The agreed commentary changes represent new paragraphs 20.1 to 20.4 of the commentary of the United Nations Model Convention, which would be inserted between quoted paragraphs 21.1 and 22 of the commentary of the OECD Model Convention (at page 175 of the United Nations Model Convention). The commentary, following the decisions with the insertion (in bold), would then read:

“…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.” [para. 21]

“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, and ‘abuse of rights’ principle, or any similar doctrine.” [para. 21.1]

20.1. 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.

20.2. The above 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 ijara² (where assimilated to finance lease), as well as sukuk based on such instruments.

20.3. 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

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1 See paragraphs 76-78 of the Report of the 4th Session; E/2008/45.
2 For more details regarding these instruments, see the Manual for Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (secretariat note: relevant reference will be provided upon preparation of revised version of the Manual).
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”.

20.4. It is clear that the above does not apply to Islamic financial instruments the economic substance of which cannot be considered as a loan.

20.5 The OECD commentary then continues:

“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 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 pro rata temporis 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.” [para. 22]

“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 civils" 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.” [para. 23]