably extended. According to the original version of paragraph 1 of Article 19 in the 1963 Draft Convention the paying State had a right to tax payments made for services rendered to that State or political subdivision or local authority thereof. The expression “may be taxed” was used and this did not connote an exclusive right of taxation.

2. [...] [S]ubparagraph *a*) of paragraphs 1 and 2 are both based on the principle that the paying State shall have an exclusive right to tax the payments. Countries using the credit method as the general method for relieving double taxation in their conventions are thus, as an exception to that method, obliged to exempt from tax such payments to their residents as are dealt with under paragraphs 1 and 2. If both Contracting States apply the exemption method for relieving double taxation, they can continue to use the expression “may be taxed” instead of “shall be taxable only”. In relation to such countries the effect will of course be the same irrespective of which of these expressions they use. It is understood that the expression “shall be taxable only” shall not prevent a Contracting State from taking into account the income exempted under subparagraph *a*) of paragraphs 1 and 2 in determining the rate of tax to be imposed on income derived by its residents from other sources. The principle of giving the exclusive taxing right to the paying State is contained in so many of the existing conventions between OECD member countries that it can be said to be already internationally accepted. It is also in conformity with the conception of international courtesy which is at the basis of the Article and with the provisions of the Vienna Conventions on Diplomatic and Consular Relations. It should, however, be observed that the Article is not intended to restrict the operation of any rules originating from international law in the case of diplomatic missions and consular posts (see Article 28) but deals with cases not covered by such rules.

2.1 In 1994, a further amendment was made to paragraph 1 by replacing the term “remuneration” by the words “salaries, wages, and other similar remuneration”. This amendment was intended to clarify the scope of the Article, which only applies to State employees and to persons deriving pensions from past employment by a State, and not to persons rendering independent services to a State or deriving pensions related to such services.

2.2 Member countries have generally understood the term “salaries, wages and other similar remuneration ... paid” to include benefits in kind received in respect of services rendered to a State or political subdivision or local authority thereof (*e.g.* the use of a residence or automobile, health or life insurance coverage and club memberships).

3. The provisions of the Article apply to payments made not only by a State but also by its political subdivisions and local authorities (constituent states, regions, provinces, *départements*, cantons, districts, *arrondissements*, *Kreise*, municipalities, or groups of municipalities, etc.).

4. An exception from the principle of giving exclusive taxing power to the paying State is contained in subparagraph *b)* of paragraph 1. It is to be seen against the background that, according to the Vienna Conventions mentioned above, the receiving State is allowed to tax remuneration paid to certain categories of personnel of foreign diplomatic missions and consular posts, who are permanent residents or nationals of that State. Given that pensions paid to retired government officials ought to be treated for tax purposes in the same way as salaries or wages paid to such employees during their active time, an exception like the one in subparagraph *b)* of paragraph 1 is incorporated also in subparagraph *b)* of paragraph 2 regarding pensions. Since the condition laid down in subdivision *b)* (*ii*) of paragraph 1 cannot be valid in relation to a pensioner, the only prerequisite for the receiving State's power to tax the pension is that the pensioner must be one of its own residents and nationals.

5. According to Article 19 of the 1963 Draft Convention, the services rendered to the State, political subdivision or local authority had to be rendered "in the discharge of functions of a governmental nature". That expression was deleted in the 1977 Model Convention. Some OECD member countries, however, thought that the exclusion would lead to a widening of the scope of the Article. Contracting States who are of that view and who feel that such a widening is not desirable may continue to use, and preferably specify, the expression "in the discharge of functions of a governmental nature" in their bilateral conventions.

5.1 Whilst the word "pension", under the ordinary meaning of the word, covers only periodic payments, the words "other similar remuneration", which were added to paragraph 2 in 2005, are broad enough to cover non-periodic payments. For example, a lump-sum payment in lieu of periodic pension payments that is made to a former State employee after cessation of employment may fall within paragraph 2 of the Article. Whether a particular lump-sum payment made in these circumstances is to be considered as other remuneration similar to a pension falling under paragraph 2 or as final remuneration for work performed falling under paragraph 1 is a question of fact which can be resolved in light of the factors presented in paragraph 5 of the Commentary on Article 18.

5.2 It should be noted that the expression "out of funds created by" in subparagraph *a)* of paragraph 2 covers the situation where the pension is not paid directly by the State, a political subdivision or a local authority but out of separate funds created by a government body. In addition, the original capital of the fund would not need to

be provided by the State, a political subdivision or a local authority. The phrase would cover payments from a privately administered fund established for the government body.

5.3 An issue arises where pensions are paid for combined private and government services. This issue may frequently arise where a person has been employed in both the private and public sector and receives one pension in respect of both periods of employment. This may occur either because the person participated in the same scheme throughout the employment or because the person's pension rights were portable. A trend towards greater mobility between private and public sectors may increase the significance of this issue.

5.4 Where a civil servant having rendered services to a State has transferred a right to a pension from a public scheme to a private scheme the pension payments would be taxed only under Article 18 because such payment would not meet the technical requirement of subparagraph 2 a).

5.5 Where the transfer is made in the opposite direction and the pension rights are transferred from a private scheme to a public scheme, some States tax the whole pension payments under Article 19. Other States, however, apportion the pension payments based on the relative source of the pension entitlement so that part is taxed under Article 18 and another part under Article 19. In so doing, some States consider that if one source has provided by far the principal amount of the pension, then the pension should be treated as having been paid exclusively from that source. Nevertheless, it is recognised that apportionment often raises significant administrative difficulties.

5.6 Contracting States may be concerned about the revenue loss or the possibility of double non-taxation if the treatment of pensions could be changed by transferring the fund between public and private schemes. Apportionment may counter this; however, to enable apportionment to be applied to pensions rights that are transferred from a public scheme to a private scheme, Contracting States may, in bilateral negotiations, consider extending subparagraph 2 a) to cover the part of any pension or other similar remuneration that it is paid in respect of services rendered to a Contracting State or a political subdivision or a local authority thereof. Such a provision could be drafted as follows:

2. a) Notwithstanding the provisions of paragraph 1, the part of any pension or other similar remuneration that is paid in respect of services rendered to a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that Contracting State.

Alternatively Contracting States may address the concern by subjecting all pensions to a common treatment.

6. Paragraphs 1 and 2 do not apply if the services are performed in connection with business carried on by the State, or one of its political subdivisions or local authorities, paying the salaries, wages, pensions or other similar remuneration. In such cases the ordinary rules apply: Article 15 for wages and salaries, Article 16 for directors' fees and other similar payments, Article 17 for artistes and sportsmen, and Article 18 for pensions. Contracting States, wishing for specific reasons to dispense with paragraph 3 in their bilateral conventions, are free to do so thus bringing in under paragraphs 1 and 2 also services rendered in connection with business. In view of the specific functions carried out by certain public bodies, *e.g.* State Railways, the Post Office, State-owned theatres etc., Contracting States wanting to keep paragraph 3 may agree in bilateral negotiations to include under the provisions of paragraphs 1 and 2 salaries, wages, pensions, and other similar remuneration paid by such bodies, even if they could be said to be performing business activities.

3. All pensions paid in respect of services rendered to a Contracting State, political subdivision or local authority thereof are subject to Article 19, even if they are paid under the social security system of one of the States. In most cases the treatment would be the same whether such payments were subject to Article 18 or Article 19. The treatment differs, however, in those cases described in subparagraph 2 (*b*) of Article 19—where the recipient is both a resident and a national of the other State. Under Article 19, government service pensions received by such individuals are taxable only in the State of residence. If they were to be subject to tax under Article 18, they would be taxable only in the State of source. The purpose of this paragraph is to indicate that a public service pension paid by one State, even if it is paid under its social security system, to a resident of the other State who is a national of that other State is taxable only in the latter State. Some countries prefer to extend the scope of Article 18 to cover also government pensions, so that private pensions and government pensions are subject to the same treatment. When such a solution is chosen, paragraph 2 of Article 19 is not necessary and should be deleted.

4. It was proposed that the question of tax treatment of a Government meeting the expenses of artistes resident of one Contracting State performing their activities in another Contracting State might be dealt with in the Commentaries. However, it was considered that the Contracting States, if they so desire, may discuss the matter during bilateral negotiations. A reference is made to the Commentaries on Article 17 in this connection.

Article 20

STUDENTS

1. Article 20 of the United Nations Model Convention, as presently worded, reproduces substantially Article 20 of the OECD Model Convention. In 1999, paragraph 2, which contained provisions dealing with grants and scholarships and remuneration from employment not covered by paragraph 1, was deleted.

2. Since Article 20 of the United Nations Model Convention reproduces Article 20 of the OECD Model Convention, the following Commentary on the latter Article is applicable:

1. The rule established in this Article concerns certain payments received by students or business apprentices for the purpose of their maintenance, education or training. All such payments received from sources outside the State in which the student or business apprentice concerned is staying shall be exempted from tax in that State.

2. The word “immediately” was inserted in the 1977 Model Convention in order to make clear that the Article does not cover a person who has once been a resident of a Contracting State but has subsequently moved his residence to a third State before visiting the other Contracting State.

3. The Article covers only payments received for the purpose of the recipient’s maintenance, education or training. It does not, therefore, apply to a payment, or any part thereof, that is remuneration for services rendered by the recipient and which is covered by Article 15 (or by [14 or] Article 7 in the case of independent services). Where the recipient’s training involves work experience, however, there is a need to distinguish between a payment for services and a payment for the recipient’s maintenance, education or training. The fact that the amount paid is similar to that paid to persons who provide similar services and are not students or business apprentices would generally indicate that the payment is a remuneration for services. Also, payments for maintenance, education or training should not exceed the level of expenses that are likely to be incurred to ensure the recipient’s maintenance, education or training.

4. For the purpose of the Article, payments that are made by or on behalf of a resident of a Contracting State or that are borne by a permanent establishment which a person has in that State are not considered to arise from sources outside that State.

3. Article 20 of the 1980 version of the United Nations Model Convention contained a paragraph 2 which read as follows:

(2) in respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a student or business apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the State which he is visiting.

The question whether paragraph 2 of Article 20 should be deleted from the United Nations Model Convention had engaged the attention of the former Group of Experts for some time. In this connection, it is relevant to reproduce paragraphs 25 to 29 of the Report of the former Group of Experts on International Cooperation in Tax Matters on the Work of its Seventh Meeting held in December 1995 (ST/ESA/250):

25. At its July 1995 meeting, the Steering Committee recommended that the group consider deleting from the Model Convention article 20, paragraph 2, which provided that if a visiting student had income not exempted by paragraph 1 from taxation in the visited country, the student should, in the taxation of non-exempted income, be entitled to the same exemptions, reliefs, and reductions as were allowed to residents of that country.

26. A participant argued that the provision should be retained because it allowed visiting students to be taxed in the same way as resident students. Another participant responded that such parity was sometimes elusive because the resident student was taxable on all income, whereas a visiting student was taxable only on income from sources in the visited country.

27. A proponent of deleting the provision noted that article 24, paragraph 4 (second sentence), stated that a country is not required to allow non-residents any personal allowances or other reliefs 'on account of civil status or family responsibilities' which might be allowed to residents; article 20, paragraph 2, it was argued, contradicted the provision of article 24.

28. A participant noted that, as an alternative to article 14, paragraph 1(c), a treaty might provide for exemption in the host State, for the normal duration of studies, of remuneration not exceeding a certain annual amount, but only to the extent that the remuneration was also not exempted in the other State. [Paragraph 1(c) of Article 14 was deleted in 1999.]

29. After discussion, it was concluded that a majority of the Group, but not a consensus, favoured deletion of article 20, paragraph 2.

4. The matter was considered again at the ninth meeting of the former Group of Experts, in May 1999, and the Group agreed to delete paragraph 2 of Article 20. Article 20 thus conforms to Article 20 of the OECD Model Convention, with the addition of the word “trainee”.

5. Although, as worded, paragraph 2 covers grants and scholarships that have their source in the country visited as well as income from an employment in the country visited, the Commentaries to the 1980 Model made it clear that the paragraph was mainly concerned with income from employment. The wording was intended to put visiting students etc. on exactly the same basis as students who were residents for tax purposes of the State where they were studying, but not to treat visiting students more favourably than tax-resident students.

6. Experience with the application of paragraph 2 in practice has shown that, as presently worded, it can give rise to difficult problems of administration. For example, if the visiting student is subject to tax in the State visited only on income from sources in that country, and not on his worldwide income, should the visitor be entitled to the full allowances which a resident who is taxed on his worldwide income is allowed? Similarly, should a married student, whose spouse does not come to the country with the student, be entitled to the married person’s allowance? These issues cannot be settled from a strict reading of the text of paragraph 2 as it stands.

7. A particular question raised by the inclusion of paragraph 2 is the tax residence status of a visiting student or business apprentice under the normal rules of residence in article 4. A student who is following a full-time course of studies may become a tax resident of the host State: in which case, he will become liable to tax there in respect of his worldwide income, and be entitled to all the personal reliefs, without the need of any special provision in Article 20.

8. Moreover, as the Commentary to the 1980 version went on to show, there are a number of further ways in which the countries may wish to consider expanding Article 20 in the course of negotiations in order to cover particular problems which may arise in special bilateral situations. Examples are given, without suggesting any particular form of words to give effect to their intentions. The 1980 Commentaries said:

[...] some countries in bilateral negotiations might wish to expand the article by adding a paragraph permitting a further exemption

(beyond that generally applicable as a personal exemption or similar allowance under the internal law of the Contracting State) of employment income under certain conditions. Some countries may, for example, wish to extend the exemption to remuneration received for services performed in the country where the student or business apprentice is present, but to limit the exemption to a specified amount of remuneration. In fixing the amount, countries may take into account the fact that students or business apprentices may incur additional costs because they are away from their home country. It may also be appropriate, in cases where the exemption is extended, to place a time limit on such exemption in the cases of business apprentices, and also perhaps in the cases of students, a longer period presumably being allowed in the latter situation.

9. In the light of the practical difficulties of applying paragraph 2, and the fact that there are a number of other issues affecting students and business apprentices that may need to be addressed in bilateral negotiations, the former Group of Experts decided that, rather than attempt a comprehensive rewording, it was preferable to omit paragraph 2 from the Convention. Countries wishing to broaden the scope of Article 20 to cover sources of income arising in the country visited should aim to draft a suitable provision as tightly as possible to meet their specific circumstances.

Article for teachers

10. During the course of discussions in the Seventh Meeting of the former Group of Experts, several participants argued for the addition to the Convention of an article dealing with visiting teachers. Currently, under the Convention visiting teachers are subject to Article 14, if the teaching services are performed in an independent capacity; Article 15, if the services are dependent; or Article 19, if the remuneration is paid by a Contracting State. Many treaties have an additional article or paragraph dealing specifically with teachers and, sometimes, researchers, which typically exempted them from taxation in the source country if their stay did not exceed a prescribed length. It was noted that Articles 14 and 15 commonly did not exempt a visiting teacher's compensation from taxation at source because they generally allowed source taxation of service performers who were present in the host country for more than 183 days, and many teaching assignments exceeded that period of time.

11. There was considerable controversy among participants about the need to provide an independent article in the United Nations Model Convention

dealing exclusively with visiting teachers. But substantially, all participants agreed that an article on teachers, if included in the Convention, should not have the effect of exempting a teacher from tax both in the home country and the country visited. One member suggested a compromise on the issue: that the Convention should not be amended to include a provision on visiting teachers but that an addition should be made in the Commentary, noting that many treaties contained such articles and providing advice for bilateral negotiations on the subject. There was general consensus for this suggestion.

12. Accordingly, the former Group of Experts appointed a drafting committee to formulate language for inclusion in the Commentary on the Convention. After being discussed and amended, the following inclusion was adopted by the Group in 1999:

No special Model Convention provision has been made regarding remuneration derived by visiting professors and other teachers. In the absence of a special provision, articles 14, 15, 19 or 23 of the Model Convention, depending on the circumstances, would apply. Many bilateral conventions, however, contain rules of some kind or other concerning such persons, the main purpose of which is to facilitate cultural relations and the exchange of knowledge by providing for a limited tax exemption in the host country for visiting teachers. Sometimes, tax exemption is already provided under domestic taxation laws, which many consider to be the preferred way of solving double taxation problems of visiting teachers.

Notwithstanding the applicability of articles 14, 15, 19 and 23 to prevent double taxation, some countries may wish to include an article on teachers. The variety of domestic tax rules in different countries, on the one hand, or the absence of such rules, on the other, constitute an impediment to a specific provision on teachers in the Model Convention. If, however, in bilateral negotiations, the Contracting States choose to include a provision relating to visiting teachers, the following issues should be considered in preparing such a provision:

- (a) The purpose of a tax treaty generally is to avoid double taxation, and double exemption of teachers is not desirable;
- (b) It is advisable to limit benefits for visits of a maximum duration (normally two years), and the time limit should be subject to expansion in individual cases by mutual agreement between competent authorities of the Contracting States. It should be determined whether income from the visits exceeding the

time limit should be taxable as of the beginning of the visit or merely from the date beyond the expiration of the time limit;

- (c) Whether the benefits should be limited to teaching services performed at certain institutions “recognized” by the Contracting States in which the services are performed;
- (d) Whether, in the case of visiting professors and other teachers who also do research, to limit benefits remuneration for research performed in the public (vs. private) interest;
- (e) Whether an individual may be entitled to the benefits of the article more than once.

Article 21

OTHER INCOME

1. Article 21 of the United Nations Model Convention reproduces Article 21 of the OECD Model Convention with the exception that paragraph 2 of Article 21 of the United Nations Model Convention also covers the case where the income is attributed to a fixed base which the beneficiary of the income has in the other Contracting State according to Article 14. Article 21 of the United Nations Model Convention also has an additional paragraph 3 containing a general provision relating to items of income of a resident of a Contracting State not dealt with in the preceding articles and arising in the other Contracting State.

2. The Article covers income of a class not expressly dealt with in the preceding articles (e.g. an alimony or a lottery income) as well as income from sources not expressly referred to therein (e.g. a rent paid by a resident of a Contracting State for the use of immovable property situated in a third State). The Article covers income arising in third States as well as income from a Contracting State.

Paragraph 1

3. This paragraph reproduces Article 21, paragraph 1, of the OECD Model Convention. The Committee considers therefore that the following part of the OECD Commentary is applicable:

- 2. Under this paragraph the exclusive right to tax is given to the State of residence. In cases of conflict between two residences, Article 4 will also allocate the taxation right in respect of third-State income.

3. [...] [W]hen income arises in a third State and the recipient of this income is considered as a resident by both Contracting States under their domestic law, the application of Article 4 will result in the recipient being treated as a resident of one Contracting State only and being liable to comprehensive taxation (“full tax liability”) in that State only. In this case, the other Contracting State may not impose tax on the income arising from the third State, even if the recipient is not taxed by the State of which he is considered a resident under Article 4. In order to avoid non-taxation, Contracting States may agree to limit the scope of the Article to income which is taxed in the Contracting State of which the recipient is a resident and may modify the provisions of the paragraph accordingly [...].

A reference is also invited to paragraph 5 of the Commentary below.

Paragraph 2

4. This paragraph reproduces Article 21, paragraph 2, of the OECD Model Convention with the difference that paragraph 2 of Article 21 of the United Nations Model Convention also covers the case where the income is attributed to a fixed base which the beneficiary of the income has in the other Contracting State according to Article 14. The Committee considers that the following part of the OECD Commentary is applicable (the additional comments that appear in square brackets, which are not part of the OECD Commentary, have been inserted in order to reflect the difference described):

4. This paragraph provides for an exception from the provisions of paragraph 1 where the income is associated with the activity of a permanent establishment [or a fixed base] which a resident of a Contracting State has in the other Contracting State. The paragraph includes income from third States. In such a case, a right to tax is given to the Contracting State in which the permanent establishment [or the fixed base] is situated. Paragraph 2 does not apply to immovable property for which, according to paragraph 4 of Article 6, the State of situs has a primary right to tax [...]. Therefore, immovable property situated in a Contracting State and forming part of the business property of a permanent establishment of an enterprise of that State situated in the other Contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient of the income is a resident. This is in consistency with the rules laid down in Articles 13 and 22 in respect of immovable property since paragraph 2 of those Articles applies only to movable property of a permanent establishment.

5. The paragraph also covers the case where the beneficiary and the payer of the income are both residents of the same Contracting State, and the income is attributed to a permanent establishment [or a fixed base,] which the beneficiary of the income has in the other Contracting State. In such a case a right to tax is given to the Contracting State in which the permanent establishment [or the fixed base] is situated. Where double taxation occurs, the State of residence should give relief under the provisions of Article 23 A or 23 B. However, a problem may arise as regards the taxation of dividends and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, the first State, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11. The State where the permanent establishment is situated would give a credit for such tax on the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit should not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws.

6. Some States which apply the exemption method (Article 23 A) may have reason to suspect that the treatment accorded in paragraph 2 may provide an inducement to an enterprise of a Contracting State to attach assets such as shares, bonds or patents, to a permanent establishment situated in the other Contracting State in order to obtain more favourable tax treatment there. To counteract such arrangements which they consider would represent abuse, some States might take the view that the transaction is artificial and, for this reason, would regard the assets as not effectively connected with the permanent establishment. Some other States may strengthen their position by adding in paragraph 2 a condition providing that the paragraph shall not apply to cases where the arrangements were primarily made for the purpose of taking advantage of this provision. Also, the requirement that a right or property be “effectively connected” with such a location requires more than merely recording the right or property in the books of the permanent establishment for accounting purposes.

Paragraph 3

5. This paragraph constitutes an addition to Article 21 of the OECD Model Convention. It allows the State in which the income arises to tax such income if its law so provides while the provisions of paragraph 1 allows exclusive taxation in the State of residence. The concurrent application of the provisions of the two paragraphs may result in double taxation. In such a situation, the provisions of Article 23 A or 23 B as appropriate are applicable, as in other cases of double taxation. In some cases paragraphs 2 and 3 may overlap; they would then produce the same result.

6. During the Ninth Meeting of the former Group of Experts held in 1999, there was extensive discussion regarding inclusion of a new paragraph dealing with financial instruments. Three options were identified. First, the Contracting States could adopt Article 21 of the United Nations Model Convention with the three paragraphs. Second, the Contracting States could adopt paragraph 3 of Article 21 but add a reduced rate of tax in respect of income referred to in paragraph 3. Third, the Contracting States could adopt the United Nations Model Convention with paragraphs 1 and 2 only. These alternatives were considered useful in dealing with this subject. It was noted that the treatment of financial products is relevant for options 2 and 3, as discussed below in paragraph 7.

Optional additional paragraph

7. The Committee considers that the following part of the OECD Commentary is relevant:

7. Some countries have encountered difficulties in dealing with income arising from certain nontraditional financial instruments when the parties to the instrument have a special relationship. These countries may wish to add the following paragraph to Article 21:

[4]. Where, by reason of a special relationship between the person referred to in paragraph 1 and some other person, or between both of them and some third person, the amount of the income referred to in paragraph 1 exceeds the amount (if any) which would have been agreed upon between them in the absence of such a relationship, the provisions of this Article shall apply only to the last mentioned amount. In such a case, the excess part of the income shall remain taxable according to the laws of each Contracting State, due regard being had to the other applicable provisions of this Convention.

The inclusion of this additional paragraph should carry no implication about the treatment of innovative financial transactions between independent persons or under other provisions of the Convention.

8. This paragraph restricts the operation of the provisions concerning the taxation of income not dealt with in other Articles in the same way that paragraph 6 of Article 11 restricts the operation of the provisions concerning the taxation of interest [...].

9. Although the restriction could apply to any income otherwise subject to Article 21, it is not envisaged that in practice it is likely to be applied to payments such as alimony payments or social security payments but rather that it is likely to be most relevant where certain nontraditional financial instruments are entered into in circumstances and on terms such that they would not have been entered into in the absence of the special relationship [...].

10. The restriction of Article 21 differs from the restriction of Article 11 in two important respects. First, the paragraph permits, where the necessary circumstances exist, all of the payments under a nontraditional financial instrument to be regarded as excessive. Second, income that is removed from the operation of the interest Article might still be subject to some other Article of the Convention [...]. Income to which Article 21 would otherwise apply is by definition not subject to any other Article. Therefore, if the Article 21 restriction removes a portion of income from the operation of that Article, then Articles 6 through 20 of the Convention are not applicable to that income at all, and each Contracting State may tax it under its domestic law.

11. Other provisions of the Convention, however, will continue to be applicable to such income, such as Article 23 (Relief from Double Taxation), Article 25 (Mutual Agreement Procedure) and Article 26 (Exchange of Information).

8. Some members of the former Group of Experts pointed out that there are artificial devices entered into by persons to take advantage of the provisions of Article 21—especially if paragraph 3 is omitted or provides for only a reduced rate of tax in the source State—through, inter alia, creation or assignment of rights with respect to which income from, e.g. financial instruments arises. While substance over form rules, abuse of rights principles or any similar doctrine could be used to counter such arrangements, Contracting States, which may want to address the issue specifically, may include a clause on the following lines in their bilateral tax treaties:

The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the rights in respect of which the income is paid to take advantage of this Article by means of that creation or assignment.

9. Countries, generally, do not include, in Article 21, a clause indicating where the income is deemed to arise for the purposes of paragraph 3. The domestic laws of both Contracting States will determine the source of the income. The domestic laws of the Contracting States may however differ and this may lead to double taxation (or non-taxation where the State of residence of the beneficiary applies Article 23 A to eliminate double taxation). Countries, which want to address the issue, may include a clause on the following lines in their bilateral tax treaties:

Income shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the income, whether that person is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the income was incurred, and such income is borne by such permanent establishment or fixed base, then such income shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

Commentary on chapter IV

TAXATION ON CAPITAL

Article 22

CAPITAL

1. In the United Nations Model Convention, Article 22 deals with taxes on capital, to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties.

2. The question whether paragraphs 1 to 4 should continue to be placed within brackets was examined by the former Group of Experts. There was general agreement that brackets are not required for the first three paragraphs but it was decided to retain them so far as paragraph 4 was concerned. There was a strong argument that the *situs* State would have the right to tax where the property was situated in that country; that would bring it into line with the treatment of the United Nations Model Convention of other income referred to in Article 21. In 1999, it was decided, to retain the brackets so far as paragraph 4 is concerned.

3. Should the negotiating parties decide to include an Article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 placed within brackets or wording that leaves taxation to the State in which the capital is located. If the wording of paragraph 4, placed within brackets, is used, the Committee considers that the OECD Commentary on Article 22, reproduced below, will be applicable.

1. This Article deals only with taxes on capital, to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties. Taxes on capital to which the Article applies are those referred to in Article 2.

2. Taxes on capital generally constitute complementary taxation of income from capital. Consequently, taxes on a given element of capital can be levied, in principle, only by the State which is entitled to tax the income from this element of capital. However, it is not possible to refer purely and simply to the rules relating to the taxation of such class of income, for not all items of income are subject to taxation exclusively in one State.

3. The Article, therefore, enumerates first property which may be taxed in the State in which they are situated. To this category belong immovable property referred to in Article 6 which a resident of a Contracting State owns and which is situated in the other Contracting State (paragraph 1) and movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State[, or pertaining to a fixed base which a resident of a Contracting State has in the other Contracting State for the performance of independent personal services] (paragraph 2).

4. Normally, ships and aircraft operated in international traffic and boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, boats or aircraft shall be taxable only in the State in which the place of effective management of the enterprise is situated (paragraph 3). This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 13. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat. Contracting States which would prefer to confer the exclusive taxing right on the State of residence or to use a combination of the residence criterion and the place of effective management criterion are free in bilateral conventions to substitute for paragraph 3 a provision corresponding to those proposed in paragraphs 2 and 3 of the Commentary on Article 8. Immovable property pertaining to the operation of ships, boats or aircraft may be taxed in the State in which they are situated in accordance with the rule laid down in paragraph 1.

4.1 Paragraph 3 applies where the enterprise that owns the property operates itself the boats, ships or aircraft referred to in the paragraph, whether for its own transportation activities or when leasing the boats, ships or aircraft on charter fully equipped, manned and supplied. It does not apply, however, where the enterprise owning the boats, ships or aircraft does not operate them (for example, where the enterprise leases the property to another person, other than in the case of an occasional bare boat lease [...]). In such a case, the capital will be covered by paragraph 2 or 4.

4.2 In their bilateral conventions, member countries are free to clarify further the application of Article 22 in this situation. They might adopt the following alternative version of paragraph 3 of the Article [...]:

3. Capital represented by property forming part of the business property of an enterprise the place of effective management

of which is situated in a Contracting State, and consisting of ships and aircraft operated by such enterprise in international traffic and of movable property pertaining to the operation of such ships and aircraft shall be taxable only in that State.

5. As regards elements of capital other than those listed in paragraphs 1 to 3, the Article provides that they are taxable only in the Contracting State of which the person to whom they belong is a resident (paragraph 4).

6. If, when the provisions of paragraph 4 are applied to elements of movable property under usufruct, double taxation subsists because of the disparity between domestic laws, the States concerned may resort to the mutual agreement procedure or settle the question by means of bilateral negotiations.

7. The Article does not provide any rule about the deductions of debts. The laws of OECD member countries are too different to allow a common solution for such a deduction. The problem of the deduction of debts which could arise when the taxpayer and the creditor are not residents of the same State is dealt with in paragraph 4 of Article 24.

Commentary on chapter V

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

Article 23

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

A. GENERAL CONSIDERATIONS

1. The United Nations Model Convention provides two alternative versions of Article 23 for the elimination of double taxation, namely Article 23 A on the exemption method and Article 23 B on the credit method.
2. The method by which a country gives relief from double taxation depends primarily on its general tax policy and the structure of its tax system. Owing to the differences which exist in the various tax systems, bilateral tax treaties provide the most flexible instrument for reconciling conflicting tax systems and for avoiding or mitigating double taxation.
3. When the United Nations Model Convention was earlier revised, members from developing countries felt that, as regards relief measures to be applied by developed countries, the methods of tax exemption and tax credit could be used as appropriate. The exemption method was considered eminently suitable where exclusive tax jurisdiction over certain income was allotted to the country of source under a treaty; it might take the form of an exemption with progression. One of the principal defects of the foreign tax credit method, in the eyes of the developing countries, is that the benefit of low taxes in developing countries or of special tax concessions granted by them may in large part inure to the benefit of the treasury of the capital-exporting country rather than to the foreign investor for whom the benefits were designed. Thus, revenue is shifted from the developing country to the capital-exporting country.
4. The effectiveness of the tax incentive measures introduced by most developing countries thus depends on the interrelationship between the tax systems of the developing countries and those of the capital-exporting countries from which the investment originates. It is of primary importance to developing countries to ensure that the tax incentive measures shall not be made ineffective by taxation in the capital-exporting countries using the

foreign tax credit system. This undesirable result is to some extent avoided in bilateral treaties through a “tax-sparing” credit, by which a developed country grants a credit not only for the tax paid but also for the tax spared by incentive legislation in the developing country. It is also avoided by the exemption method. Some members from developing countries considered it necessary to underline their understanding that either the exemption method or the tax-sparing clause is, for these countries, a basic and fundamental aim in the negotiation of tax treaties. On the other hand, some members noted that studies have shown that tax factors may not themselves be decisive in the process of investment decisions and, therefore, in their view, tax sparing may not be an appropriate policy.

5. Many members from both developed and developing countries agreed with the view that tax-sparing credits should be included in treaties between developed and developing countries, where the developed country used the credit method. However, some members expressed the view that for a variety of reasons tax-sparing credits are not an appropriate tool for economic development, an objective that can better be served by other measures.

6. While the exemption method of providing relief for double taxation eliminates the undesirable effects of the residence country’s taxes on the source country’s tax incentive scheme, many developed countries are unprepared to include this system in their treaties. Where the investor’s home country applies the principle of foreign tax credit, the most effective method of preserving the effect of the tax incentives and concessions extended by developing countries is a tax-sparing credit. Three alternatives might be considered to cope with the problem.

7. First, a tax incentive granting country’s internal legislation might include provisions allowing the incentive only if the taxpayer can show to the satisfaction of the tax administration that, upon remittance of its profits abroad, the laws of the country to which the profits are remitted will not, directly or indirectly, tax the income covered by the incentive or will give credit for tax forgone by the incentive. Such a provision would foreclose the possibility of the benefits of a tax incentive flowing from the developing country’s fisc to the taxpayer and thence to the fisc of the developed country.

8. Second, a tax convention might include a provision barring each Contracting State from taxing the profits of an enterprise resident in that State from activities in the other State benefiting from tax incentives granted by the latter until the profits are repatriated or otherwise directly or indirectly remitted to the first Contracting State. Thus, those profits would have to be reinvested in the developing country in order to remain untaxed.

Some accounting rules would have to be developed to reflect this provision, and a schedule or timetable for repatriation could be agreed upon by the Contracting States.

9. Third, the first Contracting State might be allowed to tax such profits, but be required, pursuant to a revenue-sharing agreement, to turn over to the Contracting State, where the income was produced, the amounts of tax revenue that can reasonably be attributed to the tax incentive granted by the country of source. This proposal has the attraction of preserving the incentive value of the developing country's fiscal sacrifice and of being relatively easy to administer. The existing rules in many developed countries for apportioning the source and nature of foreign income earned by its taxpayers may provide most of the information required to determine the tax revenues that can be attributed to a tax incentive.

10. On the other hand, some members contended that, theoretically, it could be argued that the effectiveness of the tax incentive measures introduced by many developing countries thus depends, in part, on the interrelationship between the tax systems of the developing countries and those of the capital-exporting countries which use the foreign tax credit system. This is because there is an expectation that the developing country tax incentives will be "matched" by a "tax-sparing" credit, granted by the developed country. By a "tax-sparing" credit is meant a credit granted in respect of tax not only actually paid, but actually forgone under its incentive legislation.

11. Since the original publication of the United Nations Model Convention in 1980, there have been various studies undertaken of the economic justification for adopting fiscal incentives with the objective of stimulating investment. According to some members, these studies have demonstrated that tax factors may not themselves be decisive in the process of investment decisions made by the enterprises and therefore, in their view, tax sparing may not be an appropriate policy. Other factors play a greater role in forming the so-called "investment climate" of any given country, for example, political and economic stability, a judicial system perceived as impartial, the availability of a skilled workforce, and labour laws and social security costs that do not serve as unintended obstacles to the development of enterprise. It has been argued that fiscal incentives undermine the tax base and can lead to the damaging effects of tax incentive competition which then takes place between neighbouring States, as they try to outdo each other's incentives and lend themselves to fiscal manipulation. Moreover, where "matching" credit provisions have been included in tax treaties, there have been examples of the artificial structuring of business transactions in order to take advantage of them, leading both to erosion of the tax base and to an unintended economic distortion in the process of investment decision-making.

12. That said, the reality is that, as a policy matter, countries remain free to adopt those investment incentives that seem to them to be useful or unavoidable, given the pressure resulting from the existence of preferential tax regimes, such as tax-free zones in the other jurisdictions, although, as a matter of observation, there is a tendency in more recent years for these to be more narrowly targeted than formerly. For example, they may be restricted to specific areas of economic activity, or to specific geographical regions; and, instead of being open-ended, they tend to be relatively tightly time-limited. Where developing countries choose to adopt such fiscal incentives, some experts from developing countries consider that they should continue to have, as a treaty negotiating aim, the inclusion of a “matching” or “tax-sparing” provision in treaties with capital exporting countries which have a foreign tax credit system. Studies of tax treaties concluded between developed and developing countries show that tax-sparing provisions are still features, although these provisions, in their turn, now show a tendency to be more strictly time-limited than previously. Sometimes, there is a “break” or “sunset” clause, providing for the provision to be terminated after, say, five years, unless the treaty partner States agree to an extension. Where such clauses are included, it is the view of some experts from developing countries that the capital-importing country should provide, both in its domestic tax laws and in its treaties, some protection against a future decision by the treaty partner to refuse to extend the life of the tax-sparing provision. This might, for instance, take the form of a so-called “soak-up tax”, which consists of a tax or levy designed to reduce the benefit granted by means of the domestic tax incentive legislation, by the amount which would otherwise be transferred to the treasury of the treaty partner, in the absence of a tax-sparing provision. Some countries do not, however, allow a foreign tax credit for soak-up taxes.

13. The flow of international investment can also be hampered if a country’s system of eliminating double taxation, although following Article 23 in form, does not lead to the elimination of double taxation in practice. For example, a system’s mechanical features may lead to unusable foreign tax credits. Not only is this inconsistent with the spirit of Article 23, but it also might impede foreign investment.

14. The following extracts from the Commentary on Article 23 A and 23 B of the OECD Model Convention are applicable to Articles 23 A and 23 B (the additional comments that appear between square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the provisions of the OECD Model Convention and those of this Model and also to specify the applicable paragraph/subparagraph of this Model):

I. Preliminary remarks

A. *The scope of the Articles*

1. These Articles deal with the so-called juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one State.

2. This case has to be distinguished especially from the so-called economic double taxation, *i.e.* where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

3. International juridical double taxation may arise in three cases:

- a) where each Contracting State subjects the same person to tax on his worldwide income or capital (concurrent full liability to tax, see paragraph 4 below);
- b) where a person is a resident of a Contracting State (R)⁴⁴ and derives income from, or owns capital in, the other Contracting State (S or E) and both States impose tax on that income or capital (see paragraph 5 below);
- c) where each Contracting State subjects the same person, not being a resident of either Contracting State to tax on income derived from, or capital owned in, a Contracting State; this may result, for instance, in the case where a non-resident person has a permanent establishment [or fixed base] in one Contracting State (E) through which he derives income from, or owns capital in, the other Contracting State (S) (concurrent limited tax liability, see paragraph 11 below).

4. The conflict in case *a*) is reduced to that of case *b*) by virtue of Article 4. This is because that Article defines the term “resident of a Contracting State” by reference to the liability to tax of a person under domestic law by reason of his domicile, residence, place of management or any other criterion of a similar nature (paragraph 1 of Article 4) and by listing special criteria for the case of double residence

⁴⁴Throughout the Commentary on Articles 23 A and 23 B, the letter “R” stands for the State of residence within the meaning of the Convention, “S” for the State of source or situs, and “E” for the State where a permanent establishment [or a fixed base] is situated.

to determine which of the two States is the State of residence (R) within the meaning of the Convention (paragraphs 2 and 3 of Article 4).

4.1 Article 4, however, only deals with cases of concurrent full liability to tax. The conflict in case *a*) may therefore not be solved if the same item of income is subject to the full liability to tax of two countries but at different times. The following example illustrates that problem. Assume that a resident of State R1 derives a taxable benefit from an employee stock-option that is granted to that person. State R1 taxes that benefit when the option is granted. The person subsequently becomes a resident of State R2, which taxes the benefit at the time of its subsequent exercise. In that case, the person is taxed by each State at a time when he is a resident of that State and Article 4 does not deal with the issue as there is no concurrent residence in the two States.

4.2 The conflict in that situation will be reduced to that of case *b*) and solved accordingly to the extent that the employment services to which the option relates have been rendered in one of the Contracting States so as to be taxable by that State under Article 15 because it is the State where the relevant employment is exercised. Indeed, in such a case, the State in which the services have been rendered will be the State of source for purposes of elimination of double taxation by the other State. It does not matter that the first State does not levy tax at the same time (see paragraph 32.8). It also does not matter that that State considers that it levies tax as a State of residence as opposed to a State of source (see the last sentence of paragraph 8).

4.3 Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation. The mutual agreement procedure could be used to deal with such a case. One possible basis to solve the case would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State. Thus, in the above example, if the relevant services were rendered in a third State before the person became a resident of State R2, it would be logical for the competent authority of State R2 to agree to provide relief (either through the credit or exemption method) for the State R1 tax that has been levied on the part of the employment benefit that relates to services rendered in the third State since, at the time when these services were rendered, the taxpayer was a resident of State R1 and not of State R2 for purposes of the convention between these two States.

5. The conflict in case *b*) may be solved by allocation of the right to tax between the Contracting States. Such allocation may be made by renunciation of the right to tax either by the State of source or situs (S) or of the situation of the permanent establishment [or the fixed base] (E), or by the State of residence (R), or by a sharing of the right to tax between the two States. The provisions of the Chapters III and IV of the Convention, combined with the provisions of Article 23 A or 23 B, govern such allocation.

6. For some items of income or capital, an exclusive right to tax is given to one of the Contracting States, and the relevant Article states that the income or capital in question “shall be taxable only” in a Contracting State.⁴⁵ The words “shall be taxable only” in a Contracting State preclude the other Contracting State from taxing, thus double taxation is avoided. The State to which the exclusive right to tax is given is normally the State of which the taxpayer is a resident within the meaning of Article 4, that is State R, but in four Articles⁴⁶ the exclusive right may be given to the other Contracting State (S) of which the taxpayer is not a resident within the meaning of Article 4.

7. For other items of income or capital, the attribution of the right to tax is not exclusive, and the relevant Article then states that the income or capital in question “may be taxed” in the Contracting State (S or E) of which the taxpayer is not a resident within the meaning of Article 4. In such case the State of residence (R) must give relief so as to avoid the double taxation. Paragraphs 1 and 2 of Article 23 A and paragraph 1 of Article 23 B are designed to give the necessary relief.

8. Articles 23 A and 23 B apply to the situation in which a resident of State R derives income from, or owns capital in, the other Contracting State E or S (not being the State of residence within the meaning of the Convention) and that such income or capital, in accordance with the Convention, may be taxed in such other State E or S. The Articles, therefore, apply only to the State of residence and do not prescribe how the other Contracting State E or S has to proceed.

⁴⁵See first sentence of paragraph 1 of Article 7, paragraphs 1 and 2 of Article 8, [...] paragraphs 3 and [6] of Article 13, [first sentence of paragraph 1 of Article 14,] first sentence of paragraph 1 and paragraph 2 of Article 15, Article 18 [except paragraphs 1 and 2 of alternative B], paragraphs 1 and 2 of Article 19, paragraph 1 of Article 21 and paragraphs 3 and 4 of Article 22.

⁴⁶See paragraphs 1 and 2 of Article 8, paragraph 3 of Article 13, subparagraph *a*) of paragraphs 1 and 2 of Article 19 and paragraph 3 of Article 22.

9. Where a resident of the Contracting State R derives income from the same State R through a permanent establishment [or a fixed base] which he has in the other Contracting State E, State E may tax such income (except income from immovable property situated in State R) if it is attributable to the said permanent establishment [or fixed base] (paragraph 2 of Article 21). In this instance too, State R must give relief under Article 23 A or Article 23 B for income attributable to the permanent establishment [or fixed base] situated in State E, notwithstanding the fact that the income in question originally arises in State R [...]. However, where the Contracting States agree to give to State R which applies the exemption method a limited right to tax as the State of source of dividends or interest within the limits fixed in paragraph 2 of the Articles 10 or 11 or 12 then the two States should also agree upon a credit to be given by State E for the tax levied by State R, along the lines of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B.

10. Where a resident of State R derives income from a third State through a permanent establishment [or a fixed base] which he has in State E, such State E may tax such income (except income from immovable property situated in the third State) if it is attributable to such permanent establishment [or fixed base] (paragraph 2 of Article 21). State R must give relief under Article 23 A or Article 23 B in respect of income attributable to the permanent establishment [or fixed base] in State E. There is no provision in the Convention for relief to be given by Contracting State E for taxes levied in the third State where the income arises; however, under paragraph 3 of Article 24 any relief provided for in the domestic laws of State E (double taxation conventions excluded) for residents of State E is also to be granted to a permanent establishment in State E of an enterprise of State R [...].

11. The conflict in case *c*) of paragraph 3 above is outside the scope of the Convention as, under Article 1, it applies only to persons who are residents of one or both of the States. It can, however, be settled by applying the mutual agreement procedure (see also paragraph 10 above).

B. Description of methods for elimination of double taxation

12. In the existing conventions, two leading principles are followed for the elimination of double taxation by the State of which the taxpayer is a resident. For purposes of simplicity, only income tax is referred to in what follows; but the principles apply equally to capital tax.

1. *The principle of exemption*

13. Under the principle of exemption, the State of residence R does not tax the income which according to the Convention may be taxed in State E or S (nor, of course, also income which shall be taxable only in State E or S [...]).

14. The principle of exemption may be applied by two main methods:

- a) the income which may be taxed in State E or S is not taken into account at all by State R for the purposes of its tax; State R is not entitled to take the income so exempted into consideration when determining the tax to be imposed on the rest of the income; this method is called “full exemption”;
- b) the income which may be taxed in State E or S is not taxed by State R, but State R retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income; this method is called “exemption with progression”.

2. *The principle of credit*

15. Under the principle of credit, the State of residence R calculates its tax on the basis of the taxpayer’s total income including the income from the other State E or S which, according to the Convention, may be taxed in that other State (but not including income which shall be taxable only in State S; see paragraph 6 above). It then allows a deduction from its own tax for the tax paid in the other State.

16. The principle of credit may be applied by two main methods:

- a) State R allows the deduction of the total amount of tax paid in the other State on income which may be taxed in that State, this method is called “full credit”;
- b) the deduction given by State R for the tax paid in the other State is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State; this method is called “ordinary credit”.

17. Fundamentally, the difference between the methods is that the exemption methods look at income, while the credit methods look at tax.

C. *Operation and effects of the methods*

18. An example in figures will facilitate the explanation of the effects of the various methods. Suppose the total income to be 100,000,

of which 80,000 is derived from one State (State of residence R) and 20,000 from the other State (State of source S). Assume that in State R the rate of tax on an income of 100,000 is 35 per cent and on an income of 80,000 is 30 per cent. Assume further that in State S the rate of tax is either 20 per cent—case (i) or 40 per cent—case (ii), so that the tax payable therein on 20,000 is 4,000 in case (i) or 8,000 in case (ii), respectively.

19. If the taxpayer's total income of 100,000 arises in State R, his tax would be 35,000. If he had an income of the same amount, but derived in the manner set out above, and if no relief is provided for in the domestic laws of State R and no conventions exists between State R and State S, then the total amount of tax would be, in case (i): 35,000 plus 4,000 = 39,000, and in case (ii): 35,000 plus 8,000 = 43,000.

1. *Exemption methods*

20. Under the exemption methods, State R limits its taxation to that part of the total income which, in accordance with the various Articles of the Convention, it has a right to tax, *i.e.* 80,000.

a) *Full exemption*

State R imposes tax on 80,000 at the rate of tax applicable to 80,000, *i.e.* at 30 per cent.

	Case (i)	Case (ii)
Tax in State R, 30 % of 80,000	24,000	24,000
Plus tax in State S	<u>4,000</u>	<u>8,000</u>
Total taxes	28,000	32,000
Relief has been given by State R in the amount of	11,000	11,000

b) *Exemption with progression*

State R imposes tax on 80,000 at the rate of tax applicable to total income wherever it arises (100,000), *i.e.* at 35 per cent.

	Case (i)	Case (ii)
Tax in State R, 35 % of 80,000	28,000	28,000
Plus tax in State S	<u>4,000</u>	<u>8,000</u>
Total taxes	32,000	36,000
Relief has been given by State R in the amount of	7,000	7,000

21. In both cases, the level of tax in State S does not affect the amount of tax given up by State R. If the tax on the income from State S is lower in State S than the relief to be given by State R—cases *a (i)*, *a (ii)*, and *b (i)*—then the taxpayer will fare better than if his total income were derived solely from State R. In the converse case—case *b (ii)*—the taxpayer will be worse off.

22. The example shows also that the relief given where State R applies the full exemption method may be higher than the tax levied in State S, even if the rates of tax in State S are higher than those in State R. This is due to the fact that under the full exemption method, not only the tax of State R on the income from State S is surrendered (35 per cent of 20,000 = 7,000; as under the exemption with progression), but that also the tax on remaining income (80,000) is reduced by an amount corresponding to the differences in rates at the two income levels in State R (35 less 30 = 5 per cent applied to 80,000 = 4,000).

2. Credit methods

23. Under the credit methods, State R retains its right to tax the total income of the taxpayer, but against the tax so imposed, it allows a deduction.

a) Full credit

State R computes tax on total income of 100,000 at the rate of 35 per cent and allows the deduction of the tax due in State S on the income from S.

	Case (i)	Case (ii)
Tax in State R, 35 % of 100,000	35,000	35,000
less tax in State S	<u>-4,000</u>	<u>-8,000</u>
Tax due	31,000	27,000
Total taxes	35,000	35,000
Relief has been given by State R in the amount of	4,000	8,000

b) Ordinary credit

State R computes tax on total income of 100,000 at the rate of 35 per cent and allows the deduction of the tax due in State S on the income from S, but in no case it allows more than the portion of tax in State R attributable to the income from S (maximum deduction). The maximum deduction would be 35 per cent of 20,000 = 7,000.

	Case (i)	Case (ii)
Tax in State R, 35 % of 100,000	35,000	35,000
less tax in State S	-4,000	
less maximum tax		<u>-7,000</u>
Tax due	31,000	28,000
Total taxes	35,000	36,000
Relief has been given by State R in the amount of	4,000	7,000

24. A characteristic of the credit methods compared with the exemption methods is that State R is never obliged to allow a deduction of more than the tax due in State S.

25. Where the tax due in State S is lower than the tax of State R appropriate to the income from State S (maximum deduction), the taxpayer will always have to pay the same amount of taxes as he would have had to pay if he were taxed only in State R, *i.e.* as if his total income were derived solely from State R.

26. The same result is achieved, where the tax due in State S is the higher while State R applies the full credit, at least as long as the total tax due to State R is as high or higher than the amount of the tax due in State S.

Table 23-1 Total amount of tax in the different cases illustrated above

A. All income arising in State R	Total tax = 35,000	
B. Income arising in two States, viz. 80,000 in State R and 20,000 in State S	Total tax if tax in State S is	
	4,000 (case (i))	8,000 (case (ii))
No convention (19) ¹	39,000	43,000
Full exemption (20a)	28,000	32,000
Exemption with progression (20b)	32,000	36,000
Full credit (23a)	35,000	35,000
Ordinary credit (23b)	35,000	36,000

¹Numbers in brackets refer to paragraphs in this Commentary.

27. Where the tax due in State S is higher and where the credit is limited (ordinary credit), the taxpayer will not get a deduction for the whole of the tax paid in State S. In such event the result would be less favourable to the taxpayer than if his whole income arose in State R, and in these circumstances the ordinary credit method would have the same effect as the method of exemption with progression.

Table 23–2 Amount of tax given up by the state of residence

	If tax in State S is	
	4,000 (case (i))	8,000 (case (ii))
No convention	0	0
Full exemption (20a) ¹	11,000	11,000
Exemption with progression (20b)	7,000	7,000
Full credit (23a)	4,000	8,000
Ordinary credit (23b)	4,000	7,000

¹Numbers in brackets refer to paragraphs in this Commentary.

D. *The methods proposed in the Articles*

28. In the conventions concluded between OECD member countries both leading principles have been followed. Some States have a preference for the first one, some for the other. Theoretically a single principle could be held to be more desirable, but, on account of the preferences referred to, each State has been left free to make its own choice.

29. On the other hand, it has been found important to limit the number of methods based on each leading principle to be employed. In view of this limitation, the Articles have been drafted so that member countries are left free to choose between two methods:

- the exemption method with progression (Article 23 A), and
- the ordinary credit method (Article 23 B).

30. If two Contracting States both adopt the same method, it will be sufficient to insert the relevant Article in the convention. On the other hand, if the two Contracting States adopt different methods, both Articles may be amalgamated in one, and the name of the State must be inserted in each appropriate part of the Article, according to the method adopted by that State.

31. Contracting States may use a combination of the two methods. Such combination is indeed necessary for a Contracting State R which generally adopts the exemption method in the case of income which under Articles 10 and 11 [and 12] may be subjected to a limited tax in the other Contracting State S. For such case, Article 23 A provides in paragraph 2 a credit for the limited tax levied in the other Contracting State S [...]. Moreover, States which in general adopt the exemption method may wish to exclude specific items of income from exemption and to apply to such items the credit method. In such case, paragraph 2 of Article 23 A could be amended to include these items of income.

32. The two Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic laws and practice applicable. Contracting States which find it necessary to settle any problem in the Convention itself are left free to do so in bilateral negotiations.

F. Timing mismatch

32.8 The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied (see, for instance, paragraph 2.2 of the Commentary on Article 15). Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year. Some States, however, do not follow the wording of Article 23 A or 23 B in their bilateral conventions and link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws. These countries, however, would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year.

**II. Commentary on the provisions of Article 23 A
(exemption method)**

Paragraph 1

A. *The obligation of the State of residence to give exemption*

33. In the Article it is laid down that the State of residence R shall exempt from tax income and capital which in accordance with the Convention “may be taxed” in the other State E or S.

34. The State of residence must accordingly exempt income and capital which may be taxed by the other State in accordance with the Convention whether or not the right to tax is in effect exercised by that other State. This method is regarded as the most practical one since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State.

35. Occasionally, negotiating States may find it reasonable in certain circumstances, in order to avoid double non-taxation, to make an exception to the absolute obligation on the State of residence to give exemption [...]. Such may be the case where no tax on specific items of income or capital is provided under the domestic laws of the State of source, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired. To avoid such double non-taxation of specific items of income, Contracting States may agree to amend the relevant Article itself [...]. One might also make an exception to the general rule, in order to achieve a certain reciprocity, where one of the States adopts the exemption method and the other the credit method. Finally, another exception to the general rule may be made where a State wishes to apply to specific items of income the credit method rather than exemption (see paragraph 31 above).

15. In the United Nations Model Convention, the right to tax in the country of source extends in many cases to income which under the OECD Model Convention is taxable only in the country of residence. As a consequence, many countries adopting the exemption method in their bilateral conventions may wish to restrict the application of paragraph 1 of Article 23 A, e.g., by limiting the exemption from tax to income effectively taxed in the country of source or by applying to some items of income the tax credit provided for in paragraph 2 of Article 23 A rather than the tax exemption. Also, because Article 23 A, paragraph 1, of the United Nations Model Convention has a

much broader scope than the corresponding provision of the OECD Model Convention, because of extended source country rights, a State which generally chooses the exemption method may elect the credit method for specific items of income not mentioned in paragraph 2 of Article 23 A.

16. The OECD Commentary continues as follows:

B. *Alternative formulation of the Article*

37. An effect of the exemption method as it is drafted in the Article is that the taxable income or capital in the State of residence is reduced by the amount exempted in that State. If in a particular State the amount of income as determined for income tax purposes is used as a measure for other purposes, *e.g.* social benefits, the application of the exemption method in the form proposed may have the effect that such benefits may be given to persons who ought not to receive them. To avoid such consequences, the Article may be altered so that the income in question is included in the taxable income in the State of residence. The State of residence must, in such cases, give up that part of the total tax appropriate to the income concerned. This procedure would give the same result as the Article in the form proposed. States can be left free to make such modifications in the drafting of the Article. If a State wants to draft the Article as indicated above, paragraph 1 may be drafted as follows:

Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only or may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraph 2, allow as a deduction from the income tax or capital tax that part of the income tax or capital tax, respectively, which is applicable, as the case may be, to the income derived from or the capital owned in that other State.

If the Article is so drafted, paragraph 3 would not be necessary and could be omitted.

C. *Miscellaneous problems*

38. Article 23 A contains the principle that the State of residence has to give exemption, but does not give detailed rules on how the exemption has to be implemented. This is consistent with the general pattern of the Convention. Articles 6 to 22 too lay down rules attributing the right to tax in respect of the various types of income or capital

without dealing, as a rule, with the determination of taxable income or capital, deductions, rate of tax, etc. (see however, [paragraph 3 of Article 7 and] Article 24). Experience has shown that many problems may arise. This is especially true with respect to Article 23 A. Some of them are dealt with in the following paragraphs. In the absence of a specific provision in the Convention, the domestic laws of each Contracting State are applicable. Some conventions contain an express reference to the domestic laws but of course this would not help where the exemption method is not used in the domestic laws. In such cases, Contracting States which face this problem should establish rules for the application of Article 23 A, if necessary, after having consulted with the competent authority of the other Contracting State (paragraph 3 of Article 25).

1. *Amount to be exempted*

39. The amount of income to be exempted from tax by the State of residence is the amount which, but for the Convention, would be subjected to domestic income tax according to the domestic laws governing such tax. It may, therefore, differ from the amount of income subjected to tax by the State of source according to its domestic laws.

40. Normally, the basis for the calculation of income tax is the total net income, *i.e.* gross income less allowable deductions. Therefore, it is the gross income derived from the State of source less any allowable deductions (specified or proportional) connected with such income which is to be exempted.

41. Problems arise from the fact that most countries provide in their respective taxation laws for additional deductions from total income or specific items of income to arrive at the income subject to tax. A numerical example may illustrate the problem:

a)	Domestic income (gross less allowable expenses).	100
b)	Income from the other State (gross less allowable expenses)	100
c)	Total income.	200
d)	Deductions for other expenses provided for under the laws of the State of residence which are not connected with any of the income under a or b, such as insurance premiums, contributions to welfare institutions	-20
e)	“Net” income	180
f)	Personal and family allowances	-30
g)	Income subject to tax	150

The question is, what amount should be exempted from tax, *e.g.*

- 100 (line *b*), leaving a taxable amount of 50;
- 90 (half of line *e*, according to the ratio between line *b* and line *c*), leaving 60 (line *f* being fully deducted from domestic income);
- 75 (half of line *g*, according to the ratio between line *b* and line *c*), leaving 75;
- or any other amount.

42. A comparison of the laws and practices of the OECD member countries shows that the amount to be exempted varies considerably from country to country. The solution adopted by a State will depend on the policy followed by that State and its tax structure. It may be the intention of a State that its residents always enjoy the full benefit of their personal and family allowances and other deductions. In other States these tax free amounts are apportioned. In many States personal or family allowances form part of the progressive scale, are granted as a deduction from tax, or are even unknown, the family status being taken into account by separate tax scales.

43. In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique. Contracting States which prefer to have special problems solved in their convention are, of course, free to do so in bilateral negotiations. Finally, attention is drawn to the fact that the problem is also of importance for States applying the credit method [...].

2. *Treatment of losses*

44. Several States in applying Article 23 A treat losses incurred in the other State in the same manner as they treat income arising in that State: as State of residence (State R), they do not allow deduction of a loss incurred from immovable property or a permanent establishment situated in the other State (E or S). Provided that this other State allows carryover of such loss, the taxpayer will not be at any disadvantage as he is merely prevented from claiming a double deduction of the same loss namely in State E (or S) and in State R. Other States may, as State of residence R, allow a loss incurred in State E (or S) as a deduction from the income they assess. In such a case State R should be free to restrict the exemption under paragraph 1 of Article 23 A for profits or income which are made subsequently in the other State E (or S) by deducting from such subsequent profits or income the amount of

earlier losses which the taxpayer can carry over in State E (or S). As the solution depends primarily on the domestic laws of the Contracting States and as the laws of the OECD member countries differ from each other substantially, no solution can be proposed in the Article itself, it being left to the Contracting States, if they find it necessary, to clarify the above-mentioned question and other problems connected with losses [...] bilaterally, either in the Article itself or by way of a mutual agreement procedure (paragraph 3 of Article 25).

3. *Taxation of the rest of the income*

45. Apart from the application of progressive tax rates which is now dealt with in paragraph 3 of the Article [...] some problems may arise from specific provisions of the tax laws. Thus, *e.g.* some tax laws provide that taxation starts only if a minimum amount of taxable income is reached or exceeded (tax exempt threshold). Total income before application of the Convention may clearly exceed such tax free threshold; but by virtue of the exemption resulting from the application of the Convention which leads to a deduction of the tax exempt income from total taxable income, the remaining taxable income may be reduced to an amount below this threshold. For the reasons mentioned in paragraph 43 above, no uniform solution can be proposed. It may be noted, however, that the problem will not arise, if the alternative formulation of paragraph 1 of Article 23 A [...] is adopted.

46. Certain States have introduced special systems for taxing corporate income [...]. In States applying a split rate corporation tax [...], the problem may arise whether the income to be exempted has to be deducted from undistributed income (to which the normal rate of tax applies) or from distributed income (to which the reduced rate applies) or whether the income to be exempted has to be attributed partly to distributed and partly to undistributed income. Where, under the laws of a State applying the split rate corporation tax, a supplementary tax is levied in the hands of a parent company on dividends which it received from a domestic subsidiary company but which it does not redistribute (on the grounds that such supplementary tax is a compensation for the benefit of a lower tax rate granted to the subsidiary on the distributions), the problem arises, whether such supplementary tax may be charged where the subsidiary pays its dividends out of income exempt from tax by virtue of the Convention. Finally a similar problem may arise in connection with taxes (*pré-compte*, Advance Corporation Tax) which are levied on distributed profits of a corporation in order to cover the tax credit attributable

to the shareholders [...]. The question is whether such special taxes connected with the distribution of profits, could be levied insofar as distributions are made out of profits exempt from tax. It is left to Contracting States to settle these questions by bilateral negotiations.

Paragraph 2

47. In Articles 10 and 11 the right to tax dividends and interest is divided between the State of residence and the State of source. In these cases, the State of residence is left free not to tax if it wants to do so [...] and to apply the exemption method also to the above-mentioned items of income. However, where the State of residence prefers to make use of its right to tax such items of income, it cannot apply the exemption method to eliminate the double taxation since it would thus give up fully its right to tax the income concerned. For the State of residence, the application of the credit method would normally seem to give a satisfactory solution. Moreover, as already indicated in paragraph 31 above, States which in general apply the exemption method may wish to apply to specific items of income the credit method rather than exemption. Consequently, the paragraph is drafted in accordance with the ordinary credit method. The Commentary on Article 23 B hereafter applies *mutatis mutandis* to paragraph 2 of Article 23 A.

48. In the cases referred to in the previous paragraph, certain maximum percentages are laid down for tax reserved to the State of source. In such cases, the rate of tax in the State of residence will very often be higher than the rate in the State of source. The limitation of the deduction which is laid down in the second sentence of paragraph 2 and which is in accordance with the ordinary credit method is therefore of consequence only in a limited number of cases. If, in such cases, the Contracting States prefer to waive the limitation and to apply the full credit method, they can do so by deleting the second sentence of paragraph 2 [...].

Dividends from substantial holdings by a company

49. The combined effect of paragraphs 1 and 2 of Article 10 and Article 23 (Article 23 A and 23 B as appropriate) is that the State of residence of the shareholder is allowed to tax dividends arising in the other State, but that it must credit against its own tax on such dividends the tax which has been collected by the State where the

dividends arise at a rate fixed under paragraph 2 of Article 10. This regime equally applies when the recipient of the dividends is a parent company receiving dividends from a subsidiary; in this case, the tax withheld in the State of the subsidiary—and credited in the State of the parent company—is limited to [____] per cent of the gross amount of the dividends by the application of subparagraph *a*) of paragraph 2 of Article 10.

50. These provisions effectively avoid the juridical double taxation of dividends but they do not prevent recurrent corporate taxation on the profits distributed to the parent company: first at the level of the subsidiary and again at the level of the parent company. Such recurrent taxation creates a very important obstacle to the development of international investment. Many States have recognised this and have inserted in their domestic laws provisions designed to avoid this obstacle. Moreover, provisions to this end are frequently inserted in double taxation conventions.

51. The Committee on Fiscal Affairs has considered whether it would be appropriate to modify Article 23 of the Convention in order to settle this question. Although many States favoured the insertion of such a provision in the Model Convention this met with many difficulties, resulting from the diverse opinions of States and the variety of possible solutions. Some States, fearing tax evasion, preferred to maintain their freedom of action and to settle the question only in their domestic laws.

52. In the end, it appeared preferable to leave States free to choose their own solution to the problem. For States preferring to solve the problem in their conventions, the solutions would most frequently follow one of the principles below:

a) Exemption with progression

The State of which the parent company is a resident exempts the dividends it receives from its subsidiary in the other State, but it may nevertheless take these dividends into account in computing the tax due by the parent company on the remaining income (such a provision will frequently be favoured by States applying the exemption method specified in Article 23 A).

b) Credit for underlying taxes

As regards dividends received from the subsidiary, the State of which the parent company is a resident gives credit as provided for in paragraph 2 of Article 23 A or in paragraph 1

of Article 23 B, as appropriate, not only for the tax on dividends as such, but also for the tax paid by the subsidiary on the profits distributed (such a provision will frequently be favoured by States applying as a general rule the credit method specified in Article 23 B).

c) Assimilation to a holding in a domestic subsidiary

The dividends that the parent company derives from a foreign subsidiary are treated, in the State of the parent company, in the same way for tax purposes as dividends received from a subsidiary which is a resident of that State.

53. When the State of the parent company levies taxes on capital, a similar solution should also be applied to such taxes.

54. Moreover, States are free to fix the limits and methods of application of these provisions (definition and minimum duration of holding of the shares, proportion of the dividends deemed to be taken up by administrative or financial expenses) or to make the relief granted under the special regime subject to the condition that the subsidiary is carrying out a genuine economic activity in the State of which it is a resident, or that it derives the major part of its income from that State or that it is subject to a substantial taxation on profits therein.

Paragraph 3

55. The 1963 Draft Convention reserved expressly the application of the progressive scale of tax rates by the State of residence (last sentence of paragraph 1 of Article 23 A) and most conventions concluded between OECD member countries which adopt the exemption method follow this principle. According to paragraph 3 of Article 23 A, the State of residence retains the right to take the amount of exempted income or capital into consideration when determining the tax to be imposed on the rest of the income or capital. The rule applies even where the exempted income (or items of capital) and the taxable income (or items of capital) accrue to those persons (e.g. husband and wife) whose incomes (or items of capital) are taxed jointly according to the domestic laws. This principle of progression applies to income or capital exempted by virtue of paragraph 1 of Article 23 A as well as to income or capital which under any other provision of the Convention “shall be taxable only” in the other Contracting State [...]. This is the reason why, in the 1977 Model Convention, the principle of progression was transferred from paragraph 1 of Article 23 A

to a new paragraph 3 of the said Article, and reference was made to exemption “in accordance with any provision of the Convention”.

56. Paragraph 3 of Article 23 A relates only to the State of residence. The form of the Article does not prejudice the application by the State of source of the provisions of its domestic laws concerning the progression.

III. Commentary on the provisions of Article 23 B (credit method)

Paragraph 1

A. Methods

57. Article 23 B, based on the credit principle, follows the ordinary credit method: the State of residence (R) allows, as a deduction from its own tax on the income or capital of its resident, an amount equal to the tax paid in the other State E (or S) on the income derived from, or capital owned in, that other State E (or S), but the deduction is restricted to the appropriate proportion of its own tax.

58. The ordinary credit method is intended to apply also for a State which follows the exemption method but has to give credit, under paragraph 2 of Article 23 A, for the tax levied at limited rates in the other State on dividends and interest (see paragraph 47 above). The possibility of some modification as mentioned in paragraphs 47 and 48 above (full credit) could, of course, also be of relevance in the case of dividends and interest paid to a resident of a State which adopted the ordinary credit method (see also paragraph 63 below).

59. The obligation imposed by Article 23 B on a State R to give credit for the tax levied in the other State E (or S) on an item of income or capital depends on whether this item may be taxed by the State E (or S) in accordance with the Convention [...]. Items of income or capital which according to Article 8, to paragraph 3 of Article 13, to subparagraph *a*) of paragraphs 1 and 2 of Article 19 and to paragraph 3 of Article 22, “shall be taxable only” in the other State, are from the outset exempt from tax in State R [...], and the Commentary on Article 23 A applies to such exempted income and capital. As regards progression, reference is made to paragraph 2 of the Article [...].

60. Article 23 B sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the

credit. This is consistent with the general pattern of the Convention. Experience has shown that many problems may arise. Some of them are dealt with in the following paragraphs. In many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of conventions, therefore, contain a reference to the domestic laws of the Contracting States and further provide that such domestic rules shall not affect the principle laid down in Article 23 B. Where the credit method is not used in the domestic laws of a Contracting State, this State should establish rules for the application of Article 23 B, if necessary after consultation with the competent authority of the other Contracting State (paragraph 3 of Article 25).

61. The amount of foreign tax for which a credit has to be allowed is the tax effectively paid in accordance with the Convention in the other Contracting State. Problems may arise, *e.g.* where such tax is not calculated on the income of the year for which it is levied but on the income of a preceding year or on the average income of two or more preceding years. Other problems may arise in connection with different methods of determining the income or in connection with changes in the currency rates (devaluation or revaluation). However, such problems could hardly be solved by an express provision in the Convention.

62. According to the provisions of the second sentence of paragraph 1 of Article 23 B, the deduction which the State of residence (R) is to allow is restricted to that part of the income tax which is appropriate to the income derived from the State S, or E (so-called “maximum deduction”). Such maximum deduction may be computed either by apportioning the total tax on total income according to the ratio between the income for which credit is to be given and the total income, or by applying the tax rate for total income to the income for which credit is to be given. In fact, in cases where the tax in State E (or S) equals or exceeds the appropriate tax of State R, the credit method will have the same effect as the exemption method with progression. Also under the credit method, similar problems as regards the amount of income, tax rate etc. may arise as are mentioned in the Commentary on Article 23 A [...]. For the same reasons mentioned in paragraphs 42 and 43 above, it is preferable also for the credit method not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique. This is also true for some further problems which are dealt with below.

63. The maximum deduction is normally computed as the tax on net income, *i.e.* on the income from State E (or S) less allowable deductions (specified or proportional) connected with such income [...].

For such reason, the maximum deduction in many cases may be lower than the tax effectively paid in State E (or S). This may especially be true in the case where, for instance, a resident of State R deriving interest from State S has borrowed funds from a third person to finance the interest-producing loan. As the interest due on such borrowed money may be offset against the interest derived from State S, the amount of net income subject to tax in State R may be very small, or there may even be no net income at all. This problem could be solved by using the full credit method in State R as mentioned in paragraph 48 above. Another solution would be to exempt such income from tax in State S, as it is proposed in the Commentary in respect of interest on credit sales and on loans granted by banks [...].

64. If a resident of State R derives income of different kinds from State S, and the latter State, according to its tax laws imposes tax only on one of these items, the maximum deduction which State R is to allow will normally be that part of its tax which is appropriate only to that item of income which is taxed in State S. However, other solutions are possible, especially in view of the following broader problem: the fact that credit has to be given, *e.g.* for several items of income on which tax at different rates is levied in State S, or for income from several States, with or without conventions, raises the question whether the maximum deduction or the credit has to be calculated separately for each item of income, or for each country, or for all foreign income qualifying for credit under domestic laws and under conventions. Under an “overall credit” system, all foreign income is aggregated, and the total of foreign taxes is credited against the domestic tax appropriate to the total foreign income.

65. Further problems may arise in case of losses. A resident of State R, deriving income from State E (or S), may have a loss in State R, or in State E (or S) or in a third State. For purposes of the tax credit, in general, a loss in a given State will be set off against other income from the same State. Whether a loss suffered outside State R (*e.g.* in a permanent establishment) may be deducted from other income, whether derived from State R or not depends on the domestic laws of State R. Here similar problems may arise, as mentioned in the Commentary on Article 23 A (paragraph 44 above). When the total income is derived from abroad, and no income but a loss not exceeding the income from abroad arises in State R, then the total tax charged in State R will be appropriate to the income from State S, and the maximum deduction which State R is to allow will consequently be the tax charged in State R. Other solutions are possible.

66. The aforementioned problems depend very much on domestic laws and practice, and the solution must, therefore, be left to each State. In this context, it may be noted that some States are very liberal in applying the credit method. Some States are also considering or have already adopted the possibility of carrying over unused tax credits. Contracting States are, of course, free in bilateral negotiations to amend the Article to deal with any of the aforementioned problems.

67. In so-called “thin capitalisation” situations, the Model Convention allows the State of the borrower company, under certain conditions, to treat an interest payment as a distribution of dividends in accordance with its domestic legislation; the essential condition is that the contributor of the loan should effectively share the risks run by the borrower company. This gives rise to two consequences:

- the taxing at source of such “interest” at the rate for dividends (paragraph 2 of Article 10);
- the inclusion of such “interest” in the taxable profits of the lender company.

68. If the relevant conditions are met, the State of residence of the lender would be obliged to give relief for any juridical or economic double taxation of the interest as if the payment was in fact a dividend. It should then give credit for tax effectively withheld on this interest in the State of residence of the borrower at the rate applicable to dividends and, in addition, if the lender is the parent company of the borrower company, apply to such “interest” any additional relief under its parent/subsidiary regime. This obligation may result:

- a) from the actual wording of Article 23 of the Convention, when it grants relief in respect of income defined as dividends in Article 10 or of items of income dealt with in Article 10;
- b) from the context of the Convention, *i.e.* from a combination of Articles 9, 10, 11, and 23 and if need be, by way of the mutual agreement procedure:
 - where the interest has been treated in the country of residence of the borrower company as a dividend under rules which are in accordance with paragraph 1 of Article 9 or paragraph 6 of Article 11 and where the State of residence of the lender agrees that it has been properly so treated and is prepared to apply a corresponding adjustment;
 - when the State of residence of the lender applies similar thin capitalisation rules and would treat the payment as a dividend

in a reciprocal situation, *i.e.* if the payment were made by a company established in its territory to a resident in the other Contracting State;

- in all other cases where the State of residence of the lender recognises that it was proper for the State of residence of the borrower to treat the interest as a dividend.

69. As regards dividends from a substantial holding by a company, reference is made to paragraphs 49 to 54 above.

69.1 Problems may arise where Contracting States treat entities such as partnerships in a different way. Assume, for example, that the State of source treats a partnership as a company and the State of residence of a partner treats it as fiscally transparent. The State of source may, subject to the applicable provisions of the Convention, tax the partnership on its income when that income is realised and, subject to the limitations of paragraph 2 of Article 10, may also tax the distribution of profits by the partnership to its non-resident partners. The State of residence, however, will only tax the partner on his share of the partnership's income when that income is realised by the partnership.

69.2 The first issue that arises in this case is whether the State of residence, which taxes the partner on his share in the partnership's income, is obliged, under the Convention, to give credit for the tax that is levied in the State of source on the partnership, which that latter State treats as a separate taxable entity. The answer to that question must be affirmative. To the extent that the State of residence flows through the income of the partnership to the partner for the purpose of taxing him, it must adopt a coherent approach and flow through to the partner the tax paid by the partnership for the purposes of eliminating double taxation arising from its taxation of the partner. In other words, if the corporate status given to the partnership by the State of source is ignored by the State of residence for purposes of taxing the partner on his share of the income, it should likewise be ignored for purposes of the foreign tax credit.

Some members of the Committee of Experts are, however, of the view that a special rule is required in a convention to provide such a result.

69.3 A second issue that arises in this case is the extent to which the State of residence must provide credit for the tax levied by the State of source on the distribution, which is not taxed in the State of residence. The answer to that question lies in that last fact. Since the distribution is not taxed in the State of residence, there is simply no tax in the State of residence against which to credit the tax levied by the State

of source upon the distribution. A clear distinction must be made between the generation of profits and the distribution of those profits and the State of residence should not be expected to credit the tax levied by the State of source upon the distribution against its own tax levied upon generation (see the first sentence of paragraph 64 above).

B. *Remarks concerning capital tax*

70. As paragraph 1 is drafted, credit is to be allowed for income tax only against income tax and for capital tax only against capital tax. Consequently, credit for or against capital tax will be given only if there is a capital tax in both Contracting States.

71. In bilateral negotiations, two Contracting States may agree that a tax called a capital tax is of a nature closely related to income tax and may, therefore, wish to allow credit for it against income tax and vice versa. There are cases where, because one State does not impose a capital tax or because both States impose capital taxes only on domestic assets, no double taxation of capital will arise. In such cases it is, of course, understood that the reference to capital taxation may be deleted. Furthermore, States may find it desirable, regardless of the nature of the taxes under the convention, to allow credit for the total amount of tax in the State of source or situs against the total amount of tax in the State of residence. Where, however, a convention includes both real capital taxes and capital taxes which are in their nature income taxes, the States may wish to allow credit against income tax only for the latter capital taxes. In such cases, States are free to alter the proposed Article so as to achieve the desired effect.

C. *Tax sparing*

72. Some States grant different kinds of tax incentives to foreign investors for the purpose of attracting foreign investment. When the State of residence of a foreign investor applies the credit method, the benefit of the incentive granted by a State of source may be reduced to the extent that the State of residence, when taxing income that has benefited from the incentive, will allow a deduction only for the tax actually paid in the State of source. Similarly, if the State of residence applies the exemption method but subject the application of that method to a certain level of taxation by the State of source, the granting of a tax reduction by the State of source may have the effect of denying the investor the application of the exemption method in his State of residence.

73. To avoid any such effect in the State of residence, some States that have adopted tax incentive programmes wish to include provisions, usually referred to as “tax sparing” provisions, in their conventions. The purpose of these provisions is to allow non-residents to obtain a foreign tax credit for the taxes that have been “spared” under the incentive programme of the source State or to ensure that these taxes will be taken into account for the purposes of applying certain conditions that may be attached to exemption systems.

74. Tax sparing provisions constitute a departure from the provisions of Articles 23 A and 23 B. Tax sparing provisions may take different forms, as for example:

- a) the State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general legislation or such amount as limited by the Convention (*e.g.* limitations of rates provided for dividends and interest in Articles 10 and 11) even if the State of source has waived all or part of that tax under special provisions for the promotion of its economic development;
- b) as a counterpart for the tax reduction by the State of [source] the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate;
- c) the State of residence exempts the income which has benefited from tax incentives in the State of source.

17. Contracting States are free to devise other formulae in the course of bilateral negotiations. The following paragraphs of the OECD Commentary before the 2000 update of that Commentary, are still relevant:

76. If a Contracting State agrees to stimulate especially investments in the other State being a developing country, the above provisions will generally be accompanied by guarantees for the investors, that is to say, the convention will limit the rate of tax which can be imposed in the State of source on dividends, interest and royalties.

77. Moreover, time restrictions or time limits can be provided for the application of the advantages referred to in formula *a*), and possibly *c*), above: the extended credit (or the exemption) may be granted only in respect of incentives applied temporarily in developing countries, or only for investments made or contracts concluded in the future (for instance, from the date of entry into force of the convention) or for a determined period of time.

78. Thus, there exist a considerable number of solutions to this problem. In fact, the concrete effects of the provisions concerned can also vary as a result of other factors such as the amount to be included in the taxable income in the State of residence (formulae *a*) and *b*) above); it may be the net income derived (after deduction of the tax effectively paid in the State of source), or the net income grossed-up by an amount equal to the tax effectively paid in the State of source, or to the tax which could have been levied in accordance with the convention (rates provided for in Articles 10 and 11) or to the tax which the State of residence agrees to allow as a deduction.

18. The following extracts from the Commentary on Article 23 A and 23 B of the OECD Model Convention are also applicable:

75. A 1998 report by the Committee of Fiscal Affairs, entitled “Tax Sparing a Reconsideration”,⁴⁷ analyses the tax policy considerations that underlie tax sparing provisions as well as their drafting. The report identifies a number of concerns that put into question the overall usefulness of the granting of tax sparing relief. These concerns relate in particular to:

- the potential for abuse offered by tax sparing;
- the effectiveness of tax sparing as an instrument of foreign aid to promote economic development of the source country; and
- general concerns with the way in which tax sparing may encourage States to use tax incentives.

Paragraph 2

79. 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 or capital. The right so retained extends to income or capital which “shall be taxable only” in the other State. The principle of progression is thus safeguarded for the State of residence, not only in relation to income or capital which “may be taxed” in the other State, but also for income or capital which “shall be taxable only” in that other State. The Commentary on paragraph 3 of Article 23 A in relation to the State of source also applies to paragraph 2 of Article 23 B.

⁴⁷Reproduced in Volume II of the full-length version of the OECD Model Tax Convention at page R(14)-1.

19. A State that generally adopts the exemption method may consider that such method should not apply where the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income or of capital falls under a provision of the Convention that does not allow that State to tax such income or capital while the State of residence adopts a different interpretation under which such income or capital falls under a provision of the Convention that allows the State of source to tax. This may not be of concern to some States. But if it is, and in order to avoid unintended double non-taxation resulting from the diverging interpretations of the State of residence and the State of source, the following provision may be included in Article 23 A:

4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11, or 12 to such income; in the latter case, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2.

Members of the Committee recognized that in a bilateral Convention between a “credit” country and “exemption” country, the decision whether to include such a provision would essentially lie with the exemption country; it would not be appropriate for the State of source to insist on double non-taxation arising in an arbitrary and unpredictable manner. If necessary the provision could be made unilateral and not reciprocal.

Commentary on chapter VI

SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

1. Article 24 of the United Nations Model Convention, except for reference to a different paragraph of Article 12 in paragraph 4, reproduces Article 24 of the OECD Model Convention. The general remarks from the OECD Commentary on Article 24 are as follows:

1. This Article deals with the elimination of tax discrimination in certain precise circumstances. All tax systems incorporate legitimate distinctions based, for example, on differences in liability to tax or ability to pay. The non-discrimination provisions of the Article seek to balance the need to prevent unjustified discrimination with the need to take account of these legitimate distinctions. For that reason, the Article should not be unduly extended to cover so-called “indirect” discrimination. For example, whilst paragraph 1, which deals with discrimination on the basis of nationality, would prevent a different treatment that is really a disguised form of discrimination based on nationality such as a different treatment of individuals based on whether or not they hold, or are entitled to, a passport issued by the State, it could not be argued that non-residents of a given State include primarily persons who are not nationals of that State to conclude that a different treatment based on residence is indirectly a discrimination based on nationality for purposes of that paragraph.

2. Likewise, the provisions of the Article cannot be interpreted as to require most-favoured-nation treatment. Where a State has concluded a bilateral or multilateral agreement which affords tax benefits to nationals or residents of the other Contracting State(s) party to that agreement, nationals or residents of a third State that is not a Contracting State of the treaty may not claim these benefits by reason of a similar non-discrimination provision in the double taxation convention between the third State and the first-mentioned State. As tax conventions are based on the principle of reciprocity, a tax treatment that is granted by one Contracting State under a bilateral or multilateral agreement to a resident or national of another Contracting State party to that agreement by reason of the specific economic relationship

between those Contracting States may not be extended to a resident or national of a third State under the non-discrimination provision of the tax convention between the first State and the third State.

3. The various provisions of Article 24 prevent differences in tax treatment that are solely based on certain specific grounds (e.g. nationality, in the case of paragraph 1). Thus, for these paragraphs to apply, other relevant aspects must be the same. The various provisions of Article 24 use different wording to achieve that result (e.g. “in the same circumstances” in paragraphs 1 and 2; “carrying on the same activities” in paragraph 3; “similar enterprises” in paragraph 5). Also, whilst the Article seeks to eliminate distinctions that are solely based on certain grounds, it is not intended to provide foreign nationals, non-residents, enterprises of other States or domestic enterprises owned or controlled by non-residents with a tax treatment that is better than that of nationals, residents or domestic enterprises owned or controlled by residents (see, for example, paragraph 34 below).

4. Finally, as illustrated by paragraph 79 below, the provisions of the Article must be read in the context of the other Articles of the Convention so that measures that are mandated or expressly authorised by the provisions of these Articles cannot be considered to violate the provisions of the Article even if they only apply, for example, as regards payments to non-residents. Conversely, however, the fact that a particular measure does not constitute a violation of the provisions of the Article does not mean that it is authorised by the Convention since that measure could violate other Articles of the Convention.

2. The Committee considers that the following extracts from the Commentary on paragraphs 1 to 4 of Article 24 of the OECD Model Convention are applicable to corresponding paragraphs of Article 24 (the additional comments that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the provisions of the OECD Model Convention and those of this Model and also to specify the applicable paragraph/subparagraph of this Model):

Paragraph 1

5. This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

6. It is noteworthy that the principle of non-discrimination, under various descriptions and with a more or less wide scope, was applied in international fiscal relations well before the appearance, at the end of the 19th Century, of the classic type of double taxation conventions. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of friendship or commerce, etc.) concluded by States, especially in the 19th Century, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other State equality of treatment with its own nationals. The fact that such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope. The text of paragraph 1 provides that the application of this paragraph is not restricted by Article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State.

7. The expression “in the same circumstances” refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact. The expression “in particular with respect to residence” makes clear that the residence of the taxpayer is one of the factors that are relevant in determining whether taxpayers are placed in similar circumstances. The expression “in the same circumstances” would be sufficient by itself to establish that a taxpayer who is a resident of a Contracting State and one who is not a resident of that State are not in the same circumstances. In fact, whilst the expression “in particular with respect to residence” did not appear in the 1963 Draft Convention or in the 1977 Model Convention, the member countries have consistently held, in applying and interpreting the expression “in the same circumstances”, that the residence of the taxpayer must be taken into account. However, in revising the Model Convention, the Committee on Fiscal Affairs felt that a specific reference to the residence of the taxpayers would be a useful clarification as it would avoid any possible doubt as to the interpretation to be given to the expression “in the same circumstances” in this respect.

8. In applying paragraph 1, therefore, the underlying question is whether two persons who are residents of the same State are being treated differently solely by reason of having a different nationality. Consequently if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its nationals who reside in the other State. Similarly, paragraph 1 does not apply where a national of a Contracting State (State R) who is also a resident of State R is taxed less favourably in the other Contracting State (State S) than a national of State S residing in a third State (for instance, as a result of the application of provisions aimed at discouraging the use of tax havens) as the two persons are not in the same circumstances with respect to their residence.

9. The expression “in the same circumstances” can in some cases refer to a person’s tax situation. This would be the case, for example, where a country would subject its nationals, or some of them, to a more comprehensive tax liability than non-nationals (this, for example, is a feature of the United States tax system). As long as such treatment is not itself a violation of paragraph 1, it could not be argued that persons who are not nationals of that State are in the same circumstances as its nationals for the purposes of the application of the other provisions of the domestic tax law of that State with respect to which the comprehensive or limited liability to tax of a taxpayer would be relevant (e.g. the granting of personal allowances).

10. Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.

11. Neither are they to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit.

12. To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful

undertakings. To the extent that these can be regarded as being on the same footing as private business undertakings, the provisions of paragraph 1 will apply to them.

13. As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.

14. Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed in accordance with Article 7 [of the United Nations Model Convention], certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

15. Subject to the foregoing observation, the words "... shall not be subjected ... to any taxation or any requirement connected therewith which is other or more burdensome ..." mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.

16. In view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under paragraph 1. This result is achieved through the definition of the term "national" in subparagraph [(f)] of paragraph 1 of Article 3.

17. By virtue of that definition, in the case of a legal person such as a company, “national of a Contracting State” means a legal person “deriving its status as such from the laws in force in that Contracting State”. A company will usually derive its status as such from the laws in force in the State in which it has been incorporated or registered. Under the domestic law of many countries, however, incorporation or registration constitutes the criterion, or one of the criteria, to determine the residence of companies for the purposes of Article 4. Since paragraph 1 of Article 24 prevents different treatment based on nationality but only with respect to persons or entities “in the same circumstances, in particular with respect to residence”, it is therefore important to distinguish, for purposes of that paragraph, a different treatment that is solely based on nationality from a different treatment that relates to other circumstances and, in particular, residence. As explained in paragraphs 7 and 8 above, paragraph 1 only prohibits discrimination based on a different nationality and requires that all other relevant factors, including the residence of the entity, be the same. The different treatment of residents and non-residents is a crucial feature of domestic tax systems and of tax treaties; when Article 24 is read in the context of the other Articles of the Convention, most of which provide for a different treatment of residents and non-residents, it is clear that two companies that are not residents of the same State for purposes of the Convention (under the rules of Article 4) are usually not in the same circumstances for purposes of paragraph 1.

18. Whilst residents and non-residents are usually not in the same circumstances for the purposes of paragraph 1, it is clear, however, that this is not the case where residence has no relevance whatsoever with respect to the different treatment under consideration.

19. The following examples illustrate these principles.

20. Example 1: Under the domestic income tax law of State A, companies incorporated in that State or having their place of effective management in that State are residents thereof. The State A - State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Since a company incorporated in State B that would have its place of effective management in State A would be a resident of State A for purposes of the State A - State B Convention, the fact that dividends paid to such a company by a company incorporated in State A would not be eligible for this exemption, even though the recipient company is in the same

circumstances as a company incorporated in State A with respect to its residence, would constitute a breach of paragraph 1 absent other relevant different circumstances.

21. Example 2: Under the domestic income tax law of State A, companies incorporated in that State are residents thereof and companies incorporated abroad are non-residents. The State A - State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Paragraph 1 does not extend that treatment to dividends paid to a company incorporated in State B. Even if a company incorporated in State A and a company incorporated in State B that receive such dividends are treated differently, these companies are not in the same circumstances with regards to their residence and residence is a relevant factor in this case (as can be concluded, for example, from paragraph 5 of Article 10, which would prevent the subsequent taxation of dividends paid by a non-resident company but not those paid by a resident company).

22. Example 3: Under the domestic income tax law of State A, companies that are incorporated in that State are residents thereof. Under the domestic tax law of State B, companies that have their place of effective management in that State are residents thereof. The State A-State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that a non-resident company that is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information is subject to an annual tax equal to 3 per cent of the value of its immovable property instead of a tax on the net income derived from that property. A company incorporated in State B but which is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information cannot claim that paragraph 1 prevents the application of the 3 per cent tax levied by State A because it is treated differently from a company incorporated in State A. In that case, such a company would not be in the same circumstances, with respect to its residence, as a company incorporated in State A and the residence of the company would be relevant (*e.g.* for purposes of accessing the information necessary to verify the net income from immovable property derived by a non-resident taxpayer).

23. Example 4: Under the domestic income tax law of State A, companies incorporated in that State are residents of State A and companies incorporated abroad are non-residents. The State A-State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. Under State A's payroll tax law, all companies that employ resident employees are subject to a payroll tax that does not make any distinction based on the residence of the employer but that provides that only companies incorporated in State A shall benefit from a lower rate of payroll tax. In that case, the fact that a company incorporated in State B will not have the same residence as a company incorporated in State A for the purposes of the A-B convention has no relevance at all with respect to the different tax treatment under the payroll tax and that different treatment would therefore be in violation of paragraph 1 absent other relevant different circumstances.

24. Example 5: Under the domestic income tax law of State A, companies incorporated in that State or which have their place of effective management in that State are residents of the State and companies that do not meet one of these two conditions are non-residents. Under the domestic income tax law of State B, companies incorporated in that State are residents of that State. The State A - State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident only of the State in which it has been incorporated. The domestic tax law of State A further provides that companies that have been incorporated and that have their place of effective management in that State are entitled to consolidate their income for tax purposes if they are part of a group of companies that have common shareholders. Company X, which was incorporated in State B, belongs to the same group as two companies incorporated in State A and all these companies are effectively managed in State A. Since it was not incorporated in State A, company X is not allowed to consolidate its income with that of the two other companies.

25. In that case, even if company X is a resident of State A under the domestic law of that State, it is not a resident of State A for purposes of the Convention by virtue of paragraph 3 of Article 4. It will therefore not be in the same circumstances as the other companies of the group as regards residence and paragraph 1 will not allow it to obtain the

benefits of consolidation even if the different treatment results from the fact that company X has not been incorporated in State A. The residence of company X is clearly relevant with respect to the benefits of consolidation since certain provisions of the Convention, such as Articles 7 and 10, would prevent State A from taxing certain types of income derived by company X.

Paragraph 2

26. On 28 September 1954, a number of States concluded in New York a Convention relating to the status of stateless persons, under Article 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD member countries.

27. It should, however, be recognised that the provisions of paragraph 2 will, in a bilateral convention, enable national treatment to be extended to stateless persons who, because they are in one of the situations enumerated in paragraph 2 of Article 1 of the above-mentioned Convention of 28 September 1954, are not covered by that Convention. This is mainly the case, on the one hand, of persons receiving at the time of signature of that Convention, protection or assistance from organs or agencies of the United Nations other than the United Nations High Commissioner for Refugees, and, on the other hand, of persons who are residents of a country and who there enjoy and are subject to the rights and obligations attaching to the possession of that country's nationality.

28. The purpose of paragraph 2 is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to stateless persons who are residents of that or of the other Contracting State.

29. By thus excluding stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other State.

30. However, if States were to consider it desirable in their bilateral relations to extend the application of paragraph 2 to all stateless persons, whether residents of a Contracting State or not, so that in all cases they enjoy the most favourable treatment accorded to nationals of the State concerned, in order to do this they would need only to adopt the following text which contains no condition as to residence in a Contracting State:

Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that State in the same circumstances, in particular with respect to residence, are or may be subjected.

31. It is possible that in the future certain States will take exception to the provisions of paragraph 2 as being too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. If such States wished to avoid this latter consequence, they would have to modify paragraph 2 as follows:

Stateless persons who are residents of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected.

32. Finally, it should be understood that the definition of the term “stateless person” to be used for the purposes of such a clause can only be that laid down in paragraph 1 of Article 1 of the Convention of 28 September 1954, which defines a stateless person as “a person who is not considered as a national by any State under the operation of its law”.

Paragraph 3

33. Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.

34. It appears necessary first to make it clear that the wording of the first sentence of paragraph 3 must be interpreted in the sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being

permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied. For example, paragraph 3 does not prevent the application of specific mechanisms that apply only for the purposes of determining the profits that are attributable to a permanent establishment. The paragraph must be read in the context of the Convention and, in particular, of paragraph 2 of Article 7 [of the United Nations Model Convention]. Clearly, rules or administrative practices that seek to determine the profits that are attributable to a permanent establishment on the basis required by paragraph 2 of Article 7 [of the United Nations Model Convention] cannot be considered to violate paragraph 3, which is based on the same principle since it requires that the taxation on the permanent establishment be not less favourable than that levied on a domestic enterprise carrying on similar activities.

35. By the terms of the first sentence of paragraph 3, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on business activities, and especially taxes on business profits.

36. However, the second sentence of paragraph 3 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.

37. It is also clear that, for purposes of paragraph 3, the tax treatment in one Contracting State of the permanent establishment of an enterprise of the other Contracting State should be compared to that of an enterprise of the first-mentioned State that has a legal structure that is similar to that of the enterprise to which the permanent

establishment belongs. Thus, for example, paragraph 3 does not require a State to apply to the profits of the permanent establishment of an enterprise carried on by a non-resident individual the same rate of tax as is applicable to an enterprise of that State that is carried on by a resident company.

38. Similarly, regulated and unregulated activities would generally not constitute the “same activities” for the purposes of paragraph 3. Thus, for instance, paragraph 3 would not require that the taxation on a permanent establishment whose activities include the borrowing and lending of money but which is not registered as a bank be not less favourably levied than that of domestic banks since the permanent establishment does not carry on the same activities. Another example would be that of activities carried on by a State or its public bodies, which, since they are controlled by the State, could not be considered, for the purposes of paragraph 3, to be similar to activities that an enterprise of the other State performs through a permanent establishment.

39. As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.

A. *Assessment of tax*

40. With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

- a) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorised by the taxation law to be deducted from taxable profits. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises [...].

- b)* Permanent establishments must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries (“wholesale” writing down, accelerated depreciation etc.). As regards reserves, it should be noted that these are sometimes authorised for purposes other than the offsetting—in accordance with commercial accounting principles—of depreciation on assets, expenses or losses which have not yet occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit, provisions or “reserves” for investment. When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises with respect to their permanent establishments situated in the State concerned, insofar, that is, as the activities to which such provisions or reserves would pertain are taxable in that State.
- c)* Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g. 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities which will qualify for such carry-forward.
- d)* Permanent establishments should further have the same rules applied to resident enterprises, with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.
41. As clearly stated in subparagraph *c)* above, the equal treatment principle of paragraph 3 only applies to the taxation of the permanent establishment’s own activities. That principle, therefore, is restricted to a comparison between the rules governing the taxation of the permanent establishment’s own activities and those applicable to similar business activities carried on by an independent resident enterprise. It does not extend to rules that take account of the relationship between an enterprise and other enterprises (e.g. rules that allow consolidation, transfer of losses or tax-free transfers of property between companies

under common ownership) since the latter rules do not focus on the taxation of an enterprise's own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises. Such rules will often operate to ensure or facilitate tax compliance and administration within a domestic group. It therefore follows that the equal treatment principle has no application. For the same reasons, rules related to the distribution of the profits of a resident enterprise cannot be extended to a permanent establishment under paragraph 3 as they do not relate to the business activities of the permanent establishment (see paragraph 59 below).

42. Also, it is clear that the application of transfer pricing rules based on the arm's length standard in the case of transfers from a permanent establishment to its head office (or vice versa) cannot be considered to be a violation of paragraph 3 even if such rules do not apply to transfers within an enterprise of the Contracting State where the permanent establishment is located. Indeed, the application of the arm's length standard to the determination of the profits attributable to a permanent establishment is mandated by paragraph 2 of Article 7 [of the United Nations Model Convention] and that paragraph forms part of the context in which paragraph 3 of Article 24 must be read; also, since Article 9 would authorise the application of the arm's length standard to a transfer between a domestic enterprise and a foreign related enterprise, one cannot consider that its application in the case of a permanent establishment results in less favourable taxation than that levied on an enterprise of the Contracting State where the permanent establishment is located.

43. Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of non-discrimination, they do not constitute an exhaustive list of the possible consequences of that principle with respect to the determination of the tax base. The application of that principle may be less clear in the tax incentive measures which most countries, faced with such problems as decentralisation of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

44. As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is

right that the benefit of them should be extended to permanent establishments of enterprises of another State which has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in business activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States.

45. It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.

46. Also it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.

47. Finally, the provisions of paragraph 3 should not be construed as obliging a State which accords special taxation privileges to non-profit institutions whose activities are performed for purposes of public benefit that are specific to that State, to extend the same privileges to permanent establishments of similar institutions of the other State whose activities are not exclusively for the first-mentioned State's public benefit.

B. *Special treatment of dividends received in respect of holdings owned by permanent establishments*

48. In many countries special rules exist for the taxation of dividends distributed between companies (parent company subsidiary treatment, the *Schachtelprivileg*, the rule *non bis in idem*). The question arises whether such treatment, should by effect of the provisions of paragraph 3, also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets.

49. On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle, profits tax should be levied once, in the hands of the subsidiary performing the profit-generating activities.

The parent company should be exempted from tax on such profits when received from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the head office of the parent company is situated to give relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The State of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (*i.e.* for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.

50. Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward relates to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends, its extension to permanent establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 3 does not entail any obligation to extend

such treatment to permanent establishments argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.

51. The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, viz.,

- reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;
- or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;
- or simple reasons of practical convenience, in line with the present tendency towards decentralisation of management functions in large enterprises.

52. In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 3. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

53. A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B) results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5 or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions of paragraphs 2 and 4 of Article 10, so as to enable

withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent establishments of companies which are residents of State B in the same way as if they are received directly, *i.e.* by the head offices of the latter companies, *viz.*, at the rate of:

- 5 per cent in the case of a holding of at least 25 per cent;
- 15 per cent in all other cases.

It is to be noted that paragraph 2 of Article 10 in the United Nations Model Convention differs from the terms quoted above.

54. Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned, to levy a withholding tax there on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.

C. *Structure and rate of tax*

55. In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 3 raise, with regard to the rate applicable in the case of permanent establishments, some specific issues related to the fact that the permanent establishment is only a part of a legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.

56. When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way [...]. States that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.

57. When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed a priori that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 3 are not observed only if the minimum rate is higher.

58. However, even if the profits of the whole enterprise to which the permanent establishment belongs are taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the [distinct and separate enterprise], according to which the profits of the permanent establishment must be determined under paragraph 2 of Article 7 [of the United Nations Model Convention]. The minimum amount of the tax levied in the State where the permanent establishment is situated is, therefore, the amount which would be due if it were a [distinct and separate enterprise], without reference to the profits of the whole enterprise to which it belongs. The State where the permanent establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment, leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.

59. Since a permanent establishment, by its very nature, does not distribute dividends, the tax treatment of distributions made by the enterprise to which the permanent establishment belongs is therefore outside the scope of paragraph 3. Paragraph 3 is restricted to the taxation of the profits from the activities of the permanent establishment itself and does not extend to the taxation of the enterprise as a whole. This is confirmed by the second sentence of the paragraph, which confirms that tax aspects related to the taxpayer that owns the permanent establishment, such as personal allowances and deductions, are outside the scope of the paragraph. Thus, issues related to various systems for the integration of the corporate and shareholder's taxes (e.g. advance corporate tax, *précompte mobilier*, computation of franked income and related dividend tax credits) are outside the scope of the paragraph.

60. In some States, the profits of a permanent establishment of an enterprise of another Contracting State are taxed at a higher rate than the profits of enterprises of that State. This additional tax, sometimes referred to as a “branch tax”, may be explained by the fact that if a subsidiary of the foreign enterprise earned the same profits as the permanent establishment and subsequently distributed these profits as a dividend, an additional tax would be levied on these dividends in accordance with paragraph 2 of Article 10. Where such tax is simply expressed as an additional tax payable on the profits of the permanent establishment, it must be considered as a tax levied on the profits of the activities of the permanent establishment itself and not as a tax on the enterprise in its capacity as owner of the permanent establishment. Such a tax would therefore be contrary to paragraph 3.

The Commentary on Article 10 has considered the issue of branch profits taxes in paragraphs 18 to 24 and suggested an optional provision for a branch profits tax which takes precedence over Article 24.

61. That situation must, however, be distinguished from that of a tax that would be imposed on amounts deducted, for instance as interest, in computing the profits of a permanent establishment (e.g. “branch level interest tax”); in that case, the tax would not be levied on the permanent establishment itself but, rather, on the enterprise to which the interest is considered to be paid and would therefore be outside the scope of paragraph 3 (depending on the circumstances, however, other provisions, such as those of Articles 7 and 11, may be relevant in determining whether such a tax is allowed by the Convention; see the last sentence of paragraph 4).

D. Withholding tax on dividends, interest and royalties received by a permanent establishment

62. When permanent establishments receive dividends, interest or royalties such income, by virtue of paragraph [3] of Articles 10 and 11 and paragraph [4] of Article 12, respectively, comes under the provisions of Article 7 and consequently—subject to the observations made in paragraph 53 above as regards dividends received on holdings of permanent establishment—falls to be included in the taxable profits of such permanent establishments.

63. According to the respective Commentaries on the above-mentioned provisions of Articles 10, 11 and 12 [...] these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any

limitation provided for in those Articles, which means—and this is the generally accepted interpretation—that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.

64. While this approach does not create any problems with regard to the provisions of paragraph 3 of Article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.

65. In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 3 that for the purpose of taxing the income which is derived from their activity, or which is normally connected with it—as is recognised to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph [4] of Article 12—permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.

66. In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.

E. Credit for foreign tax

67. In a related context, when foreign income is included in the profits attributable to a permanent establishment, it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

68. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises; as to the extension to permanent establishments of the benefit of credit provisions included in tax conventions concluded with third States [...]. Whilst the permanent establishment is not itself a person and is therefore not entitled to the benefits of these tax conventions, this issue is relevant to the taxation on the permanent establishment. This question is examined below in the particular case of dividends and interest.

F. *Extension to permanent establishments of the benefit of the credit provisions of double taxation conventions concluded with third States*

69. When the permanent establishment in a Contracting State of a resident enterprise of another Contracting State receives dividends [...], interest [or royalties] from a third State, then the question arises as to whether and to what extent the Contracting State in which the permanent establishment is situated should credit the tax that cannot be recovered from the third State.

70. There is agreement that double taxation arises in these situations and that some method of relief should be found. The majority of member countries are able to grant credit in these cases on the basis of their domestic law or under paragraph 3. States that cannot give credit in such a way or that wish to clarify the situation may wish to supplement the provision in their convention with the Contracting State in which the enterprise is resident by wording that allows the State in which the permanent establishment is situated to credit the tax liability in the State in which the income originates to an amount that does not exceed the amount that resident enterprises in the Contracting State in which the permanent establishment is situated can claim on the basis of the Contracting State's convention with the third State. If the tax that cannot be recovered under the convention between the third State and the State of residence of the enterprise which has a permanent establishment in the other Contracting State is lower than that under the convention between the third State and the Contracting State in which the permanent establishment is situated, then only the lower tax collected in the third State shall be credited. This result would be achieved by adding the following words after the first sentence of paragraph 3:

When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends, interest or royalties from a third State and the holding or debt-claim in respect of which the dividends, interest or royalties are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends, interest or royalties, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is a resident of the first-mentioned State

can claim under that State's convention on income and capital with the third State. If the convention also provides for other categories of income that may be taxed in the State in which they arise and for which credit should be given (e.g. royalties, in some conventions), the above provision should be amended to also cover these.

71. Where a permanent establishment situated in a Contracting State of an enterprise resident of another Contracting State (the State of residence) receives dividends, interest or royalties from a third State (the State of source) and, according to the procedure agreed to between the State of residence and the State of source, a certificate of domicile is requested by the State of source for the application of the withholding tax at the rate provided for in the convention between the State of source and the State of residence, this certificate must be issued by the latter State. While this procedure may be useful where the State of residence employs the credit method, it seems to serve no purposes where that State uses the exemption method as the income from the third State is not liable to tax in the State of residence of the enterprise. On the other hand, the State in which the permanent establishment is located could benefit from being involved in the certification procedure as this procedure would provide useful information for audit purposes. Another question that arises with triangular cases is that of abuses. If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.

72. In addition to the typical triangular case considered here, other triangular cases arise, particularly that in which the State of the enterprise is also the State from which the income ascribable to the permanent establishment in the other State originates (see also paragraph 5 of the Commentary on Article 21). States can settle these matters in bilateral negotiations.

Paragraph 4

73. This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.

74. Paragraph 4 does not prohibit the country of the borrower from applying its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.

75. Also, paragraph 4 does not prohibit additional information requirements with respect to payments made to non-residents since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents.

3. In the course of the discussion by the former Group of Experts in regard to paragraph 4, when the United Nations Model Convention was revised in 1999, a question was raised whether such a paragraph was suitable for inclusion in a tax treaty between developed and developing countries. It was suggested that the paragraph would not be acceptable to those countries that made deductibility of disbursements made abroad by foreign-owned corporations conditional on the recipient being taxed in such countries. After substantial discussion, the feeling of the Group was that the special circumstances mentioned above ought not to be the basis for treaty articles of broad application but that in cases where they were likely to create a problem they should be raised in bilateral negotiations.

Paragraph 5

4. Since this paragraph reproduces paragraph 5 of Article 24 of the OECD Model Convention, the Committee considers that the following extracts from the Commentary on that paragraph of the OECD Model Convention are applicable:

76. This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.

77. Since the paragraph relates only to the taxation of resident enterprises and not to that of the persons owning or controlling their capital, it follows that it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (*e.g.* rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership). For example, if the domestic tax law of one State allows a resident company to consolidate its income with that of a resident parent company, paragraph 5 cannot have the effect to force the State to allow such consolidation between a resident company and a non-resident parent company. This would require comparing the combined treatment of a resident enterprise and the non-resident that owns its capital with that of a resident enterprise of the same State and the resident that owns its capital, something that clearly goes beyond the taxation of the resident enterprise alone.

78. Also, because paragraph 5 is aimed at ensuring that all resident companies are treated equally regardless of who owns or control their capital and does not seek to ensure that distributions to residents and non-residents are treated in the same way (see paragraph 76 above), it follows that withholding tax obligations that are imposed on a resident company with respect to dividends paid to non-resident shareholders but not with respect to dividends paid to resident shareholders cannot be considered to violate paragraph 5. In that case, the different treatment is not dependent on the fact that the capital of the company is owned or controlled by non-residents but, rather, on the fact that dividends paid to non-residents are taxed differently. A similar example would be that of a State that levies a tax on resident companies that make distributions to their shareholders regardless of whether or not they are residents or non-residents, but which, in order to avoid a multiple application of that tax, would not apply it to distributions made to related resident companies that are themselves subject to the tax upon their own distributions. The fact that

the latter exemption would not apply to distributions to non-resident companies should not be considered to violate paragraph 5. In that case, it is not because the capital of the resident company is owned or controlled by non-residents that it is treated differently; it is because it makes distributions to companies that, under the provisions of the treaty, cannot be subjected to the same tax when they re-distribute the dividends received from that resident company. In this example, all resident companies are treated the same way regardless of who owns or controls their capital and the different treatment is restricted to cases where distributions are made in circumstances where the distribution tax could be avoided.

79. Since the paragraph prevents the discrimination of a resident enterprise that is solely based on who owns or controls the capital of that enterprise, it would not *prima facie* be relevant with respect to rules that provide for a different treatment of an enterprise based on whether it pays interest to resident or non-resident creditors. The paragraph is not concerned with rules based on a debtor-creditor relationship as long as the different treatment resulting from the rules is not based on whether or not non-residents own or control, wholly or partly, directly or indirectly, the capital of the enterprise. For example, if under a State's domestic thin capitalisation rules, a resident enterprise is not allowed to deduct interest paid to a non-resident associated enterprise, that rule would not be in violation of paragraph 5 even where it would be applied to payments of interest made to a creditor that would own or control the capital of the enterprise, provided that the treatment would be the same if the interest had been paid to a non-resident associated enterprise that did not itself own or control any of the capital of the payer. Clearly, however, such a domestic law rule could be in violation of paragraph 4 to the extent that different conditions would apply for the deduction of interest paid to residents and non-residents and it will therefore be important to determine, for purposes of that paragraph, whether the application of the rule is compatible with the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 (see paragraph 74 above). This would also be important for purposes of paragraph 5 in the case of thin capitalisation rules that would apply only to enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents. Indeed, since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read (as required by Article 31 of the *Vienna Convention on the Law of Treaties*), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5.

80. In the case of transfer pricing enquiries, almost all member countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of the Article.

5. When the United Nations Model Convention was revised in 1999, some members from developing countries proposed that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises are treated alike; they said that, although such a change represented a notable departure from the general principle of taxing foreign persons on the same basis as nationals, the problems of tax compliance in cases in which foreign ownership was involved and the politically sensitive position of foreign-owned enterprises in developing countries warranted the change. Therefore, they proposed that Article 24, paragraph 5, of the OECD Model Convention be amended to read as follows:

5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar enterprises the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of third countries.

They further pointed out that the proposed change in paragraph 5 had been included in several tax treaties to which developed countries were parties. Some members from developed countries noted that such a proposal would limit the effect of the non-discrimination Article to the prevention of discrimination between enterprises owned by non-residents, thus leaving the door open to discrimination against enterprises owned by non-residents as a class.

6. Several members from developed countries expressed reservations concerning the proposed change and said that they considered the OECD non-discrimination Article as the backbone of the Convention. They recalled that the antecedents of the non-discrimination Article in the present OECD Model Convention dated from the nineteenth century. They felt that if such a fundamental principle were to be altered, it would have a significant effect on international tax relations generally. Further, since the proposed change was motivated in part by problems with tax compliance where foreign ownership was involved—essentially, problems with transfer pricing—it was suggested that the problem might be dealt with more properly in other parts of the Model Convention, such as in Article 9 dealing with associated enterprises.

7. Some members from developing countries indicated that, while recognizing the essential importance of and need for the Article on non-discrimination, some countries might wish to modify certain paragraphs of that Article in bilateral negotiations. It was suggested for example that, because of the difficulties involved in determining what constituted reasonable amounts in the case of transfer payments on account of royalties, technical assistance fees, head office expenses and so on, a country might desire to deny deductions for such payments or compute the amount of deduction in accordance with the domestic law of the country when such payments were made by an enterprise situated within its territory to a foreign controlling company, whether the latter was resident in another Contracting State or in a third country. Another example cited was that of a country which granted tax preferences with a view to the attainment of certain national objectives which might wish to make a given percentage of local ownership of the enterprise involved a condition for the granting of such tax preferences. The Group recognized that special situations such as those mentioned as examples should be resolved in bilateral negotiations.

Paragraph 6

8. Since this paragraph reproduces paragraph 6 of Article 24 of the OECD Model Convention, the Committee considers that the following Commentary on that paragraph of the OECD Model Convention is applicable:

81. This paragraph states that the scope of the Article is not restricted by the provisions of Article 2. The Article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities.

Article 25

MUTUAL AGREEMENT PROCEDURE

A. GENERAL CONSIDERATIONS

1. Two alternative versions are given for Article 25 of the United Nations Model Convention. Alternative A reproduces Article 25 of the OECD Model Convention with the addition of a second sentence in paragraph 4 but excludes arbitration as is provided for in paragraph 5 of the OECD Model Convention. Alternative B reproduces Article 25 of the OECD Model Convention with the addition of a second sentence in paragraph 4 and includes mandatory arbitration as is provided for in paragraph 5 of the OECD Model Convention

but with four differences. First, paragraph 5 provides that arbitration may be initiated if the competent authorities are unable to reach an agreement on a case within three years from the presentation of that case rather than within two years as provided in the OECD Model Convention. Second, while the OECD Model Convention provides that arbitration must be requested by the person who initiated the case, paragraph 5 provides that arbitration must be requested by the competent authority of one of the Contracting States (this means that a case shall not be submitted to arbitration if the competent authorities of both Contracting States consider that such a case is not suitable for arbitration and neither of them makes a request). Third, paragraph 5, unlike the corresponding provision of the OECD Model Convention, allows the competent authorities to depart from the arbitration decision if they agree to do so within six months after the decision has been communicated to them. Finally, as alternative A does not provide for arbitration, there is no need for a footnote similar to the one included in the OECD Model Convention mentioning that, for various reasons, some countries may wish not to include the arbitration provision in a tax treaty.

2. The mutual agreement procedure is designed not only to furnish a means of settling questions relating to the interpretation and application of the Convention, but also to provide (a) a forum in which residents of the States involved can seek redress for actions not in accordance with the Convention and (b) a mechanism for eliminating double taxation in cases not provided for in the Convention. The mutual agreement procedure applies in connection with all Articles of the Convention, and, in particular, to Article 7 on business profits, Article 9 on associated enterprises, Article 10 on dividends, Article 11 on interest, Article 12 on royalties and Article 23 on methods for the elimination of double taxation. Even if a bilateral convention does not contain paragraph 2 of Article 9, the inclusion of paragraph 1 of Article 9 is sufficient to indicate that the intention of the Contracting States was to have economic double taxation covered by the convention. As a result, most countries consider that, in the absence of rules similar to those of paragraph 2 of Article 9, economic double taxation resulting from adjustments made to profits by reason of transfer pricing falls within the scope of the mutual agreement procedure set up under Article 25 (see paragraph 9 below which quotes paragraph 11 of the OECD Commentary on Article 25). Some countries consider, however, that in the absence of rules similar to those of paragraph 2 of Article 9, economic double taxation arising from transfer pricing adjustments does not fall within the scope of the mutual agreement procedure provided for under paragraphs 1 and 2 of Article 25. Contracting States that do not include paragraph 2 of Article 9 in a convention should therefore clarify during the negotiations the consequences of the absence of paragraph 2 as

to the scope of the mutual agreement procedure. Article 9 of the United Nations Model Convention contains a paragraph 3 which provides that the provisions of paragraph 2 shall not apply where in relation to the adjustment of profits under paragraph 1 an enterprise has suffered a penalty for fraud, gross negligence or wilful default. Where the conditions provided for in paragraph 3 are fulfilled, a Contracting State has no obligation to make the corresponding adjustment under paragraph 2 and the taxpayer may not initiate the mutual agreement procedure under Article 25, paragraph 1 in order to request such corresponding adjustment. However, the taxpayer may initiate the mutual agreement procedure where the taxpayer considers that all the conditions provided for in paragraph 3 are not met or that the adjustment of profits is not in accordance with paragraph 1.

3. The decision whether to agree in a bilateral convention on a mutual agreement procedure without mandatory arbitration as in alternative A or with mandatory arbitration as in alternative B depends on policy and administrative considerations of each Contracting State and its actual experiences with mutual agreement procedures. Countries should in advance analyse the advantages and disadvantages of mandatory or voluntary arbitration (see paragraph 14 below) and evaluate whether or not arbitration is appropriate for them. Countries having limited experience with mutual agreement procedures could have difficulties to determine the consequences of adding arbitration in a mutual agreement procedure. Those countries could simply decide to refuse arbitration at this stage. They could, however, also include arbitration but postpone its entry into force until each country has notified the other that the provision should become effective. Those countries could also decide that despite their lack of experience they are willing to add arbitration in a mutual agreement procedure in order to give certainty to taxpayers that a case presented under paragraph 1 of Article 25 will be solved through mutual agreement unless a taxpayer rejects the mutual agreement.

4. Members of the Committee in favour of alternative A pointed mainly to the following considerations and arguments:

- only a small number of cases are submitted to the mutual agreement procedure under paragraphs 1 and 2 of Article 25 and very few of them remain unresolved;
- domestic legal remedies can resolve the few cases that the competent authorities are not able to resolve through the mutual agreement procedure;
- due to the lack of expertise in many developing countries with mutual agreement procedures, arbitration would be unfair to those countries when the dispute occurs with more experienced countries;

- the interests of countries, which are so fundamental to their public policy, could hardly be safeguarded by private arbitrators in tax matters; arbitrators cannot be expected to make up for the lack of expertise in many developing countries;
- the neutrality and independence of possible arbitrators appears difficult to guarantee;
- it is very difficult to find experienced arbitrators;
- mandatory arbitration is costly and therefore not suitable for developing countries and countries in transition;
- it is not in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.

5. Members of the Committee in favour of alternative B pointed mainly to the following considerations and arguments:

- despite the fact that only a small number of cases remain unresolved, each of these cases represents a situation where there is no resolution for a case where one competent authority considers that there is taxation not in accordance with the Convention and where there may be significant double taxation;
- arbitration provides more certainty to taxpayers that their cases can be resolved under the mutual agreement procedure and contributes to cross-border investment;
- domestic remedies may not resolve adequately and rapidly disputes concerning the application of bilateral conventions (risks of inconsistent court decisions in both countries and of unilateral interpretation of the Convention based on domestic law);
- the obligation to submit unresolved cases to arbitration after a given period of time may facilitate the endeavours of the competent authorities to reach an agreement within that period of time;
- on the basis of the experience under the EU Arbitration Convention, the effective recourse to mandatory arbitration should be rather unusual and the costs relating to that mechanism should be low; moreover, as arbitration provides more certainty to the taxpayers, it reduces the number of costly “protective” appeals and uncertain domestic proceedings;
- arbitrators have to reach a well founded and impartial decision; consequently, they can adjust for the levels of expertise of countries and overcome the possible lack of experience of some countries;

- skilled and impartial arbitrators do exist from various backgrounds (government officials, judges, academics and practitioners) and from various regions (including from developing countries);
- it is in the interest of a State to limit its sovereignty in tax matters through mandatory arbitration.

6. In some countries, constitutional or legal impediments may restrict the ability of the competent authorities to provide relief, in certain cases, through the mutual agreement procedure. Treaty negotiators should discuss any such impediments that they are aware of. Under alternative A, the presence of such impediments should not, however, lead to a modification of the Article that would restrict its scope (especially if, in the future, such impediments are removed): the requirement that competent authorities “shall endeavour” to resolve the case does not entail an obligation to reach a resolution and acknowledges that certain factors may affect the ability of a competent authority to reach a mutual agreement or provide relief. Under alternative B, however, negotiators should ensure that the scope of paragraph 5, which provides for mandatory arbitration, is restricted to take account of any such restrictions in order to avoid the situation where a binding arbitration decision cannot be implemented because of such impediments.

7. Under alternative B, the scope of paragraph 5 has, however, already been restricted in order to take into consideration some possible constitutional or legal impediments. In some States, where a decision on issues submitted to the mutual agreement procedure has already been rendered by one of their courts or administrative tribunals, a mutual agreement on the same issues is no longer allowed under domestic law. To take this situation into account, paragraph 5 states that unresolved issues shall not be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. States that have the possibility in individual cases to deviate from court decisions may delete that sentence. Also, the domestic law of many States provides that no one can be deprived of the judicial remedies available under domestic law. Therefore, under paragraph 5, the arbitration process applies irrespective of the remedies provided by the domestic law of the Contracting States and the persons directly affected by the case have the possibility to reject the mutual agreement implementing the arbitration decision and to pursue any available domestic remedies.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 25

Paragraphs 1 and 2 of Article 25 (alternatives A and B)

8. These paragraphs reproduce the full text of paragraphs 1 and 2 of Article 25 of the OECD Model Convention. As regards the last sentence of paragraph 1, however, some members of the Committee noted that, in bilateral negotiations, States may wish to agree on a different time limit for the presentation of the case to the competent authority of a Contracting State.

9. The Committee considers that the following part of the Commentary on Article 25, paragraphs 1 and 2, of the OECD Model Convention is applicable to the corresponding paragraphs of both alternatives A and B of Article 25 (the additional comments that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the provisions of the OECD Model Convention and those of this Model):

7. The rules laid down in paragraphs 1 and 2 provide for the elimination in a particular case of taxation which does not accord with the Convention. As is known, in such cases it is normally open to taxpayers to litigate in the tax court, either immediately or upon the dismissal of their objections by the taxation authorities. When taxation not in accordance with the Convention arises from an incorrect application of the Convention in both States, taxpayers are then obliged to litigate in each State, with all the disadvantages and uncertainties that such a situation entails. So paragraph 1 makes available to taxpayers affected, without depriving them of the ordinary legal remedies available, a procedure which is called the mutual agreement procedure because it is aimed, in its second stage, at resolving the dispute on an agreed basis, *i.e.* by agreement between competent authorities, the first stage being conducted exclusively in the State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) from the presentation of the objection up to the decision taken regarding it by the competent authority on the matter.

8. In any case, the mutual agreement procedure is clearly a special procedure outside the domestic law. It follows that it can be set in motion solely in cases coming within paragraph 1, *i.e.* cases where tax has been charged, or is going to be charged, in disregard of the provisions of the Convention. So where a charge of tax has been made contrary both to the Convention and the domestic law, this case is

amenable to the mutual agreement procedure to the extent only that the Convention is affected, unless a connecting link exists between the rules of the Convention and the rules of the domestic law which have been misapplied.

9. In practice, the procedure applies to cases—by far the most numerous—where the measure in question leads to double taxation which it is the specific purpose of the Convention to avoid. Among the most common cases, mention must be made of the following:

- questions relating to the attribution of profits to a permanent establishment under paragraph 2 of Article 7;
- the taxation in the State of the payer—in case of a special relationship between the payer and the beneficial owner—of the excess part of interest and royalties, under the provisions of Article 9, paragraph 6 of Article 11 or paragraph [6 of Article 12 of the United Nations Model Convention];
- cases of application of legislation to deal with thin capitalisation when the State of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to Article 9 or paragraph 6 of Article 11;
- cases where lack of information as to the taxpayer's actual situation has led to misapplication of the Convention, especially in regard to the determination of residence (paragraph 2 of Article 4), the existence of a permanent establishment (Article 5), or the temporary nature of the services performed by an employee (paragraph 2 of Article 15).

10. Article 25 also provides machinery to enable competent authorities to consult with each other with a view to resolving, in the context of transfer pricing problems, not only problems of juridical double taxation but also those of economic double taxation, and especially those resulting from the inclusion of profits of associated enterprises under paragraph 1 of Article 9; the corresponding adjustments to be made in pursuance of paragraph 2 of the same Article thus fall within the scope of the mutual agreement procedure, both as concerns assessing whether they are well-founded and for determining their amount.

11. This in fact is implicit in the wording of paragraph 2 of Article 9 when the bilateral convention in question contains a clause of this type. When the bilateral convention does not contain rules similar to those of paragraph 2 of Article 9 (as is usually the case for

conventions signed before 1977) the mere fact that Contracting States inserted in the convention the text of Article 9, as limited to the text of paragraph 1—which usually only confirms broadly similar rules existing in domestic laws—indicates that the intention was to have economic double taxation covered by the Convention. As a result, most member countries consider that economic double taxation resulting from adjustments made to profits by reason of transfer pricing is not in accordance with—at least—the spirit of the Convention and falls within the scope of the mutual agreement procedure set up under Article 25.

12. Whilst the mutual agreement procedure has a clear role in dealing with issues arising as to the sorts of adjustments referred to in paragraph 2 of Article 9, it follows that even in the absence of such a provision, States should be seeking to avoid double taxation, including by giving corresponding adjustments in cases of the type contemplated in paragraph 2. Whilst there may be some difference of view, States would therefore generally regard a taxpayer initiated mutual agreement procedure based upon economic double taxation contrary to the terms of Article 9 as encompassing issues of whether a corresponding adjustment should have been provided, even in the absence of a provision similar to paragraph 2 of Article 9. States which do not share this view do, however, in practice, find the means of remedying economic double taxation in most cases involving *bona fide* companies by making use of provisions in their domestic laws.

13. The mutual agreement procedure is also applicable in the absence of any double taxation contrary to the Convention, once the taxation in dispute is in direct contravention of a rule in the Convention. Such is the case when one State taxes a particular class of income in respect of which the Convention gives an exclusive right to tax to the other State even though the latter is unable to exercise it owing to a gap in its domestic laws. Another category of cases concerns persons who, being nationals of one Contracting State but residents of the other State, are subjected in that other State to taxation treatment which is discriminatory under the provisions of paragraph 1 of Article 24.

14. It should be noted that the mutual agreement procedure, unlike the disputed claims procedure under domestic law, can be set in motion by a taxpayer without waiting until the taxation considered by him to be “not in accordance with the Convention” has been charged against or notified to him. To be able to set the procedure in motion, he must, and it is sufficient if he does, establish that

the “actions of one or both of the Contracting States” will result in such taxation, and that this taxation appears as a risk which is not merely possible but probable. Such actions mean all acts or decisions, whether of a legislative or a regulatory nature, and whether of general or individual application, having as their direct and necessary consequence the charging of tax against the complainant contrary to the provisions of the Convention. Thus, for example, if a change to a Contracting State’s tax law would result in a person deriving a particular type of income being subjected to taxation not in accordance with the Convention, that person could set the mutual agreement procedure in motion as soon as the law has been amended and that person has derived the relevant income or it becomes probable that the person will derive that income. Other examples include filing a return in a self assessment system or the active examination of a specific taxpayer reporting position in the course of an audit, to the extent that either event creates the probability of taxation not in accordance with the Convention (*e.g.* where the self assessment reporting position the taxpayer is required to take under a Contracting State’s domestic law would, if proposed by that State as an assessment in a non-self assessment regime, give rise to the probability of taxation not in accordance with the Convention, or where circumstances such as a Contracting State’s published positions or its audit practice create a significant likelihood that the active examination of a specific reporting position such as the taxpayer’s will lead to proposed assessments that would give rise to the probability of taxation not in accordance with the Convention). Another example might be a case where a Contracting State’s transfer pricing law requires a taxpayer to report taxable income in an amount greater than would result from the actual prices used by the taxpayer in its transactions with a related party, in order to comply with the arm’s length principle, and where there is substantial doubt whether the taxpayer’s related party will be able to obtain a corresponding adjustment in the other Contracting State in the absence of a mutual agreement procedure. As indicated by the opening words of paragraph 1, whether or not the actions of one or both of the Contracting States will result in taxation not in accordance with the Convention must be determined from the perspective of the taxpayer. Whilst the taxpayer’s belief that there will be such taxation must be reasonable and must be based on facts that can be established, the tax authorities should not refuse to consider a request under paragraph 1 merely because they consider that it has not been proven (for example to domestic law standards of proof on the “balance of probabilities”) that such taxation will occur.

15. Since the first steps in a mutual agreement procedure may be set in motion at a very early stage based upon the mere probability of taxation not in accordance with the Convention, the initiation of the procedure in this manner would not be considered the presentation of the case to the competent authority for the purposes of determining the start of the [three-year] period referred to in paragraph 5 of [alternative B of this Article; see paragraph 8 of the Annex to this Commentary].

16. To be admissible objections presented under paragraph 1 must first meet a twofold requirement expressly formulated in that paragraph: in principle, they must be presented to the competent authority of the taxpayer's State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national), and they must be so presented within three years of the first notification of the action which gives rise to taxation which is not in accordance with the Convention. The Convention does not lay down any special rule as to the form of the objections. The competent authorities may prescribe special procedures which they feel to be appropriate [paragraphs 22 ff. below, under the heading "Necessary cooperation of the person who makes the request", include a number of suggestions concerning such special procedures]. If no special procedure has been specified, the objections may be presented in the same way as objections regarding taxes are presented to the tax authorities of the State concerned.

17. The requirement laid on the taxpayer to present his case to the competent authority of the State of which he is a resident (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) is of general application, regardless of whether the taxation objected to has been charged in that or the other State and regardless of whether it has given rise to double taxation or not. If the taxpayer should have transferred his residence to the other Contracting State subsequently to the measure or taxation objected to, he must nevertheless still present his objection to the competent authority of the State of which he was a resident during the year in respect of which such taxation has been or is going to be charged.

18. However, in the case already alluded to where a person who is a national of one State but a resident of the other complains of having been subjected in that other State to an action or taxation which is discriminatory under paragraph 1 of Article 24, it appears more appropriate for obvious reasons to allow him, by way of exception to

the general rule set forth above, to present his objection to the competent authority of the Contracting State of which he is a national. Finally, it is to the same competent authority that an objection has to be presented by a person who, while not being a resident of a Contracting State, is a national of a Contracting State, and whose case comes under paragraph 1 of Article 24.

19. On the other hand, Contracting States may, if they consider it preferable, give taxpayers the option of presenting their cases to the competent authority of either State. In such a case, paragraph 1 would have to be modified as follows:

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of either Contracting State. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

20. The time limit of three years set by the second sentence of paragraph 1 for presenting objections is intended to protect administrations against late objections. This time limit must be regarded as a minimum, so that Contracting States are left free to agree in their bilateral conventions upon a longer period in the interests of taxpayers, *e.g.* on the analogy in particular of the time limits laid down by their respective domestic regulations in regard to tax conventions. Contracting States may omit the second sentence of paragraph 1 if they concur that their respective domestic regulations apply automatically to such objections and are more favourable in their effects to the taxpayers affected, either because they allow a longer time for presenting objections or because they do not set any time limits for such purpose.

21. The provision fixing the starting point of the three year time limit as the date of the “first notification of the action resulting in taxation not in accordance with the provisions of the Convention” should be interpreted in the way most favourable to the taxpayer. Thus, even if such taxation should be directly charged in pursuance of an administrative decision or action of general application, the time limit begins to run only from the date of the notification of the individual action giving rise to such taxation, that is to say, under the most favourable interpretation, from the act of taxation itself, as evidenced by a notice of assessment or an official demand or other

instrument for the collection or levy of tax. Since a taxpayer has the right to present a case as soon as the taxpayer considers that taxation will result in taxation not in accordance with the provisions of the Convention, whilst the three year limit only begins when that result has materialised, there will be cases where the taxpayer will have the right to initiate the mutual agreement procedure before the three year time limit begins (see the examples of such a situation given in paragraph 14 above).

22. In most cases it will be clear what constitutes the relevant notice of assessment, official demand or other instrument for the collection or levy of tax, and there will usually be domestic law rules governing when that notice is regarded as “given”. Such domestic law will usually look to the time when the notice is sent (time of sending), a specific number of days after it is sent, the time when it would be expected to arrive at the address it is sent to (both of which are times of presumptive physical receipt), or the time when it is in fact physically received (time of actual physical receipt). Where there are no such rules, either the time of actual physical receipt or, where this is not sufficiently evidenced, the time when the notice would normally be expected to have arrived at the relevant address should usually be treated as the time of notification, bearing in mind that this provision should be interpreted in the way most favourable to the taxpayer.

23. In self assessment cases, there will usually be some notification effecting that assessment (such as a notice of a liability or of denial or adjustment of a claim for refund), and generally the time of notification, rather than the time when the taxpayer lodges the self-assessed return, would be a starting point for the three year period to run. There may, however, be cases where there is no notice of a liability or the like. In such cases, the relevant time of “notification” would be the time when the taxpayer would, in the normal course of events, be regarded as having been made aware of the taxation that is in fact not in accordance with the Convention. This could, for example, be when information recording the transfer of funds is first made available to a taxpayer, such as in a bank balance or statement. The time begins to run whether or not the taxpayer actually regards the taxation, at that stage, as contrary to the Convention, provided that a reasonably prudent person in the taxpayer’s position would have been able to conclude at that stage that the taxation was not in accordance with the Convention. In such cases, notification of the fact of taxation to the taxpayer is enough. Where, however, it is only the combination of the self assessment with some other circumstance that would cause

a reasonably prudent person in the taxpayer's position to conclude that the taxation was contrary to the Convention (such as a judicial decision determining the imposition of tax in a case similar to the taxpayer's to be contrary to the provisions of the Convention), the time begins to run only when the latter circumstance materialises.

24. If the tax is levied by deduction at the source, the time limit begins to run from the moment when the income is paid; however, if the taxpayer proves that only at a later date did he know that the deduction had been made, the time limit will begin from that date. Where it is the combination of decisions or actions taken in both Contracting States that results in taxation not in accordance with the Convention, the time limit begins to run only from the first notification of the most recent decision or action. This means that where, for example, a Contracting State levies a tax that is not in accordance with the Convention but the other State provides relief for such tax pursuant to Article 23 A or Article 23 B so that there is no double taxation, a taxpayer will in practice often not initiate the mutual agreement procedure in relation to the action of the first State. If, however, the other State subsequently notifies the taxpayer that the relief is denied so that double taxation now arises, a new time limit begins from that notification, since the combined actions of both States then result in the taxpayer's being subjected to double taxation contrary to the provisions of the Convention. In some cases, especially of this type, the records held by taxing authorities may have been routinely destroyed before the period of the time limit ends, in accordance with the normal practice of one or both of the States. The Convention obligations do not prevent such destruction, or require a competent authority to accept the taxpayer's arguments without proof, but in such cases the taxpayer should be given the opportunity to supply the evidential deficiency, as the mutual agreement procedure continues, to the extent domestic law allows. In some cases, the other Contracting State may be able to provide sufficient evidence, in accordance with Article 26 of the Model Tax Convention. It is, of course, preferable that such records be retained by tax authorities for the full period during which a taxpayer is able to seek to initiate the mutual agreement procedure in relation to a particular matter.

25. The three year period continues to run during any domestic law (including administrative) proceedings (e.g. a domestic appeal process). This could create difficulties by in effect requiring a taxpayer to choose between domestic law and mutual agreement procedure remedies. Some taxpayers may rely solely on the mutual agreement procedure, but many taxpayers will attempt to address these difficulties by

initiating a mutual agreement procedure whilst simultaneously initiating domestic law action, even though the domestic law process is initially not actively pursued. This could result in mutual agreement procedure resources being inefficiently applied. Where domestic law allows, some States may wish to specifically deal with this issue by allowing for the three year (or longer) period to be suspended during the course of domestic law proceedings. Two approaches, each of which is consistent with Article 25 are, on one hand, requiring the taxpayer to initiate the mutual agreement procedure, with no suspension during domestic proceedings, but with the competent authorities not entering into talks in earnest until the domestic law action is finally determined, or else, on the other hand, having the competent authorities enter into talks, but without finally settling an agreement unless and until the taxpayer agrees to withdraw domestic law actions. This second possibility is discussed at paragraph 42 of this Commentary. In either of these cases, the taxpayer should be made aware that the relevant approach is being taken. Whether or not a taxpayer considers that there is a need to lodge a “protective” appeal under domestic law (because, for example, of domestic limitation requirements for instituting domestic law actions) the preferred approach for all parties is often that the mutual agreement procedure should be the initial focus for resolving the taxpayer’s issues, and for doing so on a bilateral basis.

26. Some States may deny the taxpayer the ability to initiate the mutual agreement procedure under paragraph 1 of Article 25 in cases where the transactions to which the request relates are regarded as abusive. This issue is closely related to the issue of “improper use of the Convention” discussed [in paragraph 8 and the following paragraphs of the Commentary on Article 1 of the United Nations Model Convention]. In the absence of a special provision, there is no general rule denying perceived abusive situations going to the mutual agreement procedure, however. The simple fact that a charge of tax is made under an avoidance provision of domestic law should not be a reason to deny access to mutual agreement. However, where serious violations of domestic laws resulting in significant penalties are involved, some States may wish to deny access to the mutual agreement procedure. The circumstances in which a State would deny access to the mutual agreement procedure should be made clear in the Convention.⁴⁸

⁴⁸See also paragraph 2 above concerning the access to the mutual agreement procedure where a convention includes paragraph 3 of Article 9 of the United Nations Model Convention [this footnote is not part of the quoted OECD paragraph].

27. Some States regard certain issues as not susceptible to resolution by the mutual agreement procedure generally, or at least by taxpayer initiated mutual agreement procedure, because of constitutional or other domestic law provisions or decisions. An example would be a case where granting the taxpayer relief would be contrary to a final court decision that the tax authority is required to adhere to under that State's constitution. The recognised general principle for tax and other treaties is that domestic law, even domestic constitutional law, does not justify a failure to meet treaty obligations, however. Article 27 of the *Vienna Convention on the Law of Treaties* reflects this general principle of treaty law. It follows that any justification for what would otherwise be a breach of the Convention needs to be found in the terms of the Convention itself, as interpreted in accordance with accepted tax treaty interpretation principles. Such a justification would be rare, because it would not merely govern how a matter will be dealt with by the two States once the matter is within the mutual agreement procedure, but would instead prevent the matter from even reaching the stage when it is considered by both States. Since such a determination might in practice be reached by one of the States without consultation with the other, and since there might be a bilateral solution that therefore remains unconsidered, the view that a matter is not susceptible of taxpayer initiated mutual agreement procedure should not be lightly made, and needs to be supported by the terms of the Convention as negotiated. A competent authority relying upon a domestic law impediment as the reason for not allowing the mutual agreement procedure to be initiated by a taxpayer should inform the other competent authority of this and duly explain the legal basis of its position. More usually, genuine domestic law impediments will not prevent a matter from entering into the mutual agreement procedure, but if they will clearly and unequivocally prevent a competent authority from resolving the issue in a way that avoids taxation of the taxpayer which is not in accordance with the Convention, and there is no realistic chance of the other State resolving the issue for the taxpayer, then that situation should be made public to taxpayers, so that taxpayers do not have false expectations as to the likely outcomes of the procedure.

28. In other cases, initiation of the mutual agreement procedure may have been allowed but domestic law issues that have arisen since the negotiation of the treaty may prevent a competent authority from resolving, even in part, the issue raised by the taxpayer. Where such developments have a legally constraining effect on the competent authority, so that bilateral discussions can clearly not resolve the

matter, most States would accept that this change of circumstances is of such significance as to allow that competent authority to withdraw from the procedure. In some cases, the difficulty may be only temporary however; such as whilst rectifying legislation is enacted, and in that case, the procedure should be suspended rather than terminated. The two competent authorities will need to discuss the difficulty and its possible effect on the mutual agreement procedure. There will also be situations where a decision wholly or partially in the taxpayer's favour is binding and must be followed by one of the competent authorities but where there is still scope for mutual agreement discussions, such as for example in one competent authority's demonstrating to the other that the latter should provide relief.

29. There is less justification for relying on domestic law for not implementing an agreement reached as part of the mutual agreement procedure. The obligation of implementing such agreements is unequivocally stated in the last sentence of paragraph 2, and impediments to implementation that were already existing should generally be built into the terms of the agreement itself. As tax conventions are negotiated against a background of a changing body of domestic law that is sometimes difficult to predict, and as both parties are aware of this in negotiating the original Convention and in reaching mutual agreements, subsequent unexpected changes that alter the fundamental basis of a mutual agreement would generally be considered as requiring revision of the agreement to the extent necessary. Obviously where there is a domestic law development of this type, something that should only rarely occur, good faith obligations require that it be notified as soon as possible, and there should be a good faith effort to seek a revised or new mutual agreement, to the extent the domestic law development allows. In these cases, the taxpayer's request should be regarded as still operative, rather than a new application's being required from that person.

30. As regards the procedure itself, it is necessary to consider briefly the two distinct stages into which it is divided (see paragraph 7 above).

31. In the first stage, which opens with the presentation of the taxpayer's objections, the procedure takes place exclusively at the level of dealings between him and the competent authorities of his State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national). The provisions of paragraph 1 give the taxpayer concerned the right to apply to the competent authority of the State of which he is a resident, whether or not he has exhausted all the

remedies available to him under the domestic law of each of the two States. On the other hand, that competent authority is under an obligation to consider whether the objection is justified and, if it appears to be justified, take action on it in one of the two forms provided for in paragraph 2.

32. If the competent authority duly approached recognises that the complaint is justified and considers that the taxation complained of is due wholly or in part to a measure taken in the taxpayer's State of residence, it must give the complainant satisfaction as speedily as possible by making such adjustments or allowing such reliefs as appear to be justified. In this situation, the issue can be resolved without resort to the mutual agreement procedure. On the other hand, it may be found useful to exchange views and information with the competent authority of the other Contracting State, in order, for example, to confirm a given interpretation of the Convention.

33. If, however, it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State, it will be incumbent on it, indeed it will be its duty—as clearly appears by the terms of paragraph 2—to set in motion the mutual agreement procedure proper. It is important that the authority in question carry out this duty as quickly as possible, especially in cases where the profits of associated enterprises have been adjusted as a result of transfer pricing adjustments.

34. A taxpayer is entitled to present his case under paragraph 1 to the competent authority of the State of which he is a resident whether or not he may also have made a claim or commenced litigation under the domestic law of that State. If litigation is pending, the competent authority of the State of residence should not wait for the final adjudication, but should say whether it considers the case to be eligible for the mutual agreement procedure. If it so decides, it has to determine whether it is itself able to arrive at a satisfactory solution or whether the case has to be submitted to the competent authority of the other Contracting State. An application by a taxpayer to set the mutual agreement procedure in motion should not be rejected without good reason.

35. If a claim has been finally adjudicated by a court in the State of residence, a taxpayer may wish even so to present or pursue a claim under the mutual agreement procedure. In some States, the competent authority may be able to arrive at a satisfactory solution which departs from the court decision. In other States, the competent authority is bound by the court decision. It may nevertheless present

the case to the competent authority of the other Contracting State and ask the latter to take measures for avoiding double taxation.

36. In its second stage—which opens with the approach to the competent authority of the other State by the competent authority to which the taxpayer has applied—the procedure is henceforward at the level of dealings between States, as if, so to speak, the State to which the complaint was presented had given it its backing. But whilst this procedure is indisputably a procedure between States, it may, on the other hand, be asked:

- whether, as the title of the Article and the terms employed in the first sentence of paragraph 2 suggest, it is no more than a simple procedure of mutual agreement, or constitutes the implementation of a *pactum de contrahendo* laying on the parties a mere duty to negotiate but in no way laying on them a duty to reach agreement;
- or whether on the contrary, it is to be regarded (based [in the case of alternative B of the Article] on the existence of the arbitration process provided for in paragraph 5 [of that alternative] to address unresolved issues or on the assumption that the procedure takes place within the framework of a joint commission) as a procedure of a jurisdictional nature laying on the parties a duty to resolve the dispute.

37. Paragraph 2 no doubt entails a duty to negotiate; but as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavours and not to achieve a result. Paragraph 5 [of alternative B], however, provides a mechanism that will allow an agreement to be reached even if there are issues on which the competent authorities have been unable to reach agreement through negotiations.

38. In seeking a mutual agreement, the competent authorities must first, of course, determine their position in the light of the rules of their respective taxation laws and of the provisions of the Convention, which are as binding on them as much as they are on the taxpayer. Should the strict application of such rules or provisions preclude any agreement, it may reasonably be held that the competent authorities, as in the case of international arbitration, can, subsidiarily, have regard to considerations of equity in order to give the taxpayer satisfaction.

39. The purpose of the last sentence of paragraph 2 is to enable countries with time limits relating to adjustments of assessments and tax refunds in their domestic law to give effect to an agreement

despite such time limits. This provision does not prevent, however, such States as are not, on constitutional or other legal grounds, able to overrule the time limits in the domestic law from inserting in the mutual agreement itself such time limits as are adapted to their internal statute of limitation. In certain extreme cases, a Contracting State may prefer not to enter into a mutual agreement, the implementation of which would require that the internal statute of limitation had to be disregarded. Apart from time limits there may exist other obstacles such as “final court decisions” to giving effect to an agreement. Contracting States are free to agree on firm provisions for the removal of such obstacles. As regards the practical implementation of the procedure, it is generally recommended that every effort should be made by tax administrations to ensure that as far as possible the mutual agreement procedure is not in any case frustrated by operational delays or, where time limits would be in point, by the combined effects of time limits and operational delays.

40. The Committee on Fiscal Affairs made a number of recommendations on the problems raised by corresponding adjustments of profits following transfer pricing adjustments (implementation of paragraphs 1 and 2 of Article 9) and of the difficulties of applying the mutual agreement procedure to such situations:

- a) Tax authorities should notify taxpayers as soon as possible of their intention to make a transfer pricing adjustment (and, where the date of any such notification may be important, to ensure that a clear formal notification is given as soon as possible), since it is particularly useful to ensure as early and as full contacts as possible on all relevant matters between tax authorities and taxpayers within the same jurisdiction and, across national frontiers, between the associated enterprises and tax authorities concerned.
- b) Competent authorities should communicate with each other in these matters in as flexible a manner as possible, whether in writing, by telephone, or by face-to-face or round-the-table discussion, whichever is most suitable, and should seek to develop the most effective ways of solving relevant problems. Use of the provisions of Article 26 on the exchange of information should be encouraged in order to assist the competent authority in having well-developed factual information on which a decision can be made.
- c) In the course of mutual agreement proceedings on transfer pricing matters, the taxpayers concerned should be given

every reasonable opportunity to present the relevant facts and arguments to the competent authorities both in writing and orally.

41. As regards the mutual agreement procedure in general, the Committee recommended that:

- a) The formalities involved in instituting and operating the mutual agreement procedure should be kept to a minimum and any unnecessary formalities eliminated.
- b) Mutual agreement cases should each be settled on their individual merits and not by reference to any balance of the results in other cases.
- c) Competent authorities should, where appropriate, formulate and publicise domestic rules, guidelines and procedures concerning use of the mutual agreement procedure.

42. The case may arise where a mutual agreement is concluded in relation to a taxpayer who has brought a suit for the same purpose in the competent court of either Contracting State and such suit is still pending. In such a case, there would be no grounds for rejecting a request by a taxpayer that he be allowed to defer acceptance of the solution agreed upon as a result of the mutual agreement procedure until the court had delivered its judgment in that suit.⁴⁹ [One member of the Committee considers, however, that a taxpayer should not be allowed to defer acceptance of the mutual agreement until a court has delivered its judgment in a suit. Once an agreement has been reached between the competent authorities, the taxpayer should decide within a reasonable period of time whether to accept that agreement.] Also, a view that competent authorities might reasonably take is that where the taxpayer's suit is ongoing as to the particular issue upon which mutual agreement is sought by that same taxpayer, discussions of any depth at the competent authority level should await a court decision. If the taxpayer's request for a mutual agreement procedure applied to different tax years than the court action, but to essentially the same factual and legal issues, so that the court outcome would in practice be

⁴⁹As noted in paragraph 45, however, in most countries, a mutual agreement cannot be finalized before the taxpayer has given agreement and renounced domestic legal remedies. If the taxpayer chooses to wait until the domestic legal proceedings have been concluded, the risk exists that a court decision will prevent a competent authority from implementing the proposed agreement and the taxpayer cannot be guaranteed that the proposed agreement will still be available at the conclusion of the legal proceedings [this footnote is not part of the quoted OECD paragraph].

expected to affect the treatment of the taxpayer in years not specifically the subject of litigation, the position might be the same, in practice, as for the cases just mentioned. In either case, awaiting a court decision or otherwise holding a mutual agreement procedure in abeyance whilst formalised domestic recourse proceedings are underway will not infringe upon, or cause time to expire from, the [three year period referred to in paragraph 5 of alternative B of the Article]. Of course, if competent authorities consider, in either case, that the matter might be resolved notwithstanding the domestic law proceedings (because, for example, the competent authority where the court action is taken will not be bound or constrained by the court decision) then the mutual agreement procedure may proceed as normal.

43. The situation is also different if there is a suit ongoing on an issue, but the suit has been taken by another taxpayer than the one who is seeking to initiate the mutual agreement procedure. In principle, if the case of the taxpayer seeking the mutual agreement procedure supports action by one or both competent authorities to prevent taxation not in accordance with the Convention, that should not be unduly delayed pending a general clarification of the law at the instance of another taxpayer, although the taxpayer seeking mutual agreement might agree to this if the clarification is likely to favour that taxpayer's case. In other cases, delaying competent authority discussions as part of a mutual agreement procedure may be justified in all the circumstances, but the competent authorities should as far as possible seek to prevent disadvantage to the taxpayer seeking mutual agreement in such a case. This could be done, where domestic law allows, by deferring payment of the amount outstanding during the course of the delay, or at least during that part of the delay which is beyond the taxpayer's control.

44. Depending upon domestic procedures, the choice of redress is normally that of the taxpayer and in most cases it is the domestic recourse provisions such as appeals or court proceedings that are held in abeyance in favour of the less formal and bilateral nature of mutual agreement procedure.

45. As noted above, there may be a pending suit by the taxpayer on an issue, or else the taxpayer may have preserved the right to take such domestic law action, yet the competent authorities might still consider that an agreement can be reached. In such cases, it is, however, necessary to take into account the concern of a particular competent authority to avoid any divergences or contradictions between the decision of the court and the mutual agreement that is being sought,

with the difficulties or risks of abuse that these could entail. In short, therefore, the implementation of such a mutual agreement should normally be made subject:

- to the acceptance of such mutual agreement by the taxpayer, and
- to the taxpayer's withdrawal of the suit at law concerning those points settled in the mutual agreement.

46. Some States take the view that a mutual agreement procedure may not be initiated by a taxpayer unless and until payment of all or a specified portion of the tax amount in dispute has been made. They consider that the requirement for payment of outstanding taxes, subject to repayment in whole or in part depending on the outcome of the procedure, is an essentially procedural matter not governed by Article 25, and is therefore consistent with it. A contrary view, held by many States, is that Article 25 indicates all that a taxpayer must do before the procedure is initiated, and that it imposes no such requirement. Those States find support for their view in the fact that the procedure may be implemented even before the taxpayer has been charged to tax or notified of a liability (as noted at paragraph 14 above) and in the acceptance that there is clearly no such requirement for a procedure initiated by a competent authority under paragraph 3.

47. Article 25 gives no absolutely clear answer as to whether a taxpayer initiated mutual agreement procedure may be denied on the basis that there has not been the necessary payment of all or part of the tax in dispute. However, whatever view is taken on this point, in the implementation of the Article it should be recognised that the mutual agreement procedure supports the substantive provisions of the Convention and that the text of Article 25 should therefore be understood in its context and in the light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance. States therefore should as far as possible take into account the cash flow and possible double taxation issues in requiring advance payment of an amount that the taxpayer contends was at least in part levied contrary to the terms of the relevant Convention. As a minimum, payment of outstanding tax should not be a requirement to initiate the mutual agreement procedure if it is not a requirement before initiating domestic law review. It also appears, as a minimum, that if the mutual agreement procedure is initiated prior to the taxpayer's being charged to tax (such as by an assessment), a payment should only be required once that charge to tax has occurred.

48. There are several reasons why suspension of the collection of tax pending resolution of a mutual agreement procedure can be a desirable policy, although many States may require legislative changes for the purpose of its implementation. Any requirement to pay a tax assessment specifically as a condition of obtaining access to the mutual agreement procedure in order to get relief from that very tax would generally be inconsistent with the policy of making the mutual agreement procedure broadly available to resolve such disputes. Even if a mutual agreement procedure ultimately eliminates any double taxation or other taxation not in accordance with the Convention, the requirement to pay tax prior to the conclusion of the mutual agreement procedure may permanently cost the taxpayer the time value of the money represented by the amount inappropriately imposed for the period prior to the mutual agreement procedure resolution, at least in the fairly common case where the respective interest policies of the relevant Contracting States do not fully compensate the taxpayer for that cost. Thus, this means that in such cases the mutual agreement procedure would not achieve the goal of fully eliminating, as an economic matter, the burden of the double taxation or other taxation not in accordance with the Convention. Moreover, even if that economic burden is ultimately removed, a requirement on the taxpayer to pay taxes on the same income to two Contracting States can impose cash flow burdens that are inconsistent with the Convention's goals of eliminating barriers to cross border trade and investment. Finally, another unfortunate complication may be delays in the resolution of cases if a country is less willing to enter into good faith mutual agreement procedure discussions when a probable result could be the refunding of taxes already collected. Where States take the view that payment of outstanding tax is a precondition to the taxpayer initiated mutual agreement procedure, this should be notified to the treaty partner during negotiations on the terms of a Convention. Where both States party to a Convention take this view, there is a common understanding, but also the particular risk of the taxpayer's being required to pay an amount twice. Where domestic law allows it, one possibility which States might consider to deal with this would be for the higher of the two amounts to be held in trust, escrow or similar, pending the outcome of the mutual agreement procedure. Alternatively, a bank guarantee provided by the taxpayer's bank could be sufficient to meet the requirements of the competent authorities. As another approach, one State or the other (decided by time of assessment, for example, or by residence State status under the treaty) could agree to seek a payment of no more than the difference between the amount paid to

the other State, and that which it claims, if any. Which of these possibilities is open will ultimately depend on the domestic law (including administrative requirements) of a particular State, but they are the sorts of options that should as far as possible be considered in seeking to have the mutual agreement procedure operate as effectively as possible. Where States require some payment of outstanding tax as a precondition to the taxpayer initiated mutual agreement procedure, or to the active consideration of an issue within that procedure, they should have a system in place for refunding an amount of interest on any underlying amount to be returned to the taxpayer as the result of a mutual agreement reached by the competent authorities. Any such interest payment should sufficiently reflect the value of the underlying amount and the period of time during which that amount has been unavailable to the taxpayer.

49. States take differing views as to whether administrative interest and penalty charges are treated as taxes covered by Article 2 of the Convention. Some States treat them as taking the character of the underlying amount in dispute, but other States do not. It follows that there will be different views as to whether such interest and penalties are subject to a taxpayer initiated mutual agreement procedure. Where they are covered by the Convention as taxes to which it applies, the object of the Convention in avoiding double taxation, and the requirement for States to implement conventions in good faith, suggest that as far as possible interest and penalty payments should not be imposed in a way that effectively discourages taxpayers from initiating a mutual agreement procedure, because of the cost and the cash flow impact that this would involve. Even when administrative interest and penalties are not regarded as taxes covered by the Convention under Article 2, they should not be applied in a way that severely discourages or nullifies taxpayer reliance upon the benefits of the Convention, including the right to initiate the mutual agreement procedure as provided by Article 25. For example, a State's requirements as to payment of outstanding penalties and interest should not be more onerous to taxpayers in the context of the mutual agreement procedure than they would be in the context of taxpayer initiated domestic law review.

Paragraph 3 of Article 25 (alternatives A and B)

10. This paragraph reproduces Article 25, paragraph 3, of the OECD Model Convention. The Committee considers that the following part of the OECD Commentary is therefore applicable to this paragraph:

50. The first sentence of this paragraph invites and authorises the competent authorities to resolve, if possible, difficulties of interpretation or application by means of mutual agreement. These are essentially difficulties of a general nature which concern, or which may concern, a category of taxpayers, even if they have arisen in connection with an individual case normally coming under the procedure defined in paragraphs 1 and 2.

51. This provision makes it possible to resolve difficulties arising from the application of the Convention. Such difficulties are not only those of a practical nature, which might arise in connection with the setting up and operation of procedures for the relief from tax deducted from dividends, interest and royalties in the Contracting State in which they arise, but also those which could impair or impede the normal operation of the clauses of the Convention as they were conceived by the negotiators, the solution of which does not depend on a prior agreement as to the interpretation of the Convention.

52. Under this provision the competent authorities can, in particular:

- where a term has been incompletely or ambiguously defined in the Convention, complete or clarify its definition in order to obviate any difficulty;
- where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, settle any difficulties that may emerge from the new system of taxation arising out of such changes;
- determine whether, and if so under what conditions, interest may be treated as dividends under thin capitalisation rules in the country of the borrower and give rise to relief for double taxation in the country of residence of the lender in the same way as for dividends (for example relief under a parent/subsidiary regime when provision for such relief is made in the relevant bilateral convention).

53. Paragraph 3 confers on the “competent authorities of the Contracting States”, *i.e.* generally the Ministers of Finance or their authorised representatives normally responsible for the administration of the Convention, authority to resolve by mutual agreement any difficulties arising as to the interpretation of the Convention. However, it is important not to lose sight of the fact that, depending on the domestic law of Contracting States, other authorities (Ministry of Foreign Affairs, courts) have the right to interpret international

treaties and agreements as well as the “competent authority” designated in the Convention, and that this is sometimes the exclusive right of such other authorities.

54. Mutual agreements resolving general difficulties of interpretation or application are binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.

55. The second sentence of paragraph 3 enables the competent authorities to deal also with such cases of double taxation as do not come within the scope of the provisions of the Convention. Of special interest in this connection is the case of a resident of a third State having permanent establishments in both Contracting States. It is not merely desirable, but in most cases also will particularly reflect the role of Article 25 and the mutual agreement procedure in providing that the competent authorities may consult together as a way of ensuring the Convention as a whole operates effectively, that the mutual agreement procedure should result in the effective elimination of the double taxation which can occur in such a situation. The opportunity for such matters to be dealt with under the mutual agreement procedure becomes increasingly important as Contracting States seek more coherent frameworks for issues of profit allocation involving branches, and this is an issue that could usefully be discussed at the time of negotiating conventions or protocols to them. There will be Contracting States whose domestic law prevents the Convention from being complemented on points which are not explicitly or at least implicitly dealt with in the Convention, however, and in these situations the Convention could be complemented by a protocol dealing with this issue. In most cases, however, the terms of the Convention itself, as interpreted in accordance with accepted tax treaty interpretation principles, will sufficiently support issues involving two branches of a third state entity being subject to the paragraph 3 procedures.

Paragraph 4 of Article 25 (alternatives A and B)

11. This paragraph consists of two sentences, the first of which reproduces the first sentence of Article 25, paragraph 4, of the OECD Model Convention, while the second sentence is not contained in that Model. In the first sentence, the words “including through a joint commission consisting of themselves or their representatives” were inserted in 1999 between the words “with each other directly” and “. . . for the purpose of reaching”, so as to bring the provision on a par with that of the corresponding provision

in the OECD Model Convention. The second sentence allows the competent authorities to develop bilateral procedures for the implementation of the mutual agreement procedure. Section C below discusses various procedural aspects of the mutual agreement procedure and includes suggestions concerning procedures that could be adopted by the competent authorities. These suggestions are not exhaustive and should be adapted or supplemented based on the experience and circumstances of each country. The Committee considers that the following part of the OECD Commentary is applicable to the first sentence of this paragraph:

56. This paragraph determines how the competent authorities may consult together for the resolution by mutual agreement, either of an individual case coming under the procedure defined in paragraphs 1 and 2 or of general problems relating in particular to the interpretation or application of the Convention, and which are referred to in paragraph 3.

57. It provides first that the competent authorities may communicate with each other directly. It would therefore not be necessary to go through diplomatic channels.

58. The competent authorities may communicate with each other by letter, facsimile transmission, telephone, direct meetings, or any other convenient means. They may, if they wish, formally establish a joint commission for this purpose.

59. As to this joint commission, paragraph 4 leaves it to the competent authorities of the Contracting States to determine the number of members and the rules of procedure of this body.

60. However, whilst the Contracting States may avoid any formalism in this field, it is nevertheless their duty to give taxpayers whose cases are brought before the joint commission under paragraph 2 certain essential guarantees, namely:

- the right to make representations in writing or orally, either in person or through a representative;
- the right to be assisted by counsel.

61. However, disclosure to the taxpayer or his representatives of the papers in the case does not seem to be warranted, in view of the special nature of the procedure.

62. Without infringing upon the freedom of choice enjoyed in principle by the competent authorities in designating their representatives on the joint commission, it would be desirable for them to agree to entrust the chairmanship of each Delegation—which might include one or more representatives of the service responsible for the procedure—to

a high official or judge chosen primarily on account of his special experience; it is reasonable to believe, in fact, that the participation of such persons would be likely to facilitate reaching an agreement.

Paragraph 5 of Article 25 (alternative B)

12. Paragraph 5, which is only found in alternative B of the Article, provides for mandatory arbitration under which the competent authorities are obliged to submit unresolved issues to arbitration if one of them so requests after they were unable to resolve these issues within a given period of time.

13. This paragraph reproduces paragraph 5 of Article 25 of the OECD Model Convention with four differences. First, the paragraph provides that arbitration may be initiated if the competent authorities are unable to reach an agreement on a case within three years from the presentation of that case rather than within two years as provided in the OECD Model Convention. Second, while the OECD Model Convention provides that arbitration must be requested by the person who initiated the case, paragraph 5 of alternative B provides that arbitration must be requested by the competent authority of one of the Contracting States (this means that a case shall not be submitted to arbitration if the competent authorities of both Contracting States consider that such a case is not suitable for arbitration and neither of them make a request). Third, paragraph 5 of alternative B, unlike the corresponding provision of the OECD Model Convention, allows the competent authorities to depart from the arbitration decision if they agree on a different solution within six months after the decision has been communicated to them. Finally, the footnote that is found in the OECD Model Convention, according to which the inclusion of the provision may not be appropriate in certain circumstances, has been omitted as alternative A already deals with such situations.

14. For different reasons, some States consider that it is not appropriate to commit themselves to proceed to arbitration whenever the competent authority of the other Contracting State so requests. Those States may, however, wish to include in their treaties a voluntary arbitration provision under which both competent authorities must agree, on a case by case basis, to submit a case to arbitration before an arbitration procedure will begin. An example of such an additional paragraph could read:

If the competent authorities are unable to resolve by mutual agreement a case pursuant to paragraph 2, the case, may, if both competent authorities and the person who has presented the case pursuant to

paragraph 2 agree, be submitted for arbitration, provided any person directly affected by the case agrees in writing to be bound by the decision of the arbitration board. If the competent authorities are unable to resolve by mutual agreement a difficulty or a doubt pursuant to paragraph 3, the difficulty or doubt may also, if both competent authorities agree, be submitted for arbitration. The decision of the arbitration board in a particular case shall be binding on the Contracting States with respect to that case. Where a general difficulty of interpretation or application is submitted to arbitration, the decision of the arbitration board shall be binding on the Contracting States as long as the competent authorities do not agree to modify or rescind the decision. The competent authorities shall by mutual agreement settle the procedures for such an arbitration board.

15. Voluntary arbitration allows greater control over the types of issues that will proceed to arbitration. In certain circumstances, a competent authority may consider it inappropriate to compromise its position with respect to a specific issue and thus inappropriate for that issue to be submitted to arbitration. Under voluntary arbitration countries preserve great flexibility as to the issues that will be subjected to arbitration and may restrict the potential number of cases that could proceed to arbitration and reduce the potential costs of arbitration.

16. Under voluntary arbitration, however, where the competent authority of one State refuses to depart from its own interpretations of the treaty with respect to specific issues, that competent authority may also refuse to submit those issues to arbitration, with the result that mutual agreement procedure cases involving those issues may remain unresolved. The arbitration of issues on which the competent authorities disagree is essential to ensure that treaty disputes are effectively resolved in a consistent manner in both States. In this respect, arbitration that may be requested by either competent authority gives more certainty that unresolved issues will effectively be submitted for arbitration than voluntary arbitration which needs the agreement of both competent authorities.

17. Some States that decide to include alternative B in their bilateral treaties may prefer to amend paragraph 5 so that unresolved issues shall be submitted to arbitration at the request of the person who has presented the case pursuant to paragraph 1. In order to do so, those States may replace the terms “any unresolved issues arising from the case shall be submitted to arbitration if either competent authority so requests. The person who has presented the case shall be notified of the request” by the terms “any unresolved issues arising from the case shall be submitted to arbitration if the person so requests”.

18. The Committee considers that the following part of the Commentary on paragraph 5 of Article 25 of the OECD Model Convention, together with the Annex, are applicable to paragraph 5 of alternative B (the additional comments that appear in square brackets, which are not part of the Commentary on the OECD Model, have been inserted in order to reflect the differences described in paragraph 13 above):

63. This paragraph provides that, in the cases where the competent authorities are unable to reach an agreement under paragraph 2 within [three] years, the unresolved issues will, at the request of [one of the competent authorities], be solved through an arbitration process. This process is not dependent on a prior authorization by [both] competent authorities: once the requisite procedural requirements have been met, the unresolved issues that prevent the conclusion of a mutual agreement must be submitted to arbitration. [A taxpayer may always ask a competent authority to submit the unresolved issues in a case to arbitration. However, the competent authority has no obligation to do so. It has the discretionary power to request arbitration or not in each specific case.]

64. The arbitration process provided for by the paragraph is not an alternative or additional recourse: where the competent authorities have reached an agreement that does not leave any unresolved issues as regards the application of the Convention, there are no unresolved issues that can be brought to arbitration even if the person who made the mutual agreement request does not consider that the agreement reached by the competent authorities provides a correct solution to the case. The paragraph is, therefore, an extension of the mutual agreement procedure that serves to enhance the effectiveness of that procedure by ensuring that where the competent authorities cannot reach an agreement on one or more issues that prevent the resolution of a case, a resolution of the case will still be possible by submitting those issues to arbitration. Thus, under the paragraph, the resolution of the case continues to be reached through the mutual agreement procedure, whilst the resolution of a particular issue which is preventing agreement in the case is handled through an arbitration process. This distinguishes the process established in paragraph 5 from other forms of commercial or government-private party arbitration where the jurisdiction of the arbitral panel extends to resolving the whole case.

65. It is recognised, however, that in some States, national law, policy or administrative considerations may not allow or justify the type of arbitration process provided for in the paragraph.

For example, there may be constitutional barriers preventing arbitrators from deciding tax issues. In addition, some countries may only be in a position to include this paragraph in treaties with particular States. For these reasons, the paragraph should only be included in the Convention where each State concludes that the process is capable of effective implementation.

66. In addition, some States may wish to include paragraph 5 but limit its application to a more restricted range of cases. For example, access to arbitration could be restricted to cases involving issues which are primarily factual in nature. It could also be possible to provide that arbitration would always be available for issues arising in certain classes of cases, for example, highly factual cases such as those related to transfer pricing or the question of the existence of a permanent establishment, whilst extending arbitration to other issues on a case-by-case basis.

67. States which are members of the European Union must co-ordinate the scope of paragraph 5 with their obligations under the European Arbitration Convention.

68. [Paragraph 5 allows the] arbitration of unresolved issues in all cases dealt with under the mutual agreement procedure that have been presented under paragraph 1 on the basis that the actions of one or both of the Contracting States have resulted for a person in taxation not in accordance with the provisions of this Convention. Where the mutual agreement procedure is not available, for example because of the existence of serious violations involving significant penalties (see paragraph 26), it is clear that paragraph 5 is not applicable.

69. Where two Contracting States that have not included the paragraph in their Convention wish to implement an arbitration process for general application or to deal with a specific case, it is still possible for them to do so by mutual agreement. In that case, the competent authorities can conclude a mutual agreement along the lines of the sample wording presented in the annex, to which they would add the following first paragraph:

1. Where,
 - a) under paragraph 1 of Article 25 of the Convention, a person has presented a case to the competent authority of a Contracting State on the basis that the actions of one or both of the Contracting States have resulted for that person in taxation not in accordance with the provisions of this Convention, and

- b) the competent authorities are unable to reach an agreement to resolve that case pursuant to paragraph 2 of the Article within [three] years from the presentation of the case to the competent authority of the other Contracting State,

any unresolved issues arising from the case shall be submitted to arbitration in accordance with the following paragraphs if [either competent authority so requests. The person who has presented the case shall be notified of the request]. These unresolved issues shall not, however, be submitted to arbitration if a decision on these issues has already been rendered by a court or administrative tribunal of either State. Unless [both competent authorities agree on a different solution within six months after the decision has been communicated to them or unless] a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, the competent authorities hereby agree to consider themselves bound by the arbitration decision and to resolve the case pursuant to paragraph 2 of Article 25 on the basis of that decision.

This agreement would go on to address the various structural and procedural issues discussed in the annex. Whilst the competent authorities would thus be bound by such process, such agreement would be given as part of the mutual agreement procedure and would therefore only be effective as long as the competent authorities continue to agree to follow that process to solve cases that they have been unable to resolve through the traditional mutual agreement procedure.

70. Paragraph 5 provides that [either competent authority] may request that any unresolved issues arising from [a] case be submitted to arbitration [and in that case, that the person who has presented the case to the competent authority of a Contracting State pursuant to paragraph 1 shall be notified of that request. The obligation to notify the person who has presented the case is, however, not a condition for initiating arbitration and the failure to notify such person does not suspend the arbitration process.]. This request may be made at any time after a period of [three] years that begins when the case is presented to the competent authority of the other Contracting State. Recourse to arbitration is therefore not automatic; the [competent authorities] may prefer to wait beyond the end of the [three] year period (for example, to allow [themselves] more time to resolve the case under paragraph 2) or simply not to pursue the case. States are free to provide that, in certain circumstances, a longer period of time will be required before the request can be made.

71. Under paragraph 2 of Article 25, the competent authorities must endeavour to resolve a case presented under paragraph 1 with a view to the avoidance of taxation not in accordance with the Convention. For the purposes of paragraph 5, a case should therefore not be considered to have been resolved as long as there is at least one issue on which the competent authorities disagree and which, according to one of the competent authorities, indicates that there has been taxation not in accordance with the Convention. One of the competent authorities could not, therefore, unilaterally decide that such a case is closed and that [the other competent authority] cannot request the arbitration of unresolved issues; similarly, the two competent authorities could not consider that the case has been resolved [...] if there are still unresolved issues that prevent them from agreeing that there has not been taxation not in accordance with the Convention. Where, however, the two competent authorities agree that taxation by both States has been in accordance with the Convention, there are no unresolved issues and the case may be considered to have been resolved, even in the case where there might be double taxation that is not addressed by the provisions of the Convention.

72. The arbitration process is only available in cases where the person considers that taxation not in accordance with the provisions of the Convention has actually resulted from the actions of one or both of the Contracting States; it is not available, however, in cases where it is argued that such taxation will eventually result from such actions even if the latter cases may be presented to the competent authorities under paragraph 1 of the Article [...]. For that purpose, taxation should be considered to have resulted from the actions of one or both of the Contracting States as soon as, for example, tax has been paid, assessed or otherwise determined or even in cases where the taxpayer is officially notified by the tax authorities that they intend to tax him on a certain element of income.

73. As drafted, paragraph 5 only provides for arbitration of unresolved issues arising from a request made under paragraph 1 of the Article. States wishing to extend the scope of the paragraph to also cover mutual agreement cases arising under paragraph 3 of the Article are free to do so. In some cases, a mutual agreement case may arise from other specific treaty provisions, such as subparagraph 2 *d*) of Article 4. Under that subparagraph, the competent authorities are, in certain cases, required to settle by mutual agreement the question of the status of an individual who is a resident of both Contracting States. As indicated in paragraph 20 of the Commentary on Article 4, such cases

must be resolved according to the procedure established in Article 25. If the competent authorities fail to reach an agreement on such a case and this results in taxation not in accordance with the Convention (according to which the individual should be a resident of only one State for purposes of the Convention), the taxpayer's case comes under paragraph 1 of Article 25 and, therefore, paragraph 5 is applicable.

74. In some States, it may be possible for the competent authorities to deviate from a court decision on a particular issue arising from the case presented to the competent authorities. Those States should therefore be able to omit the second sentence of the paragraph.

75. The presentation of the case to the competent authority of the other State, which is the beginning of the [three] year period referred to in the paragraph, may be made by the person who presented the case to the competent authority of the first State under paragraph 1 of Article 25 (*e.g.* by presenting the case to the competent authority of the other State at the same time or at a later time) or by the competent authority of the first State, who would contact the competent authority of the other State pursuant to paragraph 2 if it is not itself able to arrive at a satisfactory solution of the case. For the purpose of determining the start of the [three] year period, a case will only be considered to have been presented to the competent authority of the other State if sufficient information has been presented to that competent authority to allow it to decide whether the objection underlying the case appears to be justified. The mutual agreement providing for the mode of application of paragraph 5 (see the annex) should specify which type of information will normally be sufficient for that purpose.

76. The paragraph also deals with the relationship between the arbitration process and rights to domestic remedies. For the arbitration process to be effective and to avoid the risk of conflicting decisions, [...] the arbitration process [should not be available] if the [relevant] issues [...] have already been resolved through the domestic litigation process of either State (which means that any court or administrative tribunal of one of the Contracting States has already rendered a decision that deals with these issues and that applies to that person). This is consistent with the approach adopted by most countries as regards the mutual agreement procedure and according to which:

- a) A person cannot pursue simultaneously the mutual agreement procedure and domestic legal remedies. Where domestic legal remedies are still available, the competent authorities will generally either require that the taxpayer agree to the

suspension of these remedies or, if the taxpayer does not agree, will delay the mutual agreement procedure until these remedies are exhausted.

- b) Where the mutual agreement procedure is first pursued and a mutual agreement has been reached, the taxpayer and other persons directly affected by the case are offered the possibility to reject the agreement and pursue the domestic remedies that had been suspended; conversely, if these persons prefer to have the agreement apply, they will have to renounce the exercise of domestic legal remedies as regards the issues covered by the agreement.
- c) Where the domestic legal remedies are first pursued and are exhausted in a State, a person may only pursue the mutual agreement procedure in order to obtain relief of double taxation in the other State. Indeed, once a legal decision has been rendered in a particular case, most countries consider that it is impossible to override that decision through the mutual agreement procedure and would therefore restrict the subsequent application of the mutual agreement procedure to trying to obtain relief in the other State.

The same general principles should be applicable in the case of a mutual agreement procedure that would involve one or more issues submitted to arbitration. It would not be helpful to submit an issue to arbitration if it is known in advance that one of the countries is limited in the response that it could make to the arbitral decision. This, however, would not be the case if the country could, in a mutual agreement procedure, deviate from a court decision (see paragraph 74) and in that case paragraph 5 could be adjusted accordingly.

77. A second issue involves the relationship between existing domestic legal remedies and arbitration where the taxpayer has not undertaken (or has not exhausted) these legal remedies. In that case, the approach that would be the most consistent with the basic structure of the mutual agreement procedure would be to apply the same general principles when arbitration is involved. Thus, the legal remedies would be suspended pending the outcome of the mutual agreement procedure involving the arbitration of the issues that the competent authorities are unable to resolve and a tentative mutual agreement would be reached on the basis of that decision. As in other mutual agreement procedure cases, that agreement would then be presented to the taxpayer who would have to choose to accept the

agreement, which would require abandoning any remaining domestic legal remedies, or reject the agreement to pursue these remedies.

78. This approach is in line with the nature of the arbitration process set out in paragraph 5. The purpose of that process is to allow the competent authorities to reach a conclusion on the unresolved issues that prevent an agreement from being reached. When that agreement is achieved though the aid of arbitration, the essential character of the mutual agreement remains the same.

79. In some cases, this approach will mean that the parties will have to expend time and resources in an arbitration process that will lead to a mutual agreement that will not be accepted by the taxpayer. As a practical matter, however, experience shows that there are very few cases where the taxpayer rejects a mutual agreement to resort to domestic legal remedies. Also, in these rare cases, one would expect the domestic courts or administrative tribunals to take note of the fact that the taxpayer had been offered an administrative solution to his case that would have bound both States.

80. In some States, unresolved issues between competent authorities may only be submitted to arbitration if domestic legal remedies are no longer available. In order to implement an arbitration approach, these States could consider the alternative approach of requiring a person to waive the right to pursue domestic legal remedies before arbitration can take place. This could be done by replacing the second sentence of the paragraph by “these unresolved issues shall not, however, be submitted to arbitration if any person directly affected by the case is still entitled, under the domestic law of either State, to have courts or administrative tribunals of that State decide these issues or if a decision on these issues has already been rendered by such a court or administrative tribunal.” To avoid a situation where a taxpayer would be required to waive domestic legal remedies without any assurance as to the outcome of the case, it would then be important to also modify the paragraph to include a mechanism that would guarantee, for example, that double taxation would in fact be relieved. Also, since the taxpayer would then renounce the right to be heard by domestic courts, the paragraph should also be modified to ensure that sufficient legal safeguards are granted to the taxpayer as regards his participation in the arbitration process to meet the requirements that may exist under domestic law for such a renunciation to be acceptable under the applicable legal system (*e.g.* in some countries, such renunciation might not be effective if the person were not guaranteed the right to be heard orally during the arbitration).

81. Paragraph 5 provides that, [unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or] unless a person directly affected by the case does not accept the mutual agreement that implements the arbitration decision, that decision shall be binding on both States. Thus, the taxation of any person directly affected by the case will have to conform with the decision reached on the issues submitted to arbitration and the decisions reached in the arbitral process will be reflected in the mutual agreement that will be presented to these persons.

82. As noted in subparagraph 76 *b*) above, where a mutual agreement is reached before domestic legal remedies have been exhausted, it is normal for the competent authorities to require, as a condition for the application of the agreement, that the persons affected renounce the exercise of domestic legal remedies that may still exist as regards the issues covered by the agreement. Without such renunciation, a subsequent court decision could indeed prevent the competent authorities from applying the agreement. Thus, for the purpose of paragraph 5, if a person to whom the mutual agreement that implements the arbitration decision has been presented does not agree to renounce the exercise of domestic legal remedies, that person must be considered not to have accepted that agreement.

83. The arbitration decision is only binding with respect to the specific issues submitted to arbitration. Whilst nothing would prevent the competent authorities from solving other similar cases (including cases involving the same persons but different taxable periods) on the basis of the decision, there is no obligation to do so and each State therefore has the right to adopt a different approach to deal with these other cases.

Paragraph 5 allows the competent authorities to agree on a solution that is different from the solution adopted in the arbitration decision provided they do so within six months after the arbitration decision has been communicated to them. The arbitration decision is consequently not binding if both competent authorities consider that the decision is not appropriate and are able to agree on a different solution within the stated period. A subsequent mutual agreement differing from the arbitration decision is not allowed under paragraph 5 of Article 25 of the OECD Model but is allowed under Article 12 of the EU Arbitration Convention.

85. The last sentence of the paragraph leaves the mode of application of the arbitration process to be settled by mutual agreement. Some aspects could also be covered in the Article itself, a protocol or

through an exchange of diplomatic notes. Whatever form the agreement takes, it should set out the structural and procedural rules to be followed in applying the paragraph, taking into account the paragraph's requirement that the arbitration decision be binding on both States. Ideally, that agreement should be drafted at the same time as the Convention so as to be signed, and to apply, immediately after the paragraph becomes effective. Also, since the agreement will provide the details of the process to be followed to bring unresolved issues to arbitration, it would be important that this agreement be made public. A sample form of such agreement is provided in the annex together with comments on the procedural rules that it puts forward.

19. At any time after arbitration has been requested pursuant to paragraph 5 and before the arbitrators have communicated a decision to the competent authorities, the competent authorities may agree on a resolution of the unresolved issues that led to arbitration. If so, the case shall be considered as resolved under the mutual agreement procedure and no arbitration decision shall be provided. The competent authorities are however not allowed to put an end to the arbitration process without having resolved the case. Otherwise, the certainty attached to the arbitration process would be undermined (e.g. the person who has presented the case pursuant to paragraph 1 could have renounced to judicial recourses because the case has been submitted to arbitration).

C. ADDITIONAL PROCEDURAL ISSUES RELATED TO THE MUTUAL AGREEMENT PROCEDURE

20. The last sentence of paragraph 4 of Article 25 (alternatives A and B) allows the competent authorities to develop bilateral procedures for the implementation of the mutual agreement procedure. The following paragraphs discuss various procedural aspects of the mutual agreement procedure and include suggestions concerning procedures that could be adopted by the competent authorities. These suggestions are not exhaustive and should be adapted or supplemented based on the experience and circumstances of each country.

(a) Aspects of the mutual agreement procedure that should be dealt with

21. The procedural arrangements for mutual agreements in general should be suitable to the number and types of issues expected to be dealt with by the competent authorities and to the administrative capability and resources of those authorities. The arrangements should not be rigidly structured but instead should embody the degree of flexibility required to facili-

tate consultation and agreement rather than hinder them by elaborate procedural requirements and mechanisms. But even relatively simple procedural arrangements must incorporate certain minimum rules that inform taxpayers of their essential rights and obligations under the mutual agreement procedure. Such minimum rules would appear to involve such questions as:

- At what stage in a tax matter a taxpayer can invoke action by the competent authority under the mutual agreement procedure;
- Whether any particular form must be followed by a taxpayer in invoking action by the competent authority;
- Whether any time limits are applicable to a taxpayer's invocation of action by the competent authority;
- If a taxpayer invokes action by the competent authority, whether the taxpayer is bound by the decision of the competent authorities and whether the taxpayer must waive recourse to other administrative or judicial processes as a condition for the implementation of a proposed mutual agreement reached by the competent authorities;
- In what manner, if at all, a taxpayer can participate in the competent authority proceedings and what requirements regarding the furnishing of information by a taxpayer are involved.

(b) Necessary cooperation of the person who makes the request

22. The successful outcome of the mutual agreement procedure depends to a large extent on the full cooperation of the person who made the request. That person must, in particular, help the competent authorities to establish the facts on which the case is based. That requires the person to make a full and accurate disclosure of all relevant facts and supporting evidence known to that person. Where, in particular, transactions have been carried on in the other Contracting State, the person who made the request must provide the relevant documents establishing the conditions of these transactions and supply complete information on the facts and circumstances of these transactions.

23. The competent authority may, in particular, require that the person making the request provide the following as early as possible:

- a description of the general background for the case, which would include a description of the business activities of the relevant persons as well as a description of the contracts and arrangements that provide that general background, such as a shareholders' agreement, a partnership agreement, a licence agreement or a project agreement;

- the details of the situation that allegedly resulted or will result in taxation that is not in accordance with the provisions of the Convention, which could include, for example, the details of transactions or events (e.g. a payment or the delivery of a good or service) that were characterised in a certain way by the tax administration of the other Contracting State, supported by all the relevant documentation and, especially, the documents that have been presented to the tax administration of the other Contracting State;
- the amounts of income and tax involved (or an estimate thereof);
- the relevant financial statements of the person(s) involved in the transactions or activities at issue;
- a description of the relevant taxation years or periods affected by the case (in each State, where these are different);
- a description of the procedural status of the case in the other Contracting State, e.g. whether a tax audit report has been produced, a tax assessment received, an appeal filed or litigation undertaken; and
- a reference to the relevant provisions of the applicable tax treaty and the analysis supporting the claim that there is or will be taxation not in accordance with these provisions (when available, the legal analysis of the tax authorities of the other Contracting State should also be provided).

24. It may be more difficult to obtain some of the above information when the relevant transactions involve third parties which are not associated enterprises of the person making the request. In addition, certain information might not be available at the time the request is made. The information provided at the initial stage should, however, be sufficient to allow the competent authority to which the case is presented to determine whether the objection is justified. A competent authority would not in any case be able to initiate a mutual agreement procedure where the person making the request provides insufficient or inadequate information.

25. The mutual agreement procedure under paragraph 1 of Article 25 is only available in cases where a person considers that the actions of one or both States result or will result in taxation that is not in accordance with the provisions of the Convention. There may be cases where double taxation will arise because a taxpayer has failed to observe procedural rules (e.g. the expiry of time limits) without there being any taxation contrary to the provisions of the Convention; in those cases, that mutual agreement procedure will not be available.

(c) Information on adjustments

26. The competent authorities should decide on the extent of the information to be provided on adjustments involving income allocation and the time when it is to be given by one competent authority to the other. Thus, the information could cover adjustments proposed or finalized by the tax administration of one country, the related entities involved and the general nature of the adjustments.

27. Generally speaking, most competent authorities are likely to conclude that the automatic transmittal of such information is not needed or desirable. The competent authority of the country making an adjustment may find it difficult or time-consuming to gather the information and prepare it in a suitable form for transmission. In addition, the other competent authority may find it burdensome merely to process a volume of data routinely transmitted by the first competent authority. Moreover, a taxpaying corporation can usually be counted upon to inform its related entity in the other country of the proceedings and the latter is thus in a position to inform, in turn, its competent authority. For this reason, the functioning of a consultation system would be aided if a tax administration considering an adjustment possibly involving an international aspect were to give the taxpayer as much warning as possible.

28. Some competent authorities, while not wishing to be informed routinely of all adjustments in the other country, may desire to receive, either from their own taxpayers or from the other competent authority, “early warning” of serious cases or of the existence of a significant degree or pattern of activity respecting particular types of cases; similarly, they may want to transmit such information. In this event, a process should be worked out for obtaining the information. Some competent authorities may want to extend this early warning system to less serious cases, thus covering a larger number of cases.

(d) Initiation of competent authority consultation at the point of proposed or finalized adjustments

29. Paragraph 1 of the Article includes general rules concerning the presentation of a case by the taxpayer. The competent authority to which a case is validly presented must first examine whether it is itself able to arrive at a satisfactory solution. If it is unable to do so, it must determine at what stage it will consult the competent authority of the other State.

30. Many competent authorities, at least in the early stages of their experience, would prefer that the consultation process with the other State not be initiated at the point of a proposed adjustment and probably not even

at the point of a finalised adjustment. A proposed adjustment may never result in final action and even a finalized adjustment may or may not trigger a claim for a correlative adjustment; even if it does, the latter adjustment may occur without problems. As a consequence, many competent authorities may decide that the consultation process should not be initiated until the correlative adjustment (or other tax consequence in the second country) is involved at some point.

31. However, some competent authorities prefer that the bilateral process be initiated earlier, perhaps at the proposed adjustment stage. Such involvement may make the process of consultation easier, in that the first country will not have an initial fixed position. In such a case, the other competent authority should be prepared to discuss the case at this early stage with the first competent authority. Other competent authorities may be willing to let the taxpayer decide, and thus stand ready to have the process invoked at any point starting with the proposed adjustment.

32. At a minimum, taxpayers must be informed when they can invoke the mutual agreement procedure and which competent authority is to be addressed. Taxpayers should also be informed in what form the request should be submitted, although it is likely that a simple form would normally be suitable.

(e) Correlative adjustments

(i) Governing rule

33. It is recognized that, to be effective, a treaty with a correlative adjustment provision based on paragraph 2 of Article 9 must also provide that any domestic law procedural or other barriers to the making of the correlative adjustment are to be disregarded. Thus, such provisions as statutes of limitations and finality of assessments would have to be overridden to permit the correlative adjustment to be made, as required by the last sentence of paragraph 2 of Article 25. If a particular country cannot, through the application of the treaty, override such aspects of its domestic law, this would have to be provided for in the treaty, although it would be hoped that domestic law could be amended to permit the treaty to operate so as to avoid the need for such an exceptional provision.

(ii) Competent authority procedure

34. Paragraph 2 of Article 9 does not prescribe the method of the correlative adjustment since this depends on the nature of the initial adjustment and its effect on the tax payable on the profits of the associated enterprise. The method of the correlative adjustment is thus an aspect of the substantive issue underlying the initial adjustment. Given the correlative adjustment

requirement imposed by Article 9, it is clear that the mutual agreement procedure must be available at this point. Thus, if the tax authorities of the Contracting State that is required to make such an adjustment do not themselves work out the correlative adjustment, the taxpayers should be entitled to invoke the mutual agreement procedure. When a taxpayer invokes the competent authority of a Contracting State, that competent authority may be in a position to dispose of the matter without having to consult the competent authority of the other Contracting State, as provided in the first part of paragraph 2 of Article 25. For example, that competent authority may be in a position to handle a matter having potential international consequences that arises from an adjustment proposed by a political subdivision of the State even if the competent authority represents the central government of that State. This is, of course, an aspect of domestic law as affected by the treaty.

35. As a minimum procedural aspect, the competent authorities should indicate the extent to which a taxpayer may be allowed to participate in the competent authority procedure and the manner of such participation. Some countries may wish to favour a reasonable degree of taxpayer participation. Some countries may wish to allow a taxpayer to present information and even to appear before them; others may restrict the taxpayer to the presentation of data. Presumably, the competent authorities would make it a condition that a taxpayer invoking the procedure be required to submit to them relevant information needed to decide the matter. In addition, some competent authorities may, where appropriate, require that data furnished by a taxpayer be prepared as far as possible in accordance with internationally accepted accounting standards so the data provided will have some uniformity and objectivity. It is to be noted that rapid progress is being made in developing international accounting standards and the work of competent authorities should be aided by this development. As a further aspect concerning the taxpayer's participation, there should be a requirement that the taxpayer who invokes the mutual agreement procedure should be informed of the response of the competent authority.

36. The competent authorities will have to decide how their consultation should proceed once that part of the procedure comes into operation. Presumably, the nature of the consultation will depend on the number and character of the cases involved. The competent authorities should keep the consultation procedure flexible and leave every method of communication open, so that the method appropriate to the matter at hand can be used.

37. Various alternatives are available, such as informal consultation by telecommunication or in person; meetings between technical personnel or auditors of each country, whose conclusions are to be accepted or ratified

by the competent authorities; appointment of a joint commission for a complicated case or a series of cases; formal meetings of the competent authorities in person etc. It does not seem desirable to place a time limit on when the competent authorities must conclude a matter, since the complexities of particular cases may differ. Nevertheless, competent authorities should develop working habits that are conducive to prompt disposition of cases and should endeavour not to allow undue delay.

38. As discussed in paragraphs 25 and 42 of the OECD Commentary quoted in paragraph 9 above an important minimum procedural aspect of the competent authority procedure is the effect of a taxpayer's invocation of that procedure. Must a taxpayer who invokes that process be bound by the decision of the competent authorities in the sense that the taxpayer must give up rights to alternative procedures, such as recourse to domestic administrative or judicial procedures? If the competent authorities want their procedure to be exclusive and binding, it would be necessary that the treaty provisions be so drawn as to permit this result. Presumably, this may be accomplished under the general delegation in Article 25, paragraph 4, by requiring the taxpayer to waive recourse to those alternative procedures. However, even with this paragraph, some countries may consider that their domestic law requires a more explicit statement to permit the competent authority procedure to be binding, especially in view of the present practice under treaties not to make the procedure a binding one. Some competent authorities may desire that their actions be binding, since they will not want to go through the effort of reaching agreements only to have the taxpayer reject the result on the basis that the taxpayer can do better in the courts or elsewhere. Other competent authorities may desire to follow the present practice and thus may not want to bind taxpayers or may not be in a position to do so under domestic law. This would appear to be a matter on which developing experience would be a useful guide.

39. A basic issue regarding the competent authority procedure is the extent to which the competent authorities should consider themselves under obligation to reach an agreement on a matter that comes before them. At a minimum, the treaty requires consultation and the obligation to endeavour to find a solution to economic double taxation. But must the consultation end in agreement? Presumably, disagreement would, in general, leave the related entities in a situation where double taxation may result contrary to the treaty, for example, when a country has opposed a correlative adjustment on the grounds that the initial adjustment was not in conformity with the arm's length standard. On the other hand, an agreement would mean a correlative adjustment made, or a change in the initial adjustment followed then by a correlative adjustment, or perhaps the withdrawal of the initial adjustment.

In essence, the general question is whether the competent authority consultation is to be governed by the requirement that there be an “agreement to agree”.

40. In practice, this question is not as serious as it may seem. The experience of most competent authorities is that in the end an agreement or solution is almost always reached. Of course, the solution may often be a compromise, but compromise is an essential aspect of the process of consultation and negotiation. Hence, in reality, it would not be much of a further step for competent authorities to decide that their procedure should be governed by the standard of “agreement to agree”. However, some countries would consider the formal adoption of such standard as a step possessing significant juridical consequences and hence would not be disposed to adopt such a requirement.

41. It is recognized that, for some countries, the process of agreement might well be facilitated if competent authorities, when faced with an extremely difficult case or an impasse, could call, either informally or formally, upon outside experts to give an advisory opinion or otherwise assist in the resolution of the matter. Such experts could be persons currently or previously associated with other tax administrations and possessing the requisite experience in this field. In essence, it would largely be the personal experience of these experts that would be significant. This resort to outside assistance could be useful even where the competent authorities are not operating under the standard of an “agreement to agree”, since the outside assistance, by providing a fresh point of view, may help to resolve an impasse.

(f) Publication of competent authority procedures and determinations

42. The competent authorities should make public the procedures they have adopted with regard to their consultation procedure. The description of the procedures should be as complete as is feasible and at the least should contain the minimum procedural aspects discussed above.

43. Where the consultation procedure has produced a substantive determination in an important area that can reasonably be viewed as providing a guide to the viewpoints of the competent authorities, the competent authorities should develop a procedure for publication in their countries of that determination or decision.

(g) Procedures to implement adjustments

44. The competent authorities should consider what procedures may be required to implement the various adjustments involved. For example:

- (i) The first country may consider deferring a tax payment under the adjustment or even waiving the payment if, for example,

payment or reimbursement of an expense charge by the associated enterprise is prohibited at the time because of currency or other restrictions imposed by the second country.

- (ii) The first country may consider steps to facilitate carrying out the adjustment and payment of a reallocated amount. Thus, if income is imputed and taxed to a parent corporation because of service to a related foreign subsidiary, the related subsidiary may be allowed, as far as the parent country is concerned, to establish on its books an account payable in favour of the parent, and the parent will not be subject to a second tax in its country on the establishment or payment of the amount receivable. Such payment should not be considered a dividend by the country of the subsidiary.
- (iii) The second country may consider steps to facilitate carrying out the adjustment and payment of a reallocated amount. This may, for example, involve recognition of the payment made as a deductible item, even though prior to the adjustment there was no legal obligation to pay such amount. This is really an aspect of the correlative adjustment.

(h) Unilateral procedures

45. The above discussion has related almost entirely to bilateral procedures to be agreed upon by the competent authorities to implement the mutual agreement procedure. In addition, a competent authority may consider it useful to develop certain unilateral rules or procedures involving its relationship to its own taxpayers, so that these relationships may be better understood. These unilateral rules can cover such matters as the form to be followed in bringing matters to the attention of the competent authority; the permission to taxpayers to bring matters to the competent authority at an early stage even where the bilateral procedure does not require consultation at that stage; the question whether the competent authority will raise new domestic issues (so-called affirmative issues) between the tax authorities and the taxpayer if the taxpayer goes to the competent authority; and requests for information that will assist the competent authority in handling cases.

46. Unilateral rules regarding the operation of a competent authority would not require agreement to them by the other competent authority, since the rules are limited to the domestic relationship with its own taxpayers. However, it would seem appropriate to communicate such unilateral rules to the other treaty competent authorities, and to avoid, wherever possible, material differences, if any, in such rules in relation to the various treaties.

D. INTERACTION BETWEEN THE MUTUAL AGREEMENT
PROCEDURE AND THE DISPUTE RESOLUTION MECHANISM
OF THE GATS

47. In some rare cases, a dispute between countries concerning the application of the national treatment rule of Article XVII of the General Agreement on Trade in Services (GATS) to taxes covered by a tax treaty could lead to both the mutual agreement procedure and the dispute resolution mechanism of the GATS being applicable to address the issue. This problem, the solution adopted in the GATS with respect to tax treaties that existed at the time that it entered in force and a possible solution with respect to subsequent tax treaties are discussed in the following parts of the Commentary on Article 25 of the OECD Model Convention, which countries may want to take into account when negotiating a tax treaty:

88. The application of the General Agreement on Trade in Services (GATS), which entered into force on 1 January 1995 and which all member countries have signed, raises particular concerns in relation to the mutual agreement procedure.

89. Paragraph 3 of Article XXII of the GATS provides that a dispute as to the application of Article XVII of the Agreement, a national treatment rule, may not be dealt with under the dispute resolution mechanisms provided by Articles XXII and XXIII of the Agreement if the disputed measure “falls within the scope of an international agreement between them relating to the avoidance of double taxation” (e.g. a tax convention). If there is disagreement over whether a measure “falls within the scope” of such an international agreement, paragraph 3 goes on to provide that either State involved in the dispute may bring the matter to the Council on Trade in Services, which shall refer the dispute for binding arbitration. A footnote to paragraph 3, however, contains the important exception that if the dispute relates to an international agreement “which exist[s] at the time of the entry into force” of the Agreement, the matter may not be brought to the Council on Trade in Services unless both States agree.

90. That paragraph raises two particular problems with respect to tax treaties.

91. First, the footnote thereto provides for the different treatment of tax conventions concluded before and after the entry into force of the GATS, something that may be considered inappropriate, in particular where a convention in existence at the time of the entry into force of the GATS is subsequently renegotiated or where a protocol is concluded after that time in relation to a convention existing at that time.

92. Second, the phrase “falls within the scope” is inherently ambiguous, as indicated by the inclusion in paragraph 3 of Article XXII of the GATS of both an arbitration procedure and a clause exempting pre-existing conventions from its application in order to deal with disagreements related to its meaning. Whilst it seems clear that a country could not argue in good faith⁵⁰ that a measure relating to a tax to which no provision of a tax convention applied fell within the scope of that convention, it is unclear whether the phrase covers all measures that relate to taxes that are covered by all or only some provisions of the tax convention.

93. Contracting States may wish to avoid these difficulties by extending bilaterally the application of the footnote to paragraph 3 of Article XXII of the GATS to conventions concluded after the entry into force of the GATS. Such a bilateral extension, which would supplement—but not violate in any way—the Contracting States’ obligations under the GATS, could be incorporated in the convention by the addition of the following provision:

For purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that, notwithstanding that paragraph, any dispute between them as to whether a measure falls within the scope of this Convention may be brought before the Council for Trade in Services, as provided by that paragraph, only with the consent of both Contracting States. Any doubt as to the interpretation of this paragraph shall be resolved under paragraph 3 of Article 25 or, failing agreement under that procedure, pursuant to any other procedure agreed to by both Contracting States.

94. Problems similar to those discussed above may arise in relation with other bilateral or multilateral agreements related to trade or investment. Contracting States are free, in the course of their bilateral negotiations, to amend the provision suggested above so as to ensure that issues relating to the taxes covered by their tax convention are dealt with through the mutual agreement procedure rather than through the dispute settlement mechanism of such agreements.

⁵⁰The obligation of applying and interpreting treaties in good faith is expressly recognised in Articles 26 and 31 of the *Vienna Convention on the Law of Treaties*; thus, the exception in paragraph 3 of Article XXII of the GATS applies only to good faith disputes.

ANNEX TO THE COMMENTARY ON PARAGRAPH 5
OF ARTICLE 25 (ALTERNATIVE B)

Sample Mutual Agreement on Arbitration

1. The Committee considers that the paragraphs of the Annex to the Commentary on paragraph 5 of Article 25 of the OECD Model Convention that are reproduced below are relevant for the application of paragraph 5 of alternative B of the Article. The additional comments that appear between square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the two versions of the paragraph as well as the differences introduced in the sample mutual agreement itself, which are primarily:

- The following sample mutual agreement provides that, unless the competent authorities agree in a particular case that the arbitration panel will issue an independent decision, the so-called “last best offer” or “final offer” approach (commonly referred to as “baseball arbitration”) will be followed. Such a simplified arbitration process is less costly. Choosing between the competent authorities’ positions on each of the questions to be resolved will be quicker than developing and issuing an independent opinion on each of these questions; in addition, such choice may require only one independent arbitrator even if the basic rule is to have three arbitrators.
- The sample mutual agreement provides also that a case shall not be submitted to arbitration if it involves less than a certain amount of taxes (to be specified by the competent authorities). Such cases shall only be submitted to arbitration if both competent authorities agree that it is appropriate to do so (e.g. in order to resolve a question of principle). Clearly, however, taxpayers expect competent authorities to directly resolve cases that involve small amounts of taxes and no questions of principle.
- In order to guarantee their neutrality, the sample agreement provides that the appointed arbitrators are asked to fill in a statement in which they declare that, as far as they know, there exist no circumstances that might give rise to justifiable doubts regarding their independence or impartiality and that they will disclose promptly in writing to both competent authorities any such circumstances arising during the course of the arbitration process.
- The sample mutual agreement contains some rules in order to determine the remuneration of the arbitrators.

2. The OECD paragraphs included in the Annex to the Commentary on Article 25, paragraph 5 read as follow:

1. The following is a sample form of agreement that the competent authorities may use as a basis for a mutual agreement to implement the arbitration process provided for in paragraph 5 of [alternative B of the Article]. Paragraphs 2 to 43 below discuss the various provisions of the agreement and, in some cases, put forward alternatives. Competent authorities are of course free to modify, add or delete any provisions of this sample agreement when concluding their bilateral agreement.

***Mutual agreement on the implementation of paragraph 5
of Article 25***

The competent authorities of [State A] and [State B] have entered into the following mutual agreement to establish the mode of application of the arbitration process provided for in paragraph 5 of Article 25 of the [title of the Convention], which entered into force on [date of entry into force]. The competent authorities may modify or supplement this agreement by an exchange of letters between them.

1. *Request for submission of case to arbitration*

A request that unresolved issues arising from a mutual agreement case be submitted to arbitration pursuant to paragraph 5 of Article 25 of the Convention (the “request for arbitration”) shall be made in writing and sent [by one competent authority to the other competent authority and to the person who has presented the case to the competent authority of a Contracting State pursuant to paragraph 1 of Article 25]. The request shall contain sufficient information to identify the case. The request shall also be accompanied by a written statement by each of the persons who either [has presented the case] or is directly affected by the case that no decision on the same issues has already been rendered by a court or administrative tribunal of the States [...].

[No request for arbitration shall be made by a competent authority where the amount of taxes involved in the relevant mutual agreement procedure case is less than [amount to be determined bilaterally], unless both competent authorities agree that it is appropriate to do so (e.g. in order to resolve a question of principle).]

2. *Time for submission of the case to arbitration*

A request for arbitration may only be made after [three] years from the date on which a case presented to the competent authority of one Contracting State under paragraph 1 of Article 25 has also been presented to the competent authority of the other State. For this purpose, a case shall be considered to have been presented to the competent authority of the other State only if the following information has been presented: [the necessary information and documents will be specified in the agreement].

3. *Terms of Reference*

Within three months after the request for arbitration has been received by [the other competent authority], the competent authorities shall agree on the questions to be resolved by the arbitration panel and communicate them in writing to the person who [has presented the case]. This will constitute the “Terms of Reference” for the case. Notwithstanding the following paragraphs of this agreement, the competent authorities may also, in the Terms of Reference, provide procedural rules that are additional to, or different from, those included in these paragraphs and deal with such other matters as are deemed appropriate.

4. *Failure to communicate the Terms of Reference*

If [,] within the period referred to in paragraph 3 above, [the Terms of Reference have not been agreed by the competent authorities and communicated to the person who has presented the case,] each competent authority may^a, within one month after the end of that period, communicate in writing to each other a list of issues to be resolved by the arbitration. All the lists so communicated during that period shall constitute the tentative Terms of Reference. Within one month after all the arbitrators have been appointed as provided in paragraph 5 below, the arbitrators shall communicate to the competent authorities and the person who [presented the case] a revised version of the tentative Terms

^aSome members of the United Nations Committee of Experts consider however that in such a situation the person who has presented the case should also be allowed to communicate its list of issues to be resolved by arbitration. Once arbitration has been requested that person is relying on arbitration and should have the right to make up for the failure of the competent authorities.

of Reference based on the lists so communicated. Within one month after the revised version has been received by both of them, the competent authorities will have the possibility to agree on different Terms of Reference and to communicate them in writing to the arbitrators and the person who [presented the case]. If they do so within that period, these different Terms of Reference shall constitute the Terms of Reference for the case. If no different Terms of Reference have been agreed to between the competent authorities and communicated in writing within that period, the revised version of the tentative Terms of Reference prepared by the arbitrators shall constitute the Terms of Reference for the case.

5. *Selection of arbitrators*

Within three months after the Terms of Reference have been received by the person who [presented the case] or, where paragraph 4 applies, within four months after the request for arbitration has been received by [the other] competent authority, the competent authorities shall each appoint one arbitrator. Within two months of the latter appointment, the arbitrators so appointed will appoint a third arbitrator who will function as Chair. If any appointment is not made within the required time period, the arbitrator(s) not yet appointed shall be appointed by the [Chair of the UN Committee of Experts on International Cooperation in Tax Matters, or if the Chair is a national or resident of one of the two States involved in the case, by the longest serving member of that Committee who is not a national or resident of these States. Such appointment shall be made] within [one month] of receiving a request to that effect [from either competent authority]^b. The same procedure shall apply with the necessary adaptations if for any reason it is necessary to replace an arbitrator after the arbitral process has begun. Unless the Terms of Reference provide otherwise, the remuneration of all arbitrators [will be determined as follows under the streamlined arbitration process:

- The fees of the arbitrators will be set at the fixed amount of [amount to be determined bilaterally] per day, subject to modification by the competent authorities.

^bSome members of the United Nations Committee of Experts consider that in such a situation the person who has presented the case should also be allowed to request the designated chair or member of the said Committee to appoint the arbitrators not yet appointed. Once arbitration has been requested that person is relying on arbitration and should have the right to make up for the failure of the competent authorities.

- For one case, each arbitrator will be compensated for no more than three days of preparation, for two meeting days (including through video-conference) and for the travel days necessary to attend the meetings. If, however, the arbitrators consider that they require additional time to properly consider the case, the arbitrators may be compensated for additional time.
- In addition, arbitrators are entitled to be reimbursed for reasonable expenses subject to prior authorization by the competent authorities.]

6. *Streamlined arbitration process*

[Unless the competent authorities indicate otherwise in the Terms of Reference,] the following rules shall apply to a particular case [...]:

- [a)] Within two months from the appointment of the [arbitrators or, where paragraph 4 applies, within two months from the end of the period during which the competent authorities may agree on and communicate different Terms of Reference], each competent authority will present in writing to the [arbitrators] its own reply to the questions contained in the Terms of Reference.
- [b)] Within [three] month[s] from having received the last of the replies from the competent authorities, the [arbitrators] will decide each question included in the Terms of Reference in accordance with one of the two replies received from the competent authorities as regards that question and will notify the competent authorities of the choice, together with short reasons explaining that choice. Such decision will be implemented as provided in paragraph 19 [below].

7. *Eligibility and appointment of arbitrators*

Any person, including a government official of a Contracting State, may be appointed as an arbitrator, unless that person has been involved in prior stages of the case that results in the arbitration process. [Before his appointment, an arbitrator will provide a written statement in which he declares that, as far as he knows, there exist no circumstances that might give rise to justifiable doubts regarding his independence or impartiality and that he will disclose promptly in writing to both competent authorities any such circumstances arising during the course of the arbitration process.] An arbitrator will be considered to have been appointed when

a letter confirming that appointment has been signed both by the person or persons who have the power to appoint that arbitrator and by the arbitrator himself.

8. *Communication of information and confidentiality*

For the sole purposes of the application of the provisions of Articles 25 and 26, and of the domestic laws of the Contracting States, concerning the communication and the confidentiality of the information related to the case that results in the arbitration process, each arbitrator shall be designated as authorised representative of the competent authority that has appointed that arbitrator or, if that arbitrator has not been appointed exclusively by one competent authority, of the competent authority of the Contracting State to which the case giving rise to the arbitration was initially presented. For the purposes of this agreement, where a case giving rise to arbitration was initially presented simultaneously to both competent authorities, “the competent authority of the Contracting State to which the case giving rise to the arbitration was initially presented” means the competent authority referred to in paragraph 1 of Article 25.

9. *Failure to provide information in a timely manner*

Notwithstanding [paragraph 5], where both competent authorities agree that the failure to resolve an issue within the [three] year period provided in paragraph 5 of Article 25 is mainly attributable to the failure of a person directly affected by the case to provide relevant information in a timely manner, the competent authorities may postpone the nomination of the arbitrator for a period of time corresponding to the delay in providing that information.

10. *Procedural and evidentiary rules*

Subject to this agreement and the Terms of Reference, the arbitrators shall adopt those procedural and evidentiary rules that they deem necessary to answer the questions set out in the Terms of Reference. They will have access to all information necessary to decide the issues submitted to arbitration, including confidential information. Unless the competent authorities agree otherwise, any information that was not available to both competent authorities before the request for arbitration was [sent by one] of them shall not be taken into account for purposes of the decision.

[11. *Independent opinion approach*]

If the competent authorities so indicate in the Terms of Reference, the “independent opinion” approach will be followed instead of the streamlined arbitration process. Under this approach, the arbitrators will reach their own decision and the following rules shall apply to a particular case:

- a) Unless otherwise provided in the Terms of Reference, the decision of the arbitral panel will be presented in writing and shall indicate the sources of law relied upon and the reasoning which led to its result. With the permission of the person who presented the case and both competent authorities, the decision of the arbitral panel will be made public in redacted form without mentioning the names of the parties involved or any details that might disclose their identity and with the understanding that the decision has no formal precedential value.
- b) The arbitration decision must be communicated to the competent authorities and the person who presented the case within six months from the date on which the Chair notifies in writing the competent authorities and the person who presented the case that he has received all the information necessary to begin consideration of the case. Notwithstanding the first part of this paragraph, if at any time within two months from the date on which the last arbitrator was appointed, the Chair, with the consent of one of the competent authorities, notifies in writing the other competent authority and the person who presented the case that he has not received all the information necessary to begin consideration of the case, then
 - if the Chair receives the necessary information within two months after the date on which that notice was sent, the arbitration decision must be communicated to the competent authorities and the person who presented the case within six months from the date on which the information was received by the Chair, and
 - if the Chair has not received the necessary information within two months after the date on which that notice was sent, the arbitration decision must, unless the competent authorities agree otherwise, be reached without taking into account that information even if the Chair receives it later and the decision must be communicated to the competent

authorities and the person who presented the case within eight months from the date on which the notice was sent.

- c) The person who presented the case may, either directly or through his representatives, present his position to the arbitrators in writing to the same extent that the person is entitled to do so during the mutual agreement procedure.]

12. *Logistical arrangements*

Unless agreed otherwise by the competent authorities, the competent authority to which the case giving rise to the arbitration was initially presented will be responsible for the logistical arrangements for the meetings of the arbitral panel and will provide the administrative personnel necessary for the conduct of the arbitration process. The administrative personnel so provided will report only to the Chair of the arbitration panel concerning any matter related to that process.

13. *Costs*

Unless agreed otherwise by the competent authorities:

- a) each competent authority and the person who [presented the case] will bear the costs related to his own participation in the arbitration proceedings (including travel costs and costs related to the preparation and presentation of his views);
- b) each competent authority will bear the remuneration of the arbitrator appointed exclusively by that competent authority, or appointed by [another person] because of the failure of that competent authority to appoint that arbitrator, together with that arbitrator's travel, telecommunication and secretariat costs;
- c) the remuneration of the other arbitrators and their travel, telecommunication and secretariat costs will be borne equally by the two Contracting States;
- d) costs related to the meetings of the arbitral panel and to the administrative personnel necessary for the conduct of the arbitration process will be borne by the competent authority to which the case giving rise to the arbitration was initially presented, or if presented in both States, will be shared equally; and

- e) all other costs (including costs of translation and of recording the proceedings) related to expenses that both competent authorities have agreed to incur, will be borne equally by the two Contracting States.

14. *Applicable Legal Principles*

The arbitrators shall decide the issues submitted to arbitration in accordance with the applicable provisions of the [Convention] and, subject to these provisions, of those of the domestic laws of the Contracting States. Issues of treaty interpretation will be decided by the arbitrators in the light of the principles of interpretation incorporated in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties* [...]. The arbitrators will also consider any other sources which the competent authorities may expressly identify in the Terms of Reference.

15. *Arbitration decision*

Where more than one arbitrator has been appointed, the arbitration decision will be determined by a simple majority of the arbitrators. [...]

[16]. *Failure to communicate the decision within the required period*

In the event that the decision has not been communicated to the competent authorities within the period provided for in paragraphs 6 [b)] or [11 b)], the competent authorities may agree to extend that period for a period not exceeding six months or, if they fail to do so within one month from the end of the period provided for in paragraphs 6 [b)] or [11 b)], they shall appoint a new arbitrator or arbitrators in accordance with paragraph 5 [...].

[17]. *Final decision*

The arbitration decision shall be final, [unless both competent authorities agree on a different solution within six months after the decision has been communicated to them or] unless that decision is found to be unenforceable by the courts of one of the Contracting States because of a violation of paragraph 5 of Article 25 or of any procedural rule included in the Terms of Reference or in this agreement that may reasonably have affected the decision. If a decision is found to be unenforceable for one of these reasons [or if both competent authorities agree on a different

solution within six months after the decision has been communicated to them], the request for arbitration shall be considered not to have been made and the arbitration process shall be considered not to have taken place (except for the purposes of paragraphs 8 “Communication of information and confidentiality” and 13 “Costs”).

[18]. Implementing the arbitration decision

[Unless both competent authorities agree on a different solution as provided in paragraph 17 above, the] competent authorities will implement the arbitration decision within six months from the communication of the decision to them by reaching a mutual agreement on the case that led to the arbitration.

[19]. Where no arbitration decision will be provided

Notwithstanding paragraphs 6, [11] and [16], where, at any time after a request for arbitration has been made and before the arbitrators have delivered a decision to the competent authorities and the person who [presented the case], the competent authorities notify in writing the arbitrators and that person that they have solved all the unresolved issues described in the Terms of Reference, the case shall be considered as solved under the mutual agreement procedure and no arbitration decision shall be provided.

This agreement applies to any request for arbitration made pursuant to paragraph 5 of Article 25 of the Convention after that provision has become effective.

[Date of signature of the agreement]

[Signature of the competent authority of each Contracting State]

General approach of the sample agreement

2. A number of approaches can be taken to structuring the arbitral process which is used to supplement the mutual agreement procedure. Under one approach, which might be referred to as the “independent opinion” approach, the arbitrators would be presented with the facts and arguments by the parties based on the applicable

law, and would then reach their own independent decision which would be based on a written, reasoned analysis of the facts involved and applicable legal sources.

3. Alternatively, under the so-called “last best offer” or “final offer” approach, each competent authority would be required to give to the arbitral panel a proposed resolution of the issue involved and the arbitral panel would choose between the two proposals which were presented to it. There are obviously a number of variations between these two positions. For example, the arbitrators could reach an independent decision but would not be required to submit a written decision but simply their conclusions. To some extent, the appropriate method depends on the type of issue to be decided.

4. The above sample agreement takes as its starting point the [“streamlined” process, based on the “last best offer” or “final offer” approach], in recognition of the fact that many cases, especially those which involve primarily factual questions, may be best handled [that way.] [I]t also provides for an alternative [“independent opinion” process]. Competent authorities can therefore agree to use that [independent opinion process] on a case-by-case basis. Competent authorities may of course adopt this combined approach, adopt the [independent opinion process] as the generally applicable process with the [streamlined process] as an option in some circumstances or limit themselves to only one of the two approaches.

The request for arbitration

5. Paragraph 1 of the sample agreement provides the manner in which a request for arbitration should be made. Such request should be presented in writing [by one competent authority to the other competent authority and to the person who has presented the case to the competent authority of a Contracting State pursuant to paragraph 1 of Article 25].

6. In order to determine that the conditions of paragraph 5 of Article 25 have been met (see paragraph 76 of the Commentary on this Article) the request should be accompanied by statements indicating that no decision on these issues has already been rendered by domestic courts or administrative tribunals in either Contracting State.

7. Since the arbitration process is an extension of the mutual agreement procedure that is intended to deal with cases that cannot be resolved under that procedure, it would seem inappropriate to ask the person who [initiated the mutual agreement procedure]

to reimburse the expenses incurred by the competent authorities in the course of the arbitration proceedings. Unlike taxpayers' requests for rulings or other types of advance agreements, where a charge is sometimes made, providing a resolution to disputes between the Contracting States is the responsibility of these States for which they in general should bear the costs.

8. A request for arbitration may not be made before [three] years from the date when a mutual agreement case presented to the competent authority of a Contracting State has also been presented to the competent authority of the other Contracting State. Paragraph 2 of the sample agreement provides that for this purpose, a case shall only be considered to have been presented to the competent authority of that other State if the information specified in that paragraph has been so provided. The paragraph should therefore include a list of the information required; in general, that information will correspond to the information and documents that were required to initiate the mutual agreement procedure [see paragraphs 22 to 24 above dealing with the necessary cooperation of the person who makes the request].

Terms of Reference

9. Paragraph 3 of the sample agreement refers to the "Terms of Reference", which is the document that sets forth the questions to be resolved by the arbitrators. It establishes the jurisdictional basis for the issues which are to be decided by the arbitral panel. It is to be established by the competent authorities who may wish in that connection to consult with the person who [initiated the mutual agreement procedure]. If the competent authorities cannot agree on the Terms of Reference within the period provided for in paragraph 3, some mechanism is necessary to ensure that the procedure goes forward. Paragraph 4 provides for that eventuality.

10. Whilst the Terms of Reference will generally be limited to a particular issue or set of issues, it would be possible for the competent authorities, given the nature of the case and the interrelated nature of the issues, to draft the Terms of Reference so that the whole case (and not only certain specific issues) be submitted to arbitration.

11. The procedural rules provided for in the sample agreement shall apply unless the competent authorities provide otherwise in the Terms of Reference. It is therefore possible for the competent authorities, through the Terms of Reference, to depart from any of these rules or to provide for additional rules in a particular case.

Streamlined process

12. The normal process provided for by the sample agreement allows the consideration of questions of either law or fact, as well as of mixed questions of law and fact. [Under this streamlined process, which takes the form of the so-called “last best offer” or “final offer” arbitration, each competent authority is required to submit to the arbitrator, or arbitrators, that competent authority’s own reply to the questions included in the Terms of Reference, and the arbitrator, or the arbitrators, simply chooses one of the competent authorities’ replies. The competent authorities may, as for most procedural rules, amend or supplement the streamlined process through the Terms of Reference applicable to a particular case.]

13. [That streamlined process will especially be appropriate to deal with factual issues], for example a determination of the amount of adjustments to the income and deductions of the respective related parties. Such circumstances will often arise in transfer pricing cases, where the unresolved issue may be simply the determination of an arm’s length transfer price or range of prices (although there are other transfer pricing cases that involve complex factual issues); there are also cases in which an analogous principle may apply, for example, the determination of the existence of a permanent establishment. In some cases, the decision may be a statement of the factual premises on which the appropriate legal principles should then be applied by the competent authorities [...].

13.1 The replies to be provided by the competent authorities under the streamlined process may take alternative positions. For example, a competent authority may take the position that no permanent establishment exists and, nevertheless, propose an amount of income to be attributed to a permanent establishment, in the event that the arbitrators determine that a permanent establishment exists.

Selection of arbitrators

14. Paragraph 5 of the sample agreement describes how arbitrators will be selected unless the Terms of Reference drafted for a particular case provide otherwise (for instance, by [providing for only one arbitrator] or by providing for more than one arbitrator to be appointed by each competent authority). Normally, the two competent authorities will each appoint one arbitrator. These appointments must be made within three months after the Terms of Reference have been received by the person who [initiated the mutual agreement

procedure] (a different deadline is provided for cases where the competent authorities do not agree on the Terms of Reference within the required period). The arbitrators thus appointed will select a Chair who must be appointed within two months of the time at which the last of the initial appointments was made. If the competent authorities do not appoint an arbitrator during the required period, or if the arbitrators so appointed do not appoint the third arbitrator within the required period, the paragraph provides that the appointment will be made by the [Chair of the UN Committee of Experts on International Cooperation in Tax Matters, or if the Chair is a national or resident of one of the two States involved in the case, by the longest serving member of that Committee who is not a national or resident of these States.] The competent authorities may, of course, provide for other ways to address these rare situations but it seems important to provide for an independent appointing authority to solve any deadlock in the selection of the arbitrators.

15. There is no need for the agreement to stipulate any particular qualifications for an arbitrator as it will be in the interests of the competent authorities to have qualified and suitable persons act as arbitrators and in the interests of the arbitrators to have a qualified Chair. However, it might be possible to develop a list of qualified persons to facilitate the appointment process and this function could be developed by the [UN Committee of Experts on International Cooperation in Tax Matters]. It is important that the Chair of the panel have experience with the types of procedural, evidentiary and logistical issues which are likely to arise in the course of the arbitral proceedings as well as having familiarity with tax issues. There may be advantages in having representatives of each Contracting State appointed as arbitrators as they would be familiar with this type of issue. Thus it should be possible to appoint to the panel governmental officials who have not been directly involved in the case. Once an arbitrator has been appointed, it should be clear that his role is to decide the case on a neutral and objective basis; he is no longer functioning as an advocate for the country that appointed him.

16. Paragraph 9 of the sample agreement provides that the appointment of the arbitrators may be postponed where both competent authorities agree that the failure to reach a mutual agreement within the [three] year period is mainly attributable to the lack of cooperation by a person directly affected by the case [see paragraphs 22 to 24 above dealing with the necessary cooperation of the person who makes the request]. In that case, the approach taken by the sample agreement is to allow the competent authorities to postpone the

appointment of the arbitrators by a period of time corresponding to the undue delay in providing them with the relevant information. If that information has not yet been provided when the request for arbitration is submitted, the period of time corresponding to the delay in providing the information continues to run until such information is finally provided. Where, however, the competent authorities are not provided with the information necessary to solve a particular case, there is nothing that prevents them from resolving the case on the basis of the limited information that is at their disposal, thereby preventing any access to arbitration. Also, it would be possible to provide in the agreement that if within an additional period (*e.g.* one year), the taxpayer still had not provided the necessary information for the competent authorities to properly evaluate the issue, the issue would no longer be required to be submitted to arbitration.

Communication of information and confidentiality

17. It is important that arbitrators be allowed full access to the information needed to resolve the issues submitted to arbitration but, at the same time, be subjected to the same strict confidentiality requirements as regards that information as apply to the competent authorities themselves. The proposed approach to ensure that result, which is incorporated in paragraph 8 of the sample agreement, is to make the arbitrators authorised representatives of the competent authorities. This, however, will only be for the purposes of the application of the relevant provisions of the Convention (*i.e.* Articles 25 and 26) and of the provisions of the domestic laws of the Contracting States, which would normally include the sanctions applicable in case of a breach of confidentiality. The designation of the arbitrator as authorised representative of a competent authority would typically be confirmed in the letter of appointment but may need to be done differently if domestic law requires otherwise or if the arbitrator is not appointed by a competent authority.

Procedural and evidentiary rules

18. The simplest way to establish the evidentiary and other procedural rules that will govern the arbitration process and that have not already been provided in the agreement or the Terms of Reference is to leave it to the arbitrators to develop these rules on an ad hoc basis. In doing so, the arbitrators are free to refer to existing arbitration

procedures, such as the International Chamber of Commerce Rules which deal with many of these questions. It should be made clear in the procedural rules that as general matter, the factual material on which the arbitral panel will base its decision will be that developed in the mutual agreement procedure. Only in special situations would the panel be allowed to investigate factual issues which had not been developed in the earlier stages of the case.

19. Paragraph 10 of the sample agreement follows that approach. Thus, decisions as regards the dates and format of arbitration meetings will be made by the arbitrators unless the agreement or Terms of Reference provide otherwise. Also, whilst the arbitrators will have access to all information necessary to decide the issues submitted to arbitration, including confidential information, any information that was not available to both competent authorities shall not be taken into account by the arbitrators unless the competent authorities agree otherwise.

Practical arrangements

21. A number of practical arrangements will need to be made in connection with the actual functioning of the arbitral process. They include the location of the meetings, the language of the proceedings and possible translation facilities, the keeping of a record, dealing with practical details such as filing etc.

22. As regards the location and the logistical arrangements for the arbitral meetings, the easiest solution is to leave the matter to be dealt with by the competent authority to which the case giving rise to the arbitration was initially presented. That competent authority should also provide the administrative personnel necessary for the conduct of the arbitration process. This is the approach put forward in paragraph 12 of the sample agreement. It is expected that, for these purposes, the competent authority will use meeting facilities and personnel that it already has at its disposal. The two competent authorities are, however, entitled to agree otherwise (*e.g.* to take advantage of another meeting in a different location that would be attended by both competent authorities and the arbitrators).

23. It is provided that the administrative personnel provided for the conduct of the arbitration process will report only to the Chair of the arbitration panel concerning any matter related to that procedure.

24. The language of the proceedings and whether, and which, translation facilities should be provided is a matter that should normally be dealt with in the Terms of Reference. It may be, however, that

a need for translation or recording will only arise after the beginning of the proceedings. In that case, the competent authorities are entitled to reach agreement for that purpose. In the absence of such agreement, the arbitrators could, at the request of one competent authority and pursuant to paragraph 10 of the sample agreement, decide to provide such translation or recording; in that case, however, the costs thereof would have to be borne by the requesting party (see under “Costs” below).

25. Other practical details (*e.g.* notice and filing of documents) should be similarly dealt with. Thus, any such matter should be decided by agreement between the competent authorities (ideally, included in the Terms of Reference) and, failing such agreement, by decision of the arbitrators.

Costs

26. Different costs may arise in relation to the arbitration process and it should be clear who should bear these costs. Paragraph 13 of the sample agreement, which deals with this issue, is based on the principle that where a competent authority or a person involved in the case can control the amount of a particular cost, this cost should be borne by that party and that other costs should be borne equally by the two competent authorities.

27. Thus, it seems logical to provide that each competent authority, as well as the person who [initiated the mutual agreement procedure], should pay for its own participation in the arbitration proceedings. This would include costs of being represented at the meetings and of preparing and presenting a position and arguments, whether in writing or orally.

28. The fees to be paid to the arbitrators are likely to be one of the major costs of the arbitration process. Each competent authority will bear the remuneration of the arbitrator appointed exclusively by that competent authority (or appointed by [another person] because of the failure of that competent authority to appoint that arbitrator), together with that arbitrator’s travel, telecommunication and secretariat costs.

29. The fees and the travel, telecommunication and secretariat costs of the other arbitrators will, however, be shared equally by the competent authorities. The competent authorities will normally agree to incur these costs at the time that the arbitrators are appointed and this would typically be confirmed in the letter of appointment. The fees should be large enough to ensure that appropriately qualified

experts could be recruited. One possibility would be to use a fee structure similar to that established under the EU Arbitration Convention Code of Conduct.

30. The costs related to the meetings of the arbitral panel, including those of the administrative personnel necessary for the conduct of the arbitration process, should be borne by the competent authority to which the case giving rise to the arbitration was initially presented, as long as that competent authority is required to arrange such meetings and provide the administrative personnel (see paragraph 12 of the sample agreement). In most cases, that competent authority will use meeting facilities and personnel that it already has at its disposal and it would seem inappropriate to try to allocate part of the costs thereof to the other competent authority. Clearly, the reference to “costs related to the meetings” does not include the travel and accommodation costs incurred by the participants; these are dealt with above.

31. The other costs (not including any costs resulting from the taxpayers’ participation in the process) should be borne equally by the two competent authorities as long as they have agreed to incur the relevant expenses. This would include costs related to translation and recording that both competent authorities have agreed to provide. In the absence of such agreement, the party that has requested that particular costs be incurred should pay for these.

32. As indicated in paragraph 13 of the sample agreement, the competent authorities may, however, agree to a different allocation of costs [in a particular case]. Such agreement can be included in the Terms of Reference or be made afterwards (*e.g.* when unforeseen expenses arise). [The competent authorities may also agree, in the sample agreement, on different methods of allocating the costs of the arbitration procedure, especially where there is a significant disparity in the level of development of the two Contracting States.]

Applicable legal principles

33. An examination of the issues on which competent authorities have had difficulties reaching an agreement shows that these are typically matters of treaty interpretation or of applying the arm’s length principle underlying Article 9 and paragraph 2 of Article 7. As provided in paragraph 14 of the sample agreement, matters of treaty interpretation should be decided by the arbitrators in the light of the principles of interpretation incorporated in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties* [...]. Since Article 32 of the *Vienna Convention on the Law of Treaties* permits a wide access to

supplementary means of interpretation, arbitrators will, in practice, have considerable latitude in determining relevant sources for the interpretation of treaty provisions.

34. In many cases, the application of the provisions of a tax convention depends on issues of domestic law (for example, the definition of immovable property in paragraph 2 of Article 6 depends primarily on the domestic law meaning of that term). As a general rule, it would seem inappropriate to ask arbitrators to make [a] determination of purely domestic legal issues and the description of the issues to be resolved, which will be included in the Terms of Reference, should take this into account. [However, where a matter of domestic law directly affects the application of the provisions of a tax convention the arbitrators may decide on this matter.]

35. Also, there may be cases where the competent authorities agree that the interpretation or application of a provision of a tax treaty depends on a particular document (*e.g.* a memorandum of understanding or mutual agreement concluded after the entry into force of a treaty) but may disagree about the interpretation of that document. In such a case, the competent authorities may wish to make express reference to that document in the Terms of Reference.

Arbitration decision

36. Paragraph 15 of the sample agreement provides that where more than one arbitrator has been appointed, the arbitration decision will be determined by a simple majority of the arbitrators [...].

38. In order to deal with the unusual circumstances in which the arbitrators may be unable or unwilling to present an arbitration decision, paragraph [16] provides that if the decision is not communicated within the relevant period, the competent authorities may agree to extend the period for presenting the arbitration decision or, if they fail to reach such agreement within one month, appoint new arbitrators to deal with the case. In the case of the appointment of new arbitrators, the arbitration process would go back to the point where the original arbitrators were appointed and will continue with the new arbitrators.

Independent opinion approach

3. Under the alternative independent opinion approach provided for in paragraph 11 of the sample agreement, the person who initiated the mutual

agreement procedure may, either directly or through his representatives, present a written submission to the arbitrators to the same extent that he may do so during the mutual agreement procedure. If the arbitrators agree, that person may also make an oral presentation during a meeting of the arbitrators.

4. Where the competent authorities have agreed to follow the independent opinion approach in a particular case, and unless otherwise provided in the Terms of Reference, the decision of the arbitral panel is presented in writing and indicates the sources of law relied upon and the reasoning which led to its result. It is important that the arbitrators support their decision with the reasoning leading to it. Showing the method through which the decision was reached is important in assuring acceptance of the decision by all relevant participants.

5. Pursuant to paragraph 11 *b*) of the sample agreement, the arbitration decision must be communicated to the competent authorities and the person who initiated the mutual agreement procedure within six months from the date on which the Chair notifies in writing the competent authorities and the person who initiated the mutual agreement procedure that he has received all of the information necessary to begin consideration of the case. However, at any time within two months from the date on which the last arbitrator was appointed, the Chair, with the consent of one of the competent authorities, may notify in writing the other competent authority and the person who initiated the mutual agreement procedure that he has not received all the information necessary to begin consideration of the case. In that case, a further two months will be given for the necessary information to be sent to the Chair. If the information is not received by the Chair within that period, it is provided that the decision will be rendered within the next six months without taking that information into account (unless both competent authorities agree otherwise). If, on the other hand, the information is received by the Chair within the two month period, that information will be taken into account and the decision will be communicated within six months from the reception of that information.

6. The OECD Commentary on the sample mutual agreement then continues:

Publication of the decision

39. Decisions on individual cases reached under the mutual agreement procedure [and under the streamlined arbitration process] are generally not made public. In the case of [the] reasoned arbitral

decisions [presented under the independent opinion approach], however, publishing the decisions would lend additional transparency to the process. Also, whilst the decision would not be in any sense a formal precedent, having the material in the public domain could influence the course of other cases so as to avoid subsequent disputes and lead to a more uniform approach to the same issue.

40. Paragraph [11] of the sample agreement therefore provides for the possibility to publish the decision [presented under the independent opinion approach]. Such publication, however, should only be made if both competent authorities and the person who [initiated the mutual agreement procedure] so agree. Also, in order to maintain the confidentiality of information communicated to the competent authorities, the publication should be made in a form that would not disclose the names of the parties nor any element that would help to identify them.

Implementing the decision

41. Once the arbitration process has provided a binding solution to the issues that the competent authorities have been unable to resolve, the competent authorities will proceed to conclude a mutual agreement that reflects that decision and that will be presented to the persons directly affected by the case. [Both competent authorities may, however, agree on a different solution within six months after the decision has been communicated to them.] In order to avoid further delays, it is suggested that the mutual agreement that incorporates the solution arrived at should be completed and presented to the taxpayer within six months from the date of the communication of the decision. This is provided in paragraph [18] of the sample agreement.

42. Paragraph 2 of Article 25 provides that the competent authorities have the obligation to implement the agreement reached notwithstanding any time limit in their domestic law. Paragraph 5 of the Article also provides that the arbitration decision is binding on both Contracting States [unless they are able to reach agreement on a different solution]. Failure to assess taxpayers in accordance with the agreement or to implement the arbitration decision through the conclusion of a mutual agreement [unless a different solution has been agreed to] would therefore result in taxation not in accordance with the Convention and, as such, would allow the person whose taxation is affected to seek relief through domestic legal remedies or by making a new request pursuant to paragraph 1 of the Article.

43. Paragraph [19] of the sample agreement deals with the case where the competent authorities are able to solve the unresolved issues that led to arbitration before the decision is rendered. Since the arbitration process is an exceptional mechanism to deal with issues that cannot be solved under the usual mutual agreement procedure, it is appropriate to put an end to that exceptional mechanism if the competent authorities are able to resolve these issues by themselves. The competent authorities may agree on a resolution of these issues as long as the arbitration decision has not been rendered [and within a further period of six months afterwards].

Article 26

EXCHANGE OF INFORMATION

A. GENERAL CONSIDERATIONS

1. Article 26 embodies rules under which information may be exchanged to the widest possible extent, both to facilitate the proper application of the treaty and to assist the Contracting States in the enforcement of their domestic tax laws. Consequently, the obligation to exchange information under this Article should be interpreted broadly, and the limitations on that obligation should not be extended by analogy beyond their specific meaning. In particular, the Article should be understood to require the Contracting States to promote an effective exchange of information.

1.1 In a global economy, cooperation among nations on fiscal matters has become increasingly important, and the former reluctance of nations to concern themselves with the revenue laws of other countries has mostly disappeared. Article 26 provides a basis for the effective exchange of information between the Contracting States, whereas Article 27 provides for assistance in collection. From the perspective of many developing countries, Article 26 is particularly important not only for curtailing cross-border tax evasion and avoidance, but also to curtail the capital flight that is often accomplished through such evasion and avoidance.

1.2 Much of the language of Article 26 is also found in the comparable Article of the OECD Model Convention. Consequently, the OECD Commentary to that Article generally is relevant in interpreting Article 26 of the United Nations Model Convention. It should be understood, nevertheless, that Article 26 is intended to be broader in a number of respects than the comparable provision in the OECD Model Convention.

1.3 Although Article 26 imposes reciprocal obligations on the Contracting States, it does not allow a developed country to refuse to provide information to a developing country on the ground that the developing country does not have an administrative capacity comparable to the developed country. Reciprocity has to be measured by reference to the overall effects of a treaty, not with respect to the effects of a single article.

2. The text of paragraph 1 of Article 26 makes clear that the exchange of information is not restricted by Article 1 (Persons covered) or Article 2 (Taxes covered). Consequently, the information exchanged may relate to persons who are not resident in either Contracting State and to the administration or enforcement of taxes not mentioned in Article 2. Some countries may object to the extension of paragraph 1 to all taxes, for constitutional reasons or other reasons. Those concerns are addressed in section B below.

3. Following the pattern of the 2005 revisions to the OECD Model Convention, paragraph 1 of Article 26 was broken up into three separate paragraphs, now paragraphs 1, 2 and 6. This paragraphing change was made for clarity and has no substantive significance.

4. Article 26 was modified substantially in 2011, with a view to clarifying certain issues, expanding the scope of the Article, and limiting exceptions to the obligation to exchange information. In some cases, the changes made were not intended to be substantive, but rather were intended to remove doubts as to the proper interpretation of the Article. For example, the term “necessary” in paragraph 1 was changed to “foreseeably relevant” to clarify the intended meaning of the prior language. In contrast, the change in that paragraph providing for an exchange of information with respect to taxes not mentioned in Article 2 was intended to be a substantive change. Another example of substantive change is the addition of paragraph 4, which removes the requirement for a domestic tax interest.

4.1 In some cases, the issue of whether a change made to Article 26 is intended as substantive or interpretative depends on the prior practices of the Contracting States. For example, in some cases, the addition of paragraph 5, which removes, inter alia, domestic bank secrecy laws as a basis for refusing to exchange information, may simply clarify the meaning of the limitations on the exchange of information contained in paragraph 3. In other cases, it may modify that paragraph substantively. The effect of the change depends in part on the particular prior practices of the Contracting States. The position taken in the OECD Commentary is that paragraph 5 is primarily interpretative with respect to treaties between its member States. This issue may be of particular importance in interpreting treaties that entered into force prior to the adoption of the 2011 changes to Article 26.

4.2 One difference in the wording of Article 26 and the comparable provision of the OECD Model Convention is that Article 26 includes in paragraph 1 the following sentence: “In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes.” The phrase “that would be helpful to a Contracting State in preventing avoidance or evasion” was inserted in 2011. That change was thought to be useful by members of the Committee, especially members from developing countries, to make clear in the text of Article 26 a point that already was clear in the Commentary and was implicit in the language of the last sentence of prior paragraph 1, now revised and moved to paragraph 6. The statement of the purposes of information exchanges in the text of Article 26 is intended to provide guidance to the Contracting States on the proper interpretation of the Article.

4.3 Although tax evasion is illegal and tax avoidance is not, both result in loss of revenue to the government, and, by definition, both defeat the intent of the government in enacting its taxing statutes. Consequently, mutual assistance in combating tax avoidance is an important aspect of mutual cooperation on tax matters. In addition, some forms of aggressive tax avoidance are so close to the line between avoidance and evasion that a Contracting State is unlikely to know for sure whether the information it is requesting deals with avoidance or evasion until after it obtains the requested information. Information on tax avoidance may be extremely useful to a Contracting State in its efforts to close possible loopholes in its taxing statutes.

5. The term “exchange of information” should be understood broadly to include an exchange of documents and an exchange of information unrelated to specific taxpayers and the provision of information by one Contracting State whether or not information is also being provided at that time by the other Contracting State.

5.1 If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State should provide information under Article 26 in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts or writings), to the extent feasible. Under paragraph 3, the requested State may decline to provide the information in the specific form requested if, for instance, the requested form is not known or permitted under its law or administrative practice. A refusal to provide the information in the form requested does not affect the obligation to provide the information.

5.2 Contracting States may wish to use electronic or other communication and information technologies, including appropriate security systems,

to improve the timeliness and quality of exchanges of information. Indeed, the Contracting States may be obligated to provide requested information in electronic form if such action is necessary for an effective exchange of information. Contracting States which are required, according to their law, to observe data protection laws may wish to include provisions in their bilateral conventions concerning the protection of personal data exchanged. Data protection concerns the rights and fundamental freedoms of an individual, and in particular, the right to privacy, with regard to automatic processing of personal data. In no event is a Contracting State relieved of its obligation to exchange information simply because its domestic laws do not allow it to provide the information in the form requested.

5.3 The scope of exchange of information covers all tax matters without prejudice to the general rules and legal provisions governing the rights of defendants and witnesses in judicial proceedings. Exchange of information for criminal tax matters can also be based on bilateral or multilateral treaties on mutual legal assistance (to the extent that they also apply to tax crimes).

5.4 Article 26 provides in paragraph 6 that “the competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made”. This language authorizes the competent authorities to exchange information in at least three modes: exchange by specific request, automatic exchange, and other exchanges, understood to include spontaneous exchanges.

5.5 Nothing in the United Nations Model Convention prevents the application of the provisions of Article 26 to the exchange of information that existed prior to the entry into force of the Convention, as long as the assistance with respect to this information is provided after the Convention has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such information, in particular when the provisions of that Convention will have effect with respect to taxes arising or levied from a certain time.

6. The Committee of Experts has suggested some guidelines for arrangements regarding the implementation of appropriate exchanges of information (see paragraph 30 below). Those guidelines are in the form of an inventory of options available to the competent authorities. The inventory is not intended to be exhaustive or to impose any procedural obligations on a Contracting State. Instead, the inventory is a listing of suggestions to be examined by competent authorities in developing procedures for an effective exchange of information.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 26

Paragraph 1

7. The first sentence of paragraph 1 sets forth the basic obligation of the Contracting States concerning the exchange of information. It requires, subject to the limitations of paragraph 3, that the competent authorities exchange such information as is “foreseeably relevant” for the proper application of the Convention or for the administration or enforcement of their domestic tax laws, as long as taxation under those laws is not inconsistent with the Convention.

7.1 Prior to the 2011 changes to Article 26, the term “necessary” was used instead of the term “foreseeably relevant”. The view of the Committee and the OECD Commentary has been that these terms have similar, if not identical, meanings. That is, the term “necessary” is understood to mean “appropriate and helpful”, not “essential”. In any event, whatever the phrase chosen, the requesting State is not obliged to demonstrate its need for the requested information before the obligation to provide that information arises.

7.2 The standard of “foreseeably relevant” is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to request information about a particular taxpayer that is highly unlikely to be relevant to the tax affairs of that taxpayer. Contracting States may agree to an alternative formulation of this standard that is consistent with the scope of the Article. For example, they might replace “foreseeably relevant” with “necessary” or “relevant” or “may be relevant” if those terms are understood to require an effective exchange of information. In the interest of conformity with the OECD usage, the Committee decided to adopt the term “foreseeably relevant”, although some members of the Committee preferred the term “may be relevant” on the ground that its meaning was clearer.

7.3 The information covered by paragraph 1 is not limited to taxpayer-specific information. The competent authorities may also exchange other sensitive information related to tax administration and compliance improvement; for example, they might provide information about risk analysis techniques or tax avoidance or evasion schemes. They may also share information they have obtained about aggressive or abusive tax avoidance schemes, such as those promoted by some international accounting firms. In addition, the competent authorities may exchange information relating to a whole economic sector (e.g. the oil, fishing or pharmaceutical industry, the banking sector, etc.) and not to particular taxpayers.

8. The scope of the obligation to exchange information is not limited by Articles 1 or 2. That is, the obligation applies not only with respect to information relevant to the proper application of the Convention or to the administration or enforcement of domestic taxes mentioned in Article 2, but also to all other domestic taxes, including subnational taxes. In this respect, the United Nations Model Convention and the OECD Model Convention are identical.

8.1 Some members of the Committee expressed concern that sharing of information with respect to all taxes, particularly subnational taxes, might prove burdensome or might raise constitutional and political issues for them. They suggested that the obligation to provide information might be limited to taxes covered by the Convention, plus one or two important taxes, such as the value added tax (VAT). To accomplish that outcome, the following language might be substituted for paragraph 1:

1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws of the Contracting States *concerning taxes covered by the Convention and [insert specific taxes] of a Contracting State*, in so far as the taxation thereunder is not contrary to the Convention.

8.2 The obligation to provide requested information applies whether or not the person, with respect to whom the information is requested, is a resident of either Contracting State or is engaged in economic activity in either Contracting State. For example, a Contracting State may request information about the bank deposits of an individual who is resident in some third State.

9. The obligation imposed under paragraph 1 is for an *effective* exchange of information. A Contracting State may not avoid its obligations under paragraph 1 through unreasonable time delays, by imposing unreasonable or burdensome procedural barriers, or by intentionally taking steps that prevent it from having certain information otherwise subject to exchange under paragraph 1.

10. The examples provided in paragraphs 10.1 and 10.2 below illustrate the application of paragraph 1 of Article 26 of the Convention in particular cases. Some of these examples are drawn from, but are not identical to, the examples provided in paragraphs 6 and 7 of the OECD Commentary on Article 26. In all of these examples, the requested State (the Contracting State that has been asked for information) has the obligation under paragraph 1 of Article 26 of the Convention to provide the requested information.

10.1 Application of the Convention between State A and State B (information must be provided):

- (a) State A, where the recipient of royalties under a royalty contract is resident, is attempting to apply Article 12 (Royalties). It asks State B, where the payer of the royalty is resident, for information concerning the amount of royalty transmitted;
- (b) In deciding whether it is proper to grant to the recipient of a royalty the relief claimed under Article 12, State B asks State A whether the recipient is in fact a resident of State A and whether State A considers the recipient to be the beneficial owner of the royalties;
- (c) In computing the taxable profits of a permanent establishment that is located in State A and has its head office in State B, State A may request information from State B about the expenses and profits of the head office and the dealings of the head office with other permanent establishments and associated companies;
- (d) Similarly, if an associated company, within the meaning of Article 9, is located in State A and another associated company is located in State B, then State A may request information from State B about the profits and expenses of the associated company located in State B and about the dealings of that associated company with any other associated companies and permanent establishments;
- (e) State A or State B may request information that may be relevant for the purposes of applying Article 25 (Mutual agreement procedure);
- (f) State B is attempting to tax an employee resident in State A in accordance with Article 15 (Dependent personal services). The employment has been exercised for more than 183 days in State B. That State may request that State A provide it with information on the amount of the income exempted from taxation in State A in accordance with Article 23 A (exemption method for relieving double taxation);
- (g) State A is attempting to impose a corporate income tax on an entity claiming to be a partnership. State A may request information from State B that would be helpful to it in properly classifying the entity for tax purposes, including information about the way the entity is classified for tax purposes by State B;
- (h) State A is being asked to provide to one of its residents a tax credit under Article 23 B for income taxes allegedly paid to State B. State A may request from State B information about whether the alleged payment of the tax actually occurred.

10.2 Implementation of domestic laws:

- (a) A company in State A supplies goods to an independent company in State B. State A wishes to know from State B what price the company in State B paid for the goods supplied, with a view to a correct application of the provisions of its domestic value added tax;

- (b) A company in State A sells goods through a company in State C (possibly a low-tax country) to a company in State B. The companies may or may not be associated. There is no convention between State A and State C, nor between State B and State C. Under the convention between State A and State B, State A, with a view to ensuring the correct application of the provisions of its domestic laws to the profits made by the company situated in its territory, asks State B what price the company in State B paid for the goods;
- (c) State A, for the purpose of taxing a company situated in its territory, asks State B, under the convention between A and B, for information about the prices charged by a company in State B, or a group of companies in State B with which the company in State A has no business contacts in order to enable State A to check the prices charged by the company in that State by direct comparison (e.g. prices charged by a company or a group of companies in a dominant position);
- (d) A resident of State A holds a bank account in State B, and the income from that account is exempt from tax under the domestic laws of State B. State A may request that State B provide information on the amount of interest income earned on that account;
- (e) A financial intermediary invests money of its account holders in State A, earning therein dividends and interest. State A requires that the financial intermediary keep records of the beneficial owners of the accounts but does not routinely request those records in enforcing its domestic laws. State B suspects that some of the beneficiaries of the account holders of the financial intermediary are its residents and are properly taxable under its domestic laws. State B may request that State A obtain for it information on identified taxpayers from the financial intermediary;
- (f) A corporation resident in State A has companies located in State B and State C. State B believes that the company doing business in its territory has been skimming profits into the company located in State C. State B may request that State A provide it with information about the profits and expenses of the company located in State C. Domestic law of State A obliges the parent company to keep records of transactions of its foreign subsidiaries.

Paragraph 2

11. A Contracting State cannot be expected to provide confidential financial information to another Contracting State unless it has confidence that the information will not be disclosed to unauthorized persons. To provide

the assurance of secrecy required for effective information exchange, paragraph 2 provides that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.

12. Of course, the information received under Article 26 would be useless, or nearly so, to the requesting State (the Contracting State requesting the information) if the prohibition against disclosure were absolute. Paragraph 2 provides that information received under Article 26 can be disclosed to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes mentioned in paragraph 1. In addition, it is understood that the information may also be communicated to the taxpayer, his proxy or witnesses in a civil or criminal proceeding.

12.1 As stated in paragraph 12, the information obtained can be communicated to the persons and authorities mentioned and, on the basis of the last sentence of paragraph 2 of the Article, can be disclosed by them in court sessions held in public or in decisions which reveal the name of the taxpayer. Once information is used in public court proceedings or in court decisions and thus rendered public, it is clear that from that moment such information can be quoted from the court files or decisions for other purposes even as possible evidence. But this disclosure to the public does not mean that the persons and authorities mentioned in paragraph 2 are allowed to provide on request additional information received.

12.2 If either or both of the Contracting States object to information obtained under Article 26 being made public by courts, or, once the information has been made public in this way, to the information being used for other purposes, they should state this objection expressly in their Convention.

13. In general, the information received by a Contracting State may be used only for the purposes mentioned in paragraph 1. If the information appears to be of value to the receiving State for purposes other than those referred to in that paragraph, that State may not use the information for such other purposes without the authorization of the competent authority of the supplying State. That authorization should not be unreasonably withheld.

13.1 In some cases, a Contracting State may prosecute a taxpayer for tax evasion and also for an additional crime, such as money-laundering, that arises out of the same set of facts. In such circumstances, the receiving State may want to use the information provided for both purposes.

13.2 Similarly, the information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure.

13.3 Contracting States wishing to broaden the purposes for which they may use information exchanged under this Article may do so by adding the following text to the end of paragraph 2:

Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorizes such use.

14. The OECD Model Convention, as amended in 2005, includes a provision that would allow the sharing of information obtained under Article 26 with persons charged with the oversight of the persons allowed to obtain such information. This provision is also included in paragraph 2 of the United Nations Model Convention.

14.1 The disclosure should be limited to information necessary for those bodies to fulfil their oversight duties. Such oversight bodies include authorities that supervise tax administration and enforcement authorities as part of the general administration of the Government of a Contracting State. Such sharing is permitted only if the persons engaged in oversight activities are subject to confidentiality requirements at least as strict as those applicable to tax administration and enforcement officials. The competent authorities may want to agree as to the bodies that constitute an oversight body within the meaning of this paragraph.

Paragraph 3

15. Paragraph 3 of Article 26 contains provisions that limit the obligation of the requested State under paragraph 1. The limitations provided in paragraph 3, however, may be superseded by the provisions contained in paragraphs 4 and 5. The provisions of paragraph 3, read in conjunction with the provisions of paragraphs 4 and 5, should not be read in a way that would prevent an effective exchange of information between the Contracting States. In addition, a Contracting State should disclose to the other Contracting State before it enters into a convention any specific provisions of its laws and administrative practice that it believes entitle it to avoid an obligation otherwise imposed by paragraph 1.

16. Paragraph 3 (a), subject to the limitations provided in paragraphs 4 and 5, contains the clarification that a Contracting State is not bound to go

beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. For example, if a requested State is not permitted under its laws or administrative practice to seize private papers from a taxpayer without court authorization, it is not required to make such a seizure without court authorization on behalf of a requesting State even if the requesting State could make such a seizure without court authorization under its own laws or administrative practice. The purpose of this rule is to prevent Article 26 from creating an unintentional conflict between a Contracting State's obligation under Article 26 and its obligations under domestic law.

16.1 Domestic provisions requiring that information obtained by the tax authorities be kept secret should not be interpreted as constituting an obstacle to the exchange of information under paragraph 3 (a) because the tax authorities of the requesting State are obligated under paragraph 2 to observe secrecy with regard to information received under this Article.

16.2 Paragraph 1 obligates a requested State to provide information with respect to all of the taxes of the requesting State, even if the requested State does not have a comparable tax. Paragraph 3 (a) does not remove the obligation to provide information relating to taxes that the requested State does not impose. For instance, a requested State cannot avoid its obligation to provide information helpful to the requesting State in the enforcement of its value added tax merely because the requested State does not have a value added tax. Of course, the requested State may avoid the obligation to supply such information if it cannot obtain that information under its normal administrative procedures, within the meaning of paragraph 3 (b).

16.3 The purpose of paragraph 3 (a) is to avoid traps for the unwary, not to create such traps. A Contracting State that believes that it is not required to obtain certain types of information on behalf of the other Contracting State because of its own laws or administrative practice (including the laws and administrative practice of its subnational governments) should disclose that position in writing prior to entering into a convention containing Article 26. It should also disclose the likely effects of that position on its ability to provide an effective exchange of information. For instance, if a Contracting State believes that one of its laws prevents it from providing the other Contracting State with information as to the beneficial owners of its resident companies or other juridical persons, it should give written notice of that position during the negotiation of the convention, with an explanation of the impact of that law on its obligations in relation to mutual assistance. Depending on the facts and circumstances of the particular case, a failure to disclose may eliminate the right of a Contracting State to invoke paragraph 3 (a) to avoid its obligations under paragraph 1.

16.4 A Contracting State that changes its laws or administrative practice after entering into a convention containing paragraph 3 (a) must disclose that change to the other Contracting State in timely fashion. Depending on the facts and circumstances of the case, such a change may constitute a material breach of the convention. In any event, a failure to provide timely notice of such a change may eliminate the right of a Contracting State to invoke paragraph 3 (a) to avoid its obligations arising under paragraph 1.

16.5 A Contracting State that wishes to expand the scope of the limitation currently provided in paragraph 3 (a) might modify that paragraph as follows:

- (a) To carry out administrative measures at variance with the laws and administrative practice of that Contracting State or of the other Contracting State even if that Contracting State knows and fails to disclose that specific provisions of its laws or administrative practice are likely to prevent an effective exchange of information;

17. Some countries are required by law to notify the person supplying information and/or the taxpayer subject to an enquiry prior to the release of that information to another country. Such notification procedures may be an important aspect of the rights provided under domestic law. In some cases, notification should help prevent mistakes (e.g. in cases of mistaken identity) and should facilitate exchange (by allowing taxpayers who are notified to cooperate voluntarily with the tax authorities in the requesting State). Notification procedures may not be applied, however, in a manner that, in the particular circumstances of the request, would frustrate the efforts of the requesting State to prevent avoidance or evasion of taxes. That is, they should not prevent or unduly delay an effective exchange of information. For instance, notification procedures should permit exceptions from prior notification in cases in which the information request is of a very urgent nature or the notification is likely to undermine the chance of success of the investigation conducted by the requesting State.

17.1 A Contracting State that under its domestic law is required to notify the person who provided the information and/or the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance. Such information should be provided to the other Contracting State before a convention is concluded and thereafter whenever the relevant rules are modified. Depending on the facts and circumstances of the particular case, a failure to disclose may eliminate the right of a Contracting State to invoke paragraph 3 (a) to avoid its obligations under paragraph 1.

18. In general, the requested State is not obligated to carry out administrative measures on behalf of the requesting State that are not permitted under the laws or administrative practice of the requesting State. The purpose of this rule is to prevent a requesting State from using the administrative measures of the requested State to avoid limitations imposed on the requesting State by its own government.

18.1 Different countries will necessarily have different mechanisms for obtaining and providing information. Variations in laws and administrative practice may not be used as a basis for the requested State to deny a request for information unless the effect of these variations would be to limit in a significant way the requesting State's legal authority to obtain and provide the information if the requesting State itself received a legitimate request from the requested State.

18.2 The general rule of paragraph 18 has no application when the legal system or administrative practice of only one country provides for a specific procedure. For instance, a Contracting State requested to provide information about an administrative ruling or advance pricing agreement (APA) it has granted cannot point to the absence of a ruling or APA regime in the requesting State to avoid its obligation under paragraph 1 to provide such information.

19. Most countries recognize under their domestic laws that information cannot be obtained from a person to the extent that such person can claim the privilege against self-incrimination. A requested State, therefore, may decline to provide information if its self-incrimination rules preclude it from obtaining that information or if the self-incrimination rules of the requesting State would preclude it from obtaining such information under similar circumstances. In practice, however, the privilege against self-incrimination should have little, if any, application in connection with most information requests. The privilege against self-incrimination is personal and cannot be claimed by an individual who himself is not at risk of criminal prosecution. In the overwhelming majority of information requests, the objective is to obtain information from third parties such as banks, intermediaries, or the other party to a contract, and not from the individual under investigation. Furthermore, the privilege against self-incrimination generally does not attach to persons other than natural persons.

20. Paragraph 3 (b) allows a requested State to avoid an obligation otherwise imposed by paragraph 1 when it cannot obtain the requested items of information in the normal course of its administration or when the other Contracting State could not have obtained that information in the normal course of its administration. The purpose of this rule is to prevent the requesting State from imposing unreasonable burdens on the requested State.

20.1 Information is deemed to be obtainable in the normal course of administration if the information is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons. For instance, if the requested State, as part of its audit policies, obtains information about the appropriateness of the transfer prices used by its taxpayers in dealings with associated companies, it is deemed to be able to obtain similar information about its taxpayers and associated companies on behalf of a requesting State.

20.2 Unless otherwise agreed to by the Contracting States, it should be assumed that the information requested by a Contracting State could be obtained by that State in a similar situation unless that State has informed the other Contracting State to the contrary.

20.3 It is often presumed, when a convention is entered into between a developed country and a developing country, that the developed country will have a greater administrative capacity than the developing country. Such a difference in administrative capacity does not provide a basis under paragraph 3 (b) for either Contracting State to avoid an obligation to supply information under paragraph 1. That is, paragraph 3 does not require that each of the Contracting States receive reciprocal benefits under Article 26. In freely adopting a convention, the Contracting States presumably have concluded that the convention, viewed as a whole, provides each of them with reciprocal benefits. There is no necessary presumption that each of the articles, or each paragraph of each article, provides a reciprocal benefit. On the contrary, it is commonplace for a Contracting State to give up some benefit in one article in order to obtain a benefit in another article.

20.4 Although paragraphs 3 (a) and 3 (b) do not explicitly provide for reciprocity in benefits, the OECD Commentary to Article 26 has taken the position that a reciprocity requirement can be inferred from the language of paragraph 3 (b), which, *inter alia*, limits the obligation of a Contracting State to supply information obtainable in the normal course of administration of that other Contracting State. In effect, the OECD Commentary is reading the term “obtainable” to mean that the other Contracting State has the actual administrative capacity to obtain that information. The alternative reading is that “obtainable” means that the tax administration has the authority to obtain the information, whether or not it has the capacity to exercise that authority. Countries may wish to make clear in their treaty that the Contracting States are obligated to exchange information even if one of the Contracting States has a significantly less advanced capacity for obtaining information about taxpayers. To achieve that result, they might amend paragraph (b) to read as follows:

- (b) To supply information that cannot be obtained in the normal course of the administration of that Contracting State or is not obtainable under the laws of that Contracting State or of the other Contracting State;

21. In general, a requested State may decline, under paragraph 3 (c), to disclose information that constitutes a confidential communication between an attorney, solicitor, or other admitted legal representative in his role as such and his client to the extent that the communication is protected from disclosure under domestic law.

21.1 The scope of protected confidential communications should be narrowly defined. Such protection does not attach to documents or records delivered to an attorney, solicitor, or other admitted legal representative in an attempt to protect such documents or records from disclosure required by law. Also, information on the identity of a person such as a director or beneficial owner of a company is not protected from disclosure. Although the scope of protection afforded under domestic law to confidential communications may differ among States, the protection provided under paragraph 3 (c) does not extend so broadly so as to hamper the effective exchange of information.

21.2 Notwithstanding the provisions of domestic law in the requested State, that State may decline to supply requested communications between attorneys, solicitors or other admitted legal representatives and their clients only if, and to the extent that, such representatives act in their capacity as attorneys, solicitors or other admitted legal representatives and not in a different capacity, such as nominee shareholders, trustees, settlors, company directors, or accountants, or under a power of attorney to represent a company in its business affairs. More specifically, the communication must have been produced in good faith for the purpose of seeking or providing legal advice or for use in existing or contemplated legal proceedings.

21.3 In no event may a requested State decline to disclose communications between attorneys, solicitors or other admitted legal representatives and their clients if those persons have themselves participated with their clients in a plan to commit tax evasion or avoidance.

21.4 A claim that information is protected as a confidential communication between an attorney, solicitor or other admitted legal representative and its client should be adjudicated exclusively in the Contracting State under the laws of which the claim arises. Thus, it is not intended that the courts of the requested State should adjudicate claims based on the laws of the requesting State.

22. Paragraph 3 (c) also permits a requested State to decline to provide information if the disclosure of that information would reveal any trade,

business, industrial, commercial or professional secret or trade process. Before invoking this provision, a Contracting State should carefully weigh if the interests of the taxpayer really justify its application. Secrets mentioned in this paragraph should not be taken in too wide a sense. A wide interpretation of the provision in many cases would be inconsistent with the purpose of Article 26 because it would render ineffective the exchange of information provided for in that Article.

22.1 A trade or business secret or trade process is generally understood to mean information which has considerable economic importance and which can be exploited practically and the unauthorized use of which may lead to serious damage (e.g. may lead to severe financial hardship). The purpose of the secrecy exception is to prevent an exchange of information from imposing unfair hardship on taxpayers by revealing to their competitors or potential competitors valuable secret information and thereby significantly diminishing the commercial value of that information. Secret information that once had substantial commercial value may be disclosed if that information does not have substantial commercial value at the time the information is requested. Information is not secret within the meaning of paragraph 3 (c) simply because the disclosure of it would embarrass the taxpayer or a third party or may result in the taxpayer having to pay additional taxes or losing income on account of bad publicity. A Contracting State may decide to supply requested information when it finds that there is no reasonable basis for assuming that the taxpayer involved may suffer adverse consequences incompatible with information exchange.

22.2 Secret information may be disclosed to the requesting State if the requested State determines that the risk of disclosure to the public or to competitors is unlikely due to the confidentiality requirements set forth in paragraph 2. A document that is protected from full disclosure because it contains protected secret information may be disclosed if the secret information is removed.

22.3 Financial information, including books and records, does not by its nature constitute a trade, business or other secret. In certain limited cases, however, the disclosure of financial information might reveal a trade, business or other secret. For instance, a request for information on certain purchase records may raise such an issue if the disclosure of such information would reveal the proprietary formula used in the manufacture of a product. The protection of such information may also extend to information in the possession of third persons. For instance, a bank might hold a pending patent application for safe keeping, or a secret trade process or formula might be described in a loan application or in a contract held by a bank. In such circumstances,

details of the trade, business or other secret should be excised from the documents and the remaining financial information exchanged accordingly.

23. Paragraph 3 (c) includes a limitation with regard to information that concerns the vital interests of the State itself. Under that limitation, Contracting States do not have to supply information the disclosure of which would be contrary to public policy (*ordre public*). This limitation should become relevant only in extreme cases. For instance, such a case could arise if a tax investigation in the requesting State were motivated by political, racial or religious persecution. The limitation may also be invoked when the information constitutes a State secret. For instance, there is no disclosure requirement when sensitive information is held by secret services, the disclosure of which would be contrary to the vital interests of the requested State. Thus, issues of public policy (*ordre public*) rarely arise in the context of information exchange between treaty partners.

24. As discussed above, paragraph 3 may give a requested State the right to refuse to supply information under some circumstances. It is not required, however, to invoke any of the limitations of that paragraph. If the requested State declines to exercise its right under paragraph 3 and supplies the requested information, the information exchanged remains within the framework of Article 26. Consequently, the information is subject to the confidentiality rules of paragraph 2. In addition, the affected taxpayer or other third party has no ground for contending that the tax authorities in the requested State have failed to observe the obligation to secrecy imposed on them by domestic law.

25. Article 26 does not require the existence of criminal activity in either of the Contracting States for the obligation to exchange information to arise. Some treaties, nevertheless, do require such criminal activity. In such treaties, it may be important to provide that criminality in the requesting State is sufficient for the obligation to exchange information to arise. As a cautionary measure, some States that do not limit their exchange of information to criminal matters may wish to state specifically in their treaty that dual criminality is not required. To eliminate the possibility of a dual criminality requirement being read into a treaty, the following paragraph might be added as paragraph 6, with the current paragraph 6 renumbered as paragraph 7.

6. The obligation to exchange information arises under paragraph 1 whether or not a person under investigation is suspected of criminal activity. In no case shall the provisions of this Article be construed to permit a Contracting State to decline to supply information solely because the conduct being investigated would not constitute a crime under the laws of that Contracting State if such conduct occurred in that Contracting State.”

Paragraph 4

26. Paragraph 4 was added to the United Nations Model Convention in 2011. It is taken directly from the comparable provision in the OECD Model Convention. As a result, the OECD Commentary to paragraph 4 is fully applicable in interpreting paragraph 4 of Article 26. The position taken in the OECD Commentary is that the addition of this paragraph was intended to assist in the interpretation of Article 26 and does not result in a substantive change in the obligations implicit in the prior version of Article 26.

26.1 According to paragraph 4, a requested State must use its information gathering measures to obtain requested information even though those measures are invoked solely to provide information to the other Contracting State. The term “information gathering measures” means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information. That is, a requested State does not need to have a domestic tax interest in obtaining the requested information for the obligation to supply information under paragraph 1 to apply.

26.2 As stated in the second sentence of paragraph 4, the obligation imposed by that paragraph generally is subject to the limitations contained in paragraph 3. An exception applies, however, that prevents a requested State from avoiding an obligation to supply information due to domestic laws or practices that include a domestic tax interest requirement. Thus, a requested State cannot avoid an obligation to supply information on the ground that its domestic laws or practices only permit it to supply information in which it has an interest for its own tax purposes.

26.3 For many countries, the combination of paragraph 4 and their domestic law provides a sufficient basis for using their information gathering measures to obtain the requested information even in the absence of a domestic tax interest in the information. Other countries, however, may wish to clarify expressly in the Convention that Contracting States must ensure that their competent authorities have the necessary powers to do so. Contracting States wishing to clarify this point may replace paragraph 4 with the following text:

4. In order to effectuate the exchange of information as provided in paragraph 1, each Contracting State shall take the necessary measures, including legislation, rulemaking, or administrative arrangements, to ensure that its competent authority has sufficient powers under its domestic law to obtain information for the exchange of information, regardless of whether that Contracting State may need such information for its own tax purposes.

Paragraph 5

27. Paragraph 5 was added to the United Nations Model Convention in 2011. It is taken directly from the comparable provision in the OECD Model Convention. As a result, the OECD Commentary to paragraph 5 is fully applicable in interpreting paragraph 5 of Article 26. The discussion below of secrecy limitations draws heavily from the OECD Commentary. The position taken in the OECD Commentary is that the addition of this paragraph was intended to assist in the interpretation of Article 26 and does not result in a substantive change in the obligations implicit in the prior version of Article 26.

27.1 Paragraph 1 imposes a positive obligation on a Contracting State to exchange all types of information. Paragraph 5 is intended to ensure that the limitations of paragraph 3 cannot be used to prevent the exchange of information held by banks, other financial institutions, nominees, agents and fiduciaries, as well as ownership information.

27.2 Paragraph 5 states that a requested State shall not decline to supply information to a requesting State solely because the information requested is held by a bank or other financial institution. Thus, paragraph 5 overrides paragraph 3 to the extent that paragraph 3 would otherwise permit a requested Contracting State to decline to supply information on grounds of domestic bank secrecy laws. Access to information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process. The procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information.

27.3 Paragraph 5 also provides that a Contracting State shall not decline to supply information solely because the information is held by persons acting in an agency or fiduciary capacity. For instance, if a Contracting State has a law under which all information held by a fiduciary is treated as a “professional secret” merely because it was held by a fiduciary, such State could not use such law as a basis for declining to provide the information held by the fiduciary to the other Contracting State. A person acts in a “fiduciary capacity” when the business which the person transacts, or the money or property which the person handles, is not its own or for its own benefit but is held for the benefit of another person and when the fiduciary stands in a relationship to that other person implying and necessitating confidence and trust on the one part and good faith on the other part. A trustee is a common example of a person acting in a fiduciary capacity. The term “agency” is very broad and includes all forms of corporate service providers (e.g. company formation agents, trust companies, registered agents, lawyers).

27.4 Paragraph 5 states that a Contracting State shall not decline to supply information solely because the requested information relates to an ownership interest in a person, which includes companies and partnerships, foundations or similar organizational structures. Information requests cannot be declined merely because domestic laws or practices may treat ownership information as a trade or other secret.

27.5 Although paragraph 5 limits the ability of a requested State to rely on paragraph 3 to refuse to supply information held by a bank, financial institution, a person acting in an agency or fiduciary capacity or to refuse to supply information relating to ownership interests, that paragraph does not eliminate all protection under paragraph 3. The requested State may continue to refuse to supply such information if that refusal is based on substantial reasons unrelated to the status of the holder of the requested information as a bank, financial institution, agent, fiduciary or nominee, or to the fact that the information relates to ownership interests.

27.6 A requested State is not necessarily prevented by paragraph 5 from declining under paragraph 3 (*b*) to supply information constituting a confidential communication between an attorney, solicitor, or other admitted legal representative and his client even if that person is acting in an agency capacity. To qualify for protection under paragraph 3 (*b*), however, a requested State must demonstrate that the communication between the attorney, solicitor, or other admitted legal representative and his client meets all the requirements of that paragraph, including that the communication is protected from disclosure under domestic law, that the refusal is unrelated to the status of the legal representative as an agent, fiduciary, or nominee, that any documents at issue were not delivered to the legal representative to avoid disclosure, and that non-disclosure would not frustrate an effective exchange of information.

27.7 Contracting States wishing to refer expressly to the protection afforded to confidential communications between a client and an attorney, solicitor or other admitted legal representative may do so by adding the following text at the end of paragraph 5:

Nothing in the above sentence shall prevent a Contracting State from declining to obtain or provide information which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative where such communications are protected from disclosure under paragraph 3 (*b*) and when the claim for protection under that paragraph is unrelated to the status of the legal representative as an agent, fiduciary, or nominee.

28. The following examples illustrate the application of paragraph 5:
- (a) Company X owns a majority of the stock in a subsidiary company Y, and both companies are incorporated under the laws of State A. State B is conducting a tax examination of business operations of company Y in State B. In the course of this examination the question of both direct and indirect ownership in company Y becomes relevant, and State B makes a request to State A for ownership information of any person in company Y's chain of ownership. In its reply, State A should provide to State B ownership information for both company X and company Y;
 - (b) An individual subject to tax in State A maintains a bank account with Bank B in State B. State A is examining the income tax return of the individual and makes a request to State B for all bank account income and asset information held by Bank B in order to determine whether there were deposits of untaxed earned income. State B should provide the requested bank information to State A;
 - (c) Bank A in State A is suspected of entering into secret letters of agreement with some of its depositors that direct the bank to pay interest earned by those depositors to an unrelated offshore bank. State B requests that State A provide it with copies of those secret letters of agreement. Bank A asserts that the letters of agreement are legal documents protected from disclosure under the lawyer-client privilege. State A should provide the requested documents.

Paragraph 6

29. The language of paragraph 6 was taken, with some changes, from the last sentence of paragraph 1 of the United Nations Model Convention before its amendment in 2011. Paragraph 6 specifically grants to the competent authorities the authority to establish procedures for an effective exchange of information. The OECD Model Convention does not contain paragraph 6 or an equivalent. The position taken in the OECD Commentary is that this authority is implicit in Article 26.

29.1 To carry out the exchange of information in accordance with the preceding paragraphs of this Article, paragraph 6 provides that the competent authorities of the Contracting States shall work together to establish procedures for the exchange of information, including routine exchanges, typically

in electronic form. Although paragraph 6 does not require them to make such arrangements in advance of the need for particular exchanges of information, this is strongly advisable to achieve an effective exchange of information.

29.2 Some States may wish to make explicit in their treaty that the competent authorities are obligated not only to exchange information on request but also to establish measures for automatic and spontaneous exchanges of information. Those countries may wish to add the following language to the end of paragraph 6:

In addition to responding to specific requests for information, the competent authorities shall exchange information on a routine and spontaneous basis. They shall agree from time to time on the types of information or documents which shall be furnished on a routine basis.

29.3 Some members of the Committee have expressed a concern that information requests from a developed country to a developing country could place excessive burdens on the tax department in the developing country, due to the different capacity of their tax administrations to obtain and provide information. That concern might be alleviated by making the requesting State responsible for material extraordinary costs associated with a request for information. In this context, the question of whether an extraordinary cost of obtaining requested information is material could be determined not by reference to some absolute amount but by reference to the cost relative to the total budget of the tax department being asked to provide information. For example, a small absolute cost might be material for a tax department with very limited resources, whereas a larger absolute cost might not be material for a well-funded department.

29.4 Countries concerned about imposing substantial costs on developing countries might include the following language at the end of paragraph 6:

Extraordinary costs incurred in providing information shall be borne by the Contracting Party which requests the information. The competent authorities of the Contracting Parties shall consult with each other in advance if the costs of providing information with respect to a specific request are expected to be extraordinary.

C. INVENTORY OF EXCHANGE MECHANISMS

30. Paragraphs 6 to 25 of the former Article 26 Commentary of the United Nations Model Convention, as set out below with some editorial changes, could be included in a handbook that deals with exchange mechanisms.

Routine transmittal of information

6. A method of exchange of information is that of the routine or automatic flow of information from one treaty country to another.⁵¹ The following are various aspects that the competent authorities should focus on in developing a structure for such routine exchanges. In considering routine exchanges of information, it should be recognized that some countries not desiring to receive such information in a routine fashion (or unable to receive it routinely because the transmitting countries do not routinely collect such information) may desire to obtain information of this type under a specific request. Hence, in these situations, items mentioned in the present section should be considered as available for coverage under the next section, entitled “Transmittal on specific request”.

Items covered

7. *Regular sources of income.* The items covered under a routine transmittal or exchange of information may extend to regular sources of income flowing between countries, such as dividends, interest, compensation (including wages, salaries, fees and commissions), royalties, rents and other possible items whose regular flow between the two countries is significant. It should be recognized that at present a few countries are not in a position to supply routine information of this type because their tax collection procedures do not provide the needed data.

Transactions involving taxpayer activity. A routine exchange of information may cover certain significant transactions involving taxpayer activity:

- (a) Transactions relevant to the treaty itself:
 - Claims for refund of transmitting country tax made by residents of receiving country;
 - Claims for exemption or particular relief from transmitting country tax made by residents of receiving country;
- (b) Transactions relevant to special aspects of the legislation of the transmitting country: items of income derived by residents of the receiving country that receive exemption or partial relief under special provisions of the national law of the transmitting country;

⁵¹The term “transmitting country” refers to the country transmitting information, and the term “receiving country” refers to the country receiving information.

- (c) Transactions relating to activities in the transmitting country of residents of the receiving country:
 - Opening and closing by receiving country residents of a branch, office, etc. in the transmitting country;
 - Creation or termination by receiving country residents of a corporation in the transmitting country;
 - Creation or termination by receiving country residents of a trust in the transmitting country;
 - Opening and closing by receiving country residents of bank accounts in the transmitting country;
 - Property in the transmitting country acquired by residents of the receiving country by inheritance, bequest or gift;
 - Ancillary probate proceedings in the transmitting country concerning receiving country residents;
- (d) General information:
 - Tax laws, administrative procedures, etc. of the transmitting country;
 - Changes in regular sources of income flowing between countries, especially as they affect the treaty, including administrative interpretations of and court decisions on treaty provisions and administrative practices or developments affecting application of the treaty;
 - Activities that affect or distort application of the treaty, including new patterns or techniques of evasion or avoidance used by residents of the transmitting or receiving country;
 - Activities that have repercussions regarding the tax system of the receiving country, including new patterns or techniques of evasion or avoidance used by residents of either country that significantly affect the receiving country's tax system.

General operational aspects to be considered

8. The competent authorities should consider various factors that may have a bearing on the operational character of the routine exchange, including its effectiveness. For example:

- (a) Countries that are more interested in receiving information on a specific request basis than on a routine basis, in their consideration of the specific request area, should keep in mind items mentioned in this inventory under the heading of routine information;

- (b) A minimum floor amount may be fixed to limit minor data;
- (c) The routine source of income items may be rotated from year to year, for example, dividends only in one year, interest in another, etc;
- (d) The information to be exchanged routinely need not be reciprocal in all items. Country A may be interested in receiving information on some items but not others; the preferences of country B may extend to different items; it is not necessary for either country to receive items in which it is not interested, nor should either country refuse to transmit information on certain items simply because it is not interested in receiving information on those items;
- (e) While the information to be exchanged on income items may not always be significant in itself as regards the income flows escaping tax, the routine exchange may provide indications respecting the degree to which the capital or other assets producing the income flows are escaping tax;
- (f) Whether the information on items of income should cover the payee only or also the payer is a further point to be taken into account;
- (g) Another factor to be considered is whether the information should cover only residents of the receiving country or also those domiciled therein or citizens thereof, or be limited to any of these categories;
- (h) The degree of detail involved in the reporting, e.g. name of taxpayer or recipient, profession, address, etc., may need to be taken into account;
- (i) The form and the language in which the information should be provided is a further point to be considered.

Factors to be considered by the transmitting country

9. The transmitting country may wish to give consideration to factors affecting its ability to fulfil the requirements of a routine exchange of information. Such a consideration would presumably lead to a more careful selection of the information to be routinely exchanged rather than to a decision not to exchange information that could be of practical use.

10. Among the factors to be considered are the administrative ability of the transmitting country to obtain the information involved.

This, in turn, is governed by the general effectiveness of its administrative procedures, its use of withholding taxes, its use of information returns from payers or others, and the overall costs of obtaining the information involved.

Factors to be considered by receiving country

11. The receiving country may wish to give consideration to factors affecting its ability to use the information that could be received under a routine exchange of information, such as the administrative ability of the receiving country to use the information on a reasonably current basis and effectively to associate such information with its own taxpayers, either routinely or on a sufficient scale to justify the routine receipt of the information.

Transmittal on specific request

12. A method of exchange of information that is in current use is that of a request for specific information made by one treaty country to another. The specific information may relate to a particular taxpayer and certain facets of his situation, or to particular types of transactions or activities, or to information of a more general character. The following are various aspects of the question that the competent authorities should focus on in developing a structure for such exchange of information pursuant to specific requests.

Items covered

13. *Particular taxpayers.* The information that may be desired from a transmitting country with respect to a receiving country taxpayer is essentially open-ended and depends on the factors involved in the situation of the taxpayer under the tax system of the receiving country and the relationship of the taxpayer and his activities to the transmitting country. A specific enumeration in advance of the type of information that may be within the scope of an exchange pursuant to specific request does not seem to be a fruitful or necessary task. The agreement to provide information pursuant to specific request may, thus, be open-ended as to the range, scope and type of information, subject to the overall constraints to be discussed herein.

14. The request for specific information may arise in a variety of ways. For example:

- (a) Information needed to complete the determination of a taxpayer's liability in the receiving country when that

liability depends on the taxpayer's worldwide income or assets; the nature of the stock ownership in the transmitting country of the receiving country corporation; the amount or type of expense incurred in the transmitting country; and the fiscal domicile of an individual or corporation;

- (b) Information needed to determine the accuracy of a taxpayer's tax return to the tax administration of the receiving country or the accuracy of the claims or proof asserted by the taxpayer in defence of the tax return when the return is regarded as suspect or is under actual investigation;
- (c) Information needed to determine the true liability of a taxpayer in the receiving country when it is suspected that his reported liability is wrong.

Particular types of transactions or activities. The exchange on specific request need not be confined to requests regarding particular taxpayers but may extend to requests for information on particular types of transactions or activities. For example:

- (a) Information on price, cost, commission or other such patterns in the transmitting country necessary to enable the tax administration of the receiving country either to determine tax liability in a particular situation or to develop standards for investigation of its taxpayers in situations involving possible under-or over-invoicing of exported or imported goods, the payment of commissions on international transactions and the like;
- (b) Information on the typical methods by which particular transactions or activities are customarily conducted in the transmitting country;
- (c) Information on whether a particular type of activity is being carried on in the transmitting country that may have effects on taxpayers or tax liabilities in the receiving country.

15. *Economic relationships between the countries.* The specific request may extend to requests for information regarding certain economic relationships between the countries which may be useful to a country as a check on the effectiveness of its tax administration activities, for example:

- (a) The volume of exports from the transmitting country to the receiving country;
- (b) The volume of imports into the transmitting country from the receiving country;

- (c) Names of banks dealing in the transmitting country with branches, subsidiaries etc. of residents of the receiving country.

It should be noted that since items in this category, such as the volume of exports between the countries, are presumably not regarded as secret to the tax authorities in the transmitting country, they may be disclosed generally in the receiving country, as provided in Article 26.

Rules applicable to the specific request

16. The competent authorities should develop rules applicable to the transmission of specific requests by the receiving country and to the response by the transmitting country. These rules should be designed to facilitate a systematic operational procedure regarding such exchange that is both efficient and orderly. While the rules may be general in character in the sense that they set standards or guidelines governing the specific request procedures, the rules should also permit discussion between the competent authorities of special situations that either country believes require special handling. The rules should pertain to:

- (a) The specificity of detail required in the request by the receiving country, the form of such request and the language of the request and reply;
- (b) The extent to which the receiving country must pursue or exhaust its own administrative processes and possibilities before making a specific request; presumably the receiving country should make a bona fide effort to obtain the information for itself before resorting to the specific request procedure;
- (c) The conditions affecting the nature and extent of the response by the transmitting country. This aspect should cover the ability of the transmitting country to provide documentary material when the receiving country needs material in that form for use in judicial or other proceedings, including the appropriate authentication of the documents.

Transmittal of information on discretionary initiative of transmitting country (spontaneous exchange)

17. The competent authorities should determine whether, in addition to the routine and specific request methods of exchange

of information under which a transmitting country is automatically transmitting information or systematically responding to specific requests by the receiving country, they desire a transmittal of information on the discretionary initiative of the transmitting country itself. Such a transmittal could occur when, in the course of its own activities, the tax administration of the transmitting country obtains information that it considers would be of importance to the receiving country. The information may relate to facets of a particular taxpayer's situation and the relationship of that situation to the taxpayer's liability in the receiving country or to the liability of other taxpayers in the receiving country. Or the information may relate to a pattern of transactions or conduct by various taxpayers or groups of taxpayers occurring in either country that is likely to affect the tax situation or tax administration of the receiving country in relation either to its national laws or to the treaty provisions.

18. The competent authorities will have to determine, under the standards governing the exchange of information developed pursuant to the treaty, whether it is the duty of a transmitting country affirmatively to develop a procedure and guidelines governing when such information is to be transmitted, whether such transmittal is to be considered by the transmitting country but is fully discretionary, or whether such transmittal need not even be considered by the transmitting country. Even if it is agreed that it is the duty of the transmitting country to develop a system for such transmittal, presumably the decision on when the conditions under that system have been met will rest on the discretionary judgement of the latter country.

Use of information received

19. The competent authorities will have to decide on the permissible use of the information received. The decisions on this matter basically depend on the legal requirements set forth in Article 26 itself. The extent of the use of information depends primarily on the requirements of national law regarding the disclosure of tax information or on other "security requirements" regarding tax information. This being so, it is possible that the extent of the disclosure or the restrictions on disclosure may vary between the two countries. However, such possible variance need not be regarded as inappropriate or as negating exchanges of information that would otherwise occur if the countries involved are satisfied with such a consequence under Article 26 as adopted in their Convention.

Recipients of information received through exchange

20. The competent authorities will have to specify, either in detail or by reference to existing comparable rules in the receiving country, who the qualifying recipients of information in that country are. Under Article 26 the information can be disclosed, for example:

- (a) To administrators of the taxes covered in the Convention;
- (b) To enforcement officials and prosecutors for such taxes;
- (c) To administrative tribunals for such taxes;
- (d) To judicial tribunals for such taxes;
- (e) In public court proceedings or in judicial decisions where it may become available to the public if considered appropriate;
- (f) To the competent authority of another country (see the section below entitled “Consultation among several competent authorities”).

The form in which information is provided

21. The permissible extent of the disclosure may affect the form in which the information is to be provided if it is to be useful to the receiving country. Thus, if the information may be used in judicial tribunals and if, to be so used, it must be of a particular character or form, then the competent authorities will have to consider how to provide for a transmittal that meets this need. (See also the comment on documents in the section above dealing with rules applicable to the specific request.)

Consultation among several competent authorities

22. Countries may wish to give consideration to procedures developed by the competent authorities for consultations covering more than the two competent authorities under a particular treaty. Thus, if countries A, B and C are joined in a network of treaties, the competent authorities of A, B and C might desire to hold a joint consultation. A joint meeting could be desired whether or not all three countries are directly intertwined by their treaty network. For example, the joint meeting might be desirable where there are A-B, A-C and B-C treaties, or where there are A-B and B-C treaties but not an A-C treaty. Countries desiring to have their competent authorities engage in such consultations should provide the legal basis for the consultations by

adding the necessary authority in their treaties. Some countries may feel that Article 26 permits joint consultation where all three countries are directly linked by bilateral treaties. However, the guideline⁵² does not cover joint consultation where a link in the chain is not fully joined, as in the second situation described above. In such a case, it would be necessary to add a treaty provision allowing the competent authority of country B to provide information received from country A to the competent authority of country C. Such a treaty provision could include a safeguard that the competent authority of country A must consent to the action of the competent authority of country B. Presumably, it would so consent only where it was satisfied as to the provisions regarding protection of secrecy in the B-C treaty.

Overall factors

23. There are a variety of overall factors affecting the exchanges of information that the competent authorities will have to consider and decide upon, either as to their specific operational handling in the implementation of the exchange of information or as to their effect on the entire exchange process itself. Such overall factors include those set out below:

Factors affecting implementation of exchange of information

These include the following:

- (a) The competent authorities should decide on the channels of communication for the different types of exchanges of information. One method of communication that may be provided for is to permit an official of one country to go in person to the other country to receive the information from the competent authority and discuss it so as to expedite the process of exchange of information;
- (b) Some countries may have decided that it is useful and appropriate for a country to have representatives of its own tax administration stationed in the other treaty country. Such an arrangement would presumably rest on authority, treaty or agreements other than that in the article on exchange of information of the envisaged double

⁵²See the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries [2003], Part Three, Chapter III., Section E. Available at: <http://www.un.org/esa/ffd/tax/>.

taxation treaty (although, if national laws of both countries permit, this article would be treated as covering this topic) and the arrangement would determine the conditions governing the presence of such representatives and their duties. In this regard, it should be noted that it would not seem necessary that the process be reciprocal, so that it would be appropriate for country A to have its representatives in country B but not vice-versa if country A considered the process to be useful and country B did not. If arrangements do exist for such representatives, then the competent authorities may want to coordinate with those representatives where such coordination would make the exchange of information process more effective and where such coordination is otherwise appropriate;

- (c) Some countries may decide it is appropriate to have a tax official of one country participate directly with tax officials of the other country in a joint or “team” investigation of a particular taxpayer or activity. The existence of the arrangement for most countries would presumably rest on authority, treaty or agreements other than that in the envisaged treaty article on exchange of information, although, if national laws of both countries permit, this article could be treated by the countries as authorizing the competent authorities to sanction this arrangement. In either event, if the arrangement is made, it would be appropriate to extend to such an investigation the safeguards and procedures developed under the envisaged treaty article on exchange of information;
- (d) The process of exchange of information should be developed so that it has the needed relevance to the effective implementation of the substantive treaty provisions. Thus, treaty provisions regarding intercompany pricing and the allocation of income and expenses produce their own informational requirements for effective implementation. The exchange of information process should be responsive to those requirements;
- (e) The substantive provisions of the treaty should take account of and be responsive to the exchange of information process. Thus, if there is an adequate informational base for the exchange of information process to support allowing one country to deduct expenses incurred in another

country, then the treaty should be developed on the basis of the substantive appropriateness of such deduction;

- (f) The competent authorities will have to determine to what extent there should be cost-sharing or cost reimbursement with respect to the process of exchange of information.

Factors affecting structure of exchange of information process

24. These include the following:

- (a) It should be recognized that the arrangements regarding exchange of information worked out by country A with country B need not parallel those worked out between country A and country C or between country B and country C. The arrangements should in the first instance be responsive to the needs of the two countries directly involved and need not be fully parallel in every case just for the sake of formal uniformity. However, it should be observed that prevention of international tax evasion and avoidance will often require international cooperation of tax authorities in a number of countries. As a consequence, some countries may consider it appropriate to devise procedures and treaty provisions that are sufficiently flexible to enable them to extend their cooperation to multi-country consultation and exchange arrangements;
- (b) The competent authorities will have to weigh the effect of a domestic legal restriction on obtaining information in a country that requests information from another country not under a similar domestic legal restriction. Thus, suppose country A requests information from country B, and the tax authorities in country B are able to go to their financial institutions to obtain such information, whereas the tax authorities in country A are generally not able to go to their own financial institutions to obtain information for tax purposes. How should the matter be regarded in country B? It should be noted that Article 26 here permits country B to obtain the information from its financial institutions and transmit it to country A. Thus, country B is not barred by its domestic laws regarding tax secrecy if it decides to obtain and transmit the information. Thus, it becomes a matter of discretion in country B as to whether it should respond, and may perhaps become a matter for negotiation between the competent authorities. It should

be noted that many countries in practice do respond in this situation and that such a course is indeed useful in achieving effective exchange of information to prevent tax avoidance. However, it should also be noted that country A, being anxious to obtain information in such cases from other countries, should also recognize its responsibility to try to change its domestic laws to strengthen the domestic authority of its own tax administration and to enable it to respond to requests from other countries. It should be noted that a country that has entered into a tax convention that includes paragraph 5 of Article 26 of the United Nations Model Convention is required to provide information to its treaty partner notwithstanding its domestic bank secrecy laws;

- (c) In addition to situations involving the legal imbalance discussed above, the competent authorities will have to weigh the effects of a possible imbalance growing out of a divergence in other aspects of tax administration. Thus, if country A cannot respond as fully to a request as country B can because of practical problems of tax administration in country A, then might the level of the process of exchange of information be geared to the position of country A? Or, in general or in particular aspects, should country B be willing to respond to requests of country A even when country A would not be able to respond to requests of country B? This matter is similar to that discussed in the preceding paragraph and a similar response should be noted;
- (d) It should be noted that Article 26 authorizes a transmitting country to use its administrative procedures solely to provide information to the requesting country, even when the person about whom information is sought is not involved in a tax proceeding in the transmitting country. Moreover, the transmitting country should, for the purpose of exchange of information, use its own administrative authority in the same way as if its own taxation were involved;
- (e) The competent authorities will have to weigh the effect on the process of exchange of information of one country's belief that the tax system or tax administration of the other country, either in general or in particular situations, is discriminatory or confiscatory. It may be that further exploration of such a belief could lead to substantive provisions in

the treaty or in national law that would eliminate the problems perceived by the first country and thereby facilitate a process of exchange of information. One possible example of this is the treatment of non-permanent residents;

- (f) The competent authorities will have to weigh the effects that the process of exchange of information may have on the competitive position of taxpayers of the countries involved. Thus, if country A has a treaty with country B providing for exchange of information, country A will have to weigh the effect on the structure or process of that exchange of the fact that country C does not have a treaty with country B, so that firms of country C doing business in country B may be subject to a different tax posture in country B than firms of country A. Similarly, even if a treaty with an exchange of information article exists between countries C and B, if the tax administration of country A has more authority to obtain information (to be exchanged with country B) than does the tax administration of country C, or is otherwise more effective in its administration, and therefore, has more information, then a similar difference in tax posture may result. As a corollary, it seems clear that the adequate implementation of exchange of information provisions requires a universal effort of tax administrations to obtain and develop under national laws a capacity for securing information and a competence in utilizing information that is appropriate to a high level of efficient and equitable tax administration.

Periodic consultation and review

25. Since differences in interpretation and application, specific difficulties and unforeseen problems and situations are bound to arise, provision must be made for efficient and expeditious consultation between the competent authorities. Such consultation should extend both to particular situations and problems and to periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.

Article 27

ASSISTANCE IN THE COLLECTION OF TAXES

1. This Article provides the rules under which Contracting States⁵³ may agree to provide each other assistance in the collection of taxes. In some States, national law or policy may prevent this form of assistance or set limitations to it. Also, in some cases, administrative considerations may not justify providing assistance in the collection of taxes to another State or may similarly limit it. During the negotiations each Contracting State will therefore need to decide whether and to what extent assistance should be given to the other State based on various factors, including:

- the stance taken in national law to providing assistance in the collection of other States' taxes;
- whether and to what extent the tax systems, tax administrations and legal standards of the two States are similar, particularly as concerns the protection of fundamental taxpayers' rights (e.g. timely and adequate notice of claims against the taxpayer, the right to confidentiality of taxpayer information, the right to appeal, the right to be heard and present argument and evidence, the right to be assisted by a counsel of the taxpayer's choice, the right to a fair trial, etc.);
- whether assistance in the collection of taxes will provide balanced and reciprocal benefits to both States;
- whether each State's tax administration will be able to effectively provide such assistance;
- whether the cost of assistance is not too high for the requested State with regard to the money at stake;
- whether trade and investment flows between the two States are sufficient to justify this form of assistance; or
- whether, for constitutional or other reasons, the taxes to which the Article applies should be limited.

The Article should only be included in the Convention where each State concludes that, based on these factors, they can agree to provide assistance in the collection of taxes levied by the other State.

⁵³Throughout this Commentary on Article 27, the State making a request for assistance is referred to as the "requesting State" whilst the State from which assistance is requested is referred to as the "requested State".

2. The Article provides for comprehensive collection assistance. Some States may prefer to provide a more limited type of collection assistance. This may be the only form of collection assistance that they are generally able to provide or that they may agree to in a particular convention. For instance, a State may want to limit assistance to cases where the benefits of the Convention (e.g. a reduction of taxes in the State where income such as interest arises) have been claimed by persons not entitled to them. States wishing to provide such limited collection assistance are free to adopt bilaterally an alternative Article drafted along the following lines:

Article 27

ASSISTANCE IN THE COLLECTION OF TAXES

1. The Contracting States shall lend assistance to each other in the collection of tax to the extent needed to ensure that any exemption or reduced rate of tax granted under this Convention shall not be enjoyed by persons not entitled to such benefits. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.
2. In no case shall the provisions of this Article be construed so as to impose on a Contracting State the obligation:
 - a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
 - b) to carry out measures which would be contrary to public policy (*ordre public*).

Paragraph 1

3. This paragraph contains the principle that a Contracting State is obliged to assist the other State in the collection of taxes owed to it, provided that the conditions of the Article are met. Paragraphs 3 and 4 provide the two forms that this assistance will take.

4. The paragraph also provides that assistance under the Article is not restricted by Articles 1 and 2. Assistance must therefore be provided as regards a revenue claim owed to a Contracting State by any person, whether or not a resident of a Contracting State. Some Contracting States may, however,

wish to limit assistance to taxes owed by residents of either Contracting State. Such States are free to restrict the scope of the Article by omitting the reference to Article 1 from the paragraph.

5. Paragraph 1 of the Article applies to the exchange of information for purposes of the provisions of this Article. The confidentiality of information exchanged for purposes of assistance in collection is thus ensured.

6. The paragraph finally provides that the competent authorities of the Contracting States may, by mutual agreement, decide the details of the practical application of the provisions of the Article.

7. Such agreement should, in particular, deal with the documentation that should accompany a request made pursuant to paragraph 3 or 4. It is common practice to agree that a request for assistance will be accompanied by such documentation as is required by the law of the requested State, or has been agreed to by the competent authorities of the Contracting States, and that is necessary to undertake, as the case may be, collection of the revenue claim or measures of conservancy. Such documentation may include, for example, a declaration that the revenue claim is enforceable and is owed by a person who cannot, under the law of the requesting State, prevent its collection or an official copy of the instrument permitting enforcement in the requesting State. An official translation of the documentation in the language of the requested State should also be provided. It could also be agreed, where appropriate, that the instrument permitting enforcement in the requesting State shall, where appropriate and in accordance with the provisions in force in the requested State, be accepted, recognized, supplemented or replaced as soon as possible after the date of the receipt of the request for assistance, by an instrument permitting enforcement in the latter State.

8. The agreement should also deal with the issue of the costs that will be incurred by the requested State in satisfying a request made under paragraph 3 or 4. In general, the costs of collecting a revenue claim are charged to the debtor but it is necessary to determine which State will bear costs that cannot be recovered from that person. The usual practice, in this respect, is to provide that in the absence of an agreement specific to a particular case, ordinary costs incurred by a State in providing assistance to the other State will not be reimbursed by that other State. Ordinary costs are those directly and normally related to the collection, i.e. those expected in normal domestic collection proceedings. In the case of extraordinary costs, however, the practice is to provide that these will be borne by the requesting State, unless otherwise agreed bilaterally. Such costs would cover, for instance, costs incurred when a particular type of procedure has been used at the request of the other

State or supplementary costs of experts, interpreters or translators. Most States also consider as extraordinary costs the costs of judicial and bankruptcy proceedings. The agreement should provide a definition of extraordinary costs and consultation between the Contracting States should take place in any particular case where extraordinary costs are likely to be involved. It should also be agreed that, as soon as a Contracting State anticipates that extraordinary costs may be incurred, it will inform the other Contracting State and indicate the estimated amount of such costs so that the other State may decide whether such costs should be incurred. It is, of course, also possible for the Contracting States to provide that costs will be allocated on a basis different from what is described above; this may be necessary, for instance, where a request for assistance in collection is suspended or withdrawn under paragraph 7 or where the issue of costs incurred in providing assistance in collection is already dealt with in another legal instrument applicable to these States. Finally, the agreement shall take into account the differences in development of Contracting States. It could therefore be agreed that all costs, including ordinary costs, will be borne by one State only. In such a case, the Contracting States will have to agree on the costs. These could for instance be determined on the basis of a fixed amount.

9. In the agreement, the competent authorities may also deal with other practical issues such as:

- whether there should be a limit of time after which a request for assistance could no longer be made as regards a particular revenue claim;
- what should be the applicable exchange rate when a revenue claim is collected in a currency that differs from the one which is used in the requesting State;
- how any amount collected pursuant to a request under paragraph 3 should be remitted to the requesting State; or
- whether there should be a minimum threshold below which assistance will not be provided.

Paragraph 2

10. Paragraph 2 defines the term “revenue claim” for the purposes of the Article. The definition applies to any amount owed in respect of all taxes that are imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, but only insofar as the imposition of such taxes is not contrary to the Convention or other instrument in force between the Contracting States. It also applies to the interest, administrative penalties

and costs of collection or conservancy that are related to such an amount. Assistance is therefore not restricted to taxes to which the Convention generally applies pursuant to Article 2, as is confirmed in paragraph 1.

11. Some Contracting States may prefer to limit the application of the Article to taxes that are covered by the Convention under the general rules of Article 2. States wishing to do so should replace paragraphs 1 and 2 by the following:

1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Article 1. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.

2. The term “revenue claim” as used in this Article means any amount owed in respect of taxes covered by the Convention together with interest, administrative penalties and costs of collection or conservancy related to such amount.

12. Similarly, some Contracting States may wish to limit the types of tax to which the provisions of the Article will apply or to clarify the scope of application of these provisions by including in the definition a detailed list of the taxes. States wishing to do so are free to adopt bilaterally the following definition:

The term “revenue claim” as used in this Article means any amount owed in respect of the following taxes imposed by the Contracting States, together with interest, administrative penalties and costs of collection or conservancy related to such amount:

(a) (in State A): __

(b) (in State B): __

13. In order to make sure that the competent authorities can freely communicate information for purposes of the Article, Contracting States should ensure that the Article is drafted in a way that allows exchanges of information with respect to any tax to which this Article applies.

14. Nothing in the Convention prevents the application of the provisions of the Article to revenue claims that arise before the Convention enters into force, as long as assistance with respect to these claims is provided after the treaty has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such revenue claims, in particular when the provisions concerning the entry into force of their Convention provide that the provisions of that Convention will have effect

with respect to taxes arising or levied from a certain time. States wishing to restrict the application of the Article to claims arising after the Convention enters into force are also free to do so in the course of bilateral negotiations.

Paragraph 3

15. This paragraph stipulates the conditions under which a request for assistance in collection can be made. The revenue claim has to be enforceable under the law of the requesting State and be owed by a person who, at that time, cannot, under the law of that State, prevent its collection. This will be the case where the requesting State has the right, under its internal law, to collect the revenue claim and the person owing the amount has no administrative or judicial rights to prevent such collection.

16. In many States, a revenue claim can be collected even though there is still a right to appeal to an administrative body or a court as regards the validity or the amount of the claim. If, however, the internal law of the requested State does not allow it to collect its own revenue claims when appeals are still pending, the paragraph does not authorise it to do so in the case of revenue claims of the other State in respect of which such appeal rights still exist even if this does not prevent collection in that other State. Indeed, the phrase “collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State” has the effect of making that requested State’s internal law restriction applicable to the collection of the revenue claim of the other State. Many States, however, may wish to allow collection assistance where a revenue claim may be collected in the requesting State notwithstanding the existence of appeal rights, even though the requested State’s own law prevents collection in that case. States wishing to do so are free to modify paragraph 3 to read as follows:

When a revenue claim of a Contracting State is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State that met the conditions allowing that other State to make a request under this paragraph.

17. Paragraph 3 also regulates the way in which the revenue claim of the requesting State is to be collected by the requested State. Except with respect to time limits and priority (see the Commentary on paragraph 5), the requested State is obliged to collect the revenue claim of the requesting State as though it were the requested State's own revenue claim, even if, at the time, it has no need to undertake collection actions related to that taxpayer for its own purposes. As already mentioned, the phrase "in accordance with the provisions of its law applicable to the enforcement and collection of its own taxes" has the effect of limiting collection assistance to claims with respect to which no further appeal rights exist if, under the requested State's internal law, collection of that State's own revenue claims are not permitted as long as such rights still exist.

18. It is possible that the request may concern a tax that does not exist in the requested State. The requesting State shall indicate where appropriate the nature of the revenue claim, the components of the revenue claim, the date of expiry of the claim and the assets from which the revenue claim may be recovered. The requested State will then follow the procedure applicable to a claim for a tax of its own which is similar to that of the requesting State or any other appropriate procedure if no similar tax exists.

Paragraph 4

19. In order to safeguard the collection rights of a Contracting State, this paragraph enables it to request the other State to take measures of conservancy even where it cannot yet ask for assistance in collection, e.g. when the revenue claim is not yet enforceable or when the debtor still has the right to prevent its collection. This paragraph should only be included in conventions between States that are able to take measures of conservancy under their own laws. Also, States that consider that it is not appropriate to take measures of conservancy in respect of taxes owed to another State may decide not to include the paragraph in their conventions or to restrict its scope. In some States, measures of conservancy are referred to as "interim measures" and such States are free to add these words to the paragraph to clarify its scope in relation to their own terminology.

20. One example of measures to which the paragraph applies is the seizure or the freezing of assets before final judgement to guarantee that these assets will still be available when collection can subsequently take place. The conditions required for the taking of measures of conservancy may vary from one State to another but in all cases the amount of the revenue claim should be determined beforehand, if only provisionally or partially. A request for

measures of conservancy as regards a particular revenue claim cannot be made unless the requesting State can itself take such measures with respect to that claim (see the Commentary on paragraph 8).

21. In making a request for measures of conservancy the requesting State should indicate in each case what stage in the process of assessment or collection has been reached. The requested State will then have to consider whether in such a case its own laws and administrative practice permit it to take measures of conservancy.

Paragraph 5

22. Paragraph 5 first provides that the time limits of the requested State, i.e. time limitations beyond which a revenue claim cannot be enforced or collected, shall not apply to a revenue claim in respect of which the other State has made a request under paragraph 3 or 4. Since paragraph 3 refers to revenue claims that are enforceable in the requesting State and paragraph 4 to revenue claims in respect of which the requesting State can take measures of conservancy, it follows that it is the time limits of the requesting State that are solely applicable.

23. Thus, as long as a revenue claim can still be enforced or collected (paragraph 3) or give rise to measures of conservancy (paragraph 4) in the requesting State, no objection based on the time limits provided under the laws of the requested State may be made to the application of paragraph 3 or 4 to that revenue claim. States which cannot agree to disregard their own domestic time limits should amend paragraph 5 accordingly.

24. The Contracting States may agree that after a certain period of time the obligation to assist in the collection of the revenue claim no longer exists. The period should run from the date of the original instrument permitting enforcement. Legislation in some States requires renewal of the enforcement instrument, in which case the first instrument is the one that counts for purposes of calculating the time period after which the obligation to provide assistance ends.

25. Paragraph 5 also provides that the rules of both the requested (first sentence) and requesting (second sentence) States giving their own revenue claims priority over the claims of other creditors shall not apply to a revenue claim in respect of which a request has been made under paragraph 3 or 4. Such rules are often included in domestic laws to ensure that tax authorities can collect taxes to the fullest possible extent.

26. The rule according to which the priority rules of the requested State do not apply to a revenue claim of the other State in respect of which a request for assistance has been made applies even if the requested State must generally treat that claim as its own revenue claim pursuant to paragraphs 3 and 4. States wishing to provide that revenue claims of the other State should have the same priority as is applicable to their own revenue claims are free to amend the paragraph by deleting the words “or accorded any priority” in the first sentence.

27. The words “by reason of their nature as such”, which are found at the end of the first sentence, indicate that the time limits and priority rules of the requested State to which the paragraph applies are only those that are specific to unpaid taxes. Thus, the paragraph does not prevent the application of general rules concerning time limits or priority which would apply to all debts (e.g. rules giving priority to a claim by reason of that claim having arisen or having been registered before another one).

Paragraph 6

28. This paragraph ensures that any legal or administrative objection concerning the existence, validity or the amount of a revenue claim of the requesting State shall not be dealt with by the requested State’s courts or administrative bodies. Thus, no legal or administrative proceedings, such as a request for judicial review, shall be undertaken in the requested State with respect to these matters. The main purpose of this rule is to prevent administrative or judicial bodies of the requested State from being asked to decide matters which concern whether an amount, or part thereof, is owed under the internal law of the other State. Any legal actions contesting the recovery measures taken by the requested State can, of course, be brought before the competent judicial authorities of that State. States in which the paragraph may raise constitutional or legal difficulties may amend or omit it in the course of bilateral negotiations.

Paragraph 7

29. This paragraph provides that if, after a request has been made under paragraph 3 or 4, the conditions that applied when such request was made cease to apply (e.g. a revenue claim ceases to be enforceable in the requesting State), the State that made the request must promptly notify the other State of this change of situation. Following the receipt of such a notice, the requested State has the option to ask the requesting State to either suspend or withdraw

the request. If the request is suspended, the suspension should apply until such time as the State that made the request informs the other State that the conditions necessary for making a request as regards the relevant revenue claim are again satisfied, or that it withdraws its request.

Paragraph 8

30. This paragraph contains certain limitations to the obligations imposed on the State which receives a request for assistance.

31. The requested State is at liberty to refuse to provide assistance in the cases referred to in the paragraph. However, if it does provide assistance in these cases, such assistance remains within the framework of the Article and it cannot be objected that this State has failed to observe the provisions of the Article.

32. In the first place, the paragraph contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice or those of the other State in fulfilling its obligations under the Article. Thus, if the requesting State has no domestic power to take measures of conservancy, the requested State could decline to take such measures on behalf of the requesting State. Similarly, if the seizure of assets to satisfy a revenue claim is not permitted in the requested State, that State is not obliged to seize assets when providing assistance in collection under the provisions of the Article. However, types of administrative measures authorised for the purpose of the requested State's tax must be utilised, even though invoked solely to provide assistance in the collection of taxes owed to the requesting State.

33. Paragraph 5 of the Article provides that a Contracting State's time limits will not apply to a revenue claim in respect of which the other State has requested assistance. Subparagraph (a) is not intended to defeat that principle. Providing assistance with respect to a revenue claim after the requested State's time limits have expired will not, therefore, be considered to be at variance with the laws and administrative practice of that or of the other Contracting State in cases where the time limits applicable to that claim have not expired in the requesting State.

34. Subparagraph (b) includes a limitation to carrying out measures contrary to public policy (*ordre public*). As is the case under Article 26 (see paragraph 19 of the Commentary on Article 26), it has been felt necessary to prescribe a limitation with regard to assistance which may affect the vital interests of the State itself.

35. Under subparagraph (c), a Contracting State is not obliged to satisfy the request if the other State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice.

36. Finally, under subparagraph (d), the requested State may also reject the request for practical considerations, for instance if the costs that it would incur in collecting a revenue claim of the requesting State would exceed the amount of the revenue claim.

37. Some States may wish to add to the paragraph a further limitation, already found in the joint Council of Europe-OECD multilateral Convention on Mutual Administrative Assistance in Tax Matters, which would allow a State not to provide assistance if it considers that the taxes, with respect to which assistance is requested, are imposed contrary to generally accepted taxation principles.

Article 28

MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Article 28 of the United Nations Model Convention reproduces Article 28 of the OECD Model Convention. The Commentary of that Article is therefore relevant:

1. The aim of the provision is to secure that members of diplomatic missions and consular posts shall, under the provisions of a double taxation convention, receive no less favourable treatment than that to which they are entitled under international law or under special international agreements.

2. The simultaneous application of the provisions of a double taxation convention and of diplomatic and consular privileges conferred by virtue of the general rules of international law, or under a special international agreement may, under certain circumstances, have the result of discharging, in both Contracting States, tax that would otherwise have been due. As an illustration, it may be mentioned that *e.g.* a diplomatic agent who is accredited by State A to State B and derives royalties, or dividends from sources in State A will not, owing to international law, be subject to tax in State B in respect of this income and may also, depending upon the provisions of the bilateral convention between the two States, be entitled as a resident of State B to an exemption from, or a reduction of, the tax

imposed on the income in State A. In order to avoid tax reliefs that are not intended, the Contracting States are free to adopt bilaterally an additional provision which may be drafted on the following lines:

Insofar as, due to fiscal privileges granted to members of diplomatic missions and consular posts under the general rules of international law or under the provisions of special international agreements, income or capital are not subject to tax in the receiving State, the right to tax shall be reserved to the sending State.

3. In many OECD member countries, the domestic laws contain provisions to the effect that members of diplomatic missions and consular posts whilst abroad shall for tax purposes be deemed to be residents of the sending State. In the bilateral relations between member countries in which provisions of this kind are operative internally, a further step may be taken by including in the Convention specific rules that establish, for purposes of the Convention, the sending State as the State of residence of the members of the diplomatic missions and consular posts of the Contracting States. The special provision suggested here could be drafted as follows:

Notwithstanding the provisions of Article 4, an individual who is a member of a diplomatic mission or a consular post of a Contracting State which is situated in the other Contracting State or in a third State shall be deemed for the purposes of the Convention to be a resident of the sending State if:

- a) in accordance with international law he is not liable to tax in the receiving State in respect of income from sources outside that State or on capital situated outside that State, and
- b) he is liable in the sending State to the same obligations in relation to tax on his total income or on capital as are residents of that State.

4. By virtue of paragraph 1 of Article 4⁵⁴ the members of diplomatic missions and consular posts of a third State accredited to a Contracting State, are not deemed to be residents of the receiving State if they are only subject to a limited taxation in that State [...]. This consideration also holds true of the international organisations established in a Contracting State and their officials as they usually benefit from certain fiscal privileges either under the convention or treaty establishing the organisation or under a treaty between the

⁵⁴This paragraph will not apply to those bilateral agreements which omit the second sentence of paragraph 1 of Article 4.

organisation and the State in which it is established. Contracting States wishing to settle expressly this question, or to prevent undesirable tax reliefs, may add the following provision to this Article:

The Convention shall not apply to international organisations, to organs or officials thereof and to persons who are members of a diplomatic mission or a consular post of a third State, being present in a Contracting State and not treated in either Contracting State as residents in respect of taxes on income or on capital.

This means that international organisations, organs or officials who are liable in a Contracting State in respect only of income from sources therein should not have the benefit of the Convention.

5. Although honorary consular officers cannot derive from the provisions of the Article any privileges to which they are not entitled under the general rules of international law (there commonly exists only tax exemption for payments received as consideration for expenses honorary consuls have on behalf of the sending State), the Contracting States are free to exclude, by bilateral agreement, expressly honorary consular officers from the application of the Article.

Commentary on chapter VII

FINAL PROVISIONS

Articles 29 and 30

ENTRY INTO FORCE AND TERMINATION

Articles 29 and 30 of the United Nations Model Convention reproduce Articles 30 and 31 of the OECD Model Convention. The Commentary on the latter Articles is therefore relevant:

1. The present provisions on the procedure for entry into force, ratification and termination are drafted for bilateral conventions and correspond to the rules usually contained in international treaties.
2. Some Contracting States may need an additional provision in the first paragraph of Article 30 indicating the authorities which have to give their consent to the ratification. Other Contracting States may agree that the Article should indicate that the entry into force takes place after an exchange of notes confirming that each State has completed the procedures required for such entry into force.
3. It is open to Contracting States to agree that the Convention shall enter into force when a specified period has elapsed after the exchange of the instruments of ratification or after the confirmation that each State has completed the procedures required for such entry into force.
4. No provisions have been drafted as to the date on which the Convention shall have effect or cease to have effect, since such provisions would largely depend on the domestic laws of the Contracting States concerned. Some of the States assess tax on the income received during the current year, others on the income received during the previous year, others again have a fiscal year which differs from the calendar year. Furthermore, some conventions provide, as regards taxes levied by deduction at the source, a date for the application or termination which differs from the date applying to taxes levied by assessment.
5. As it is of advantage that the Convention should remain in force at least for a certain period, the Article on termination provides that notice of termination can only be given after a certain year, to be fixed by bilateral agreement. It is open to the Contracting States to decide upon the earliest year during which such notice can be given or even to agree not to fix any such year, if they so desire.



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