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Items of the provisional agenda*:
6(a) Issues related to updating of the United Nations Model Tax Convention: Items (i) – (xi)

Model Tax Convention - Issues for consideration by the Committee

Note by the Secretariat[1]

This note gives a brief background of the issues involved and history of the various items for consideration as agenda item 6(a) at the ninth annual session of the Committee of Experts on International Cooperation in Tax Matters. This is particularly for the benefit of new members of the Committee. As indicated in relation to the sub-items of this agenda item, this note does not address sub-items to be addressed in other notes.

* E/C.18/2012/1.
[1] This paper was prepared by the Secretariat. It is an overview of the "state of play" solely to assist Committee consideration and should not be taken as reflecting particular views on substantive issues.

A. Introduction

1. There are a range of specific issues on the provisional agenda for the annual session that involve consideration of the UN Model Tax Convention (the UN Model). Work in this area would be expected to feed into the next version of the UN Model, which should be completed within the four year terms of current Members.

2. The mandate of the Committee contained in Economic and Social Council resolution 2004/69 specifically refers to its role to "keep under review and update as necessary the [UN Model]" while noting that the Committee should "give special attention to developing countries and countries with economies in transition" in dealing with this and other aspects of its mandate. The agenda sub-items dealing with the Model for the ninth annual session of the Committee as Item 6(a) are as follows, with some explanation of the issues and prior discussions:

B. Agenda Sub-items

(i) Article 4 (resident): application of treaty rules to hybrid entities;

3. At its seventh annual session in 2011, the Committee decided as follows, as noted in the Report of that session:

> 118. With the latest update of the United Nations Model Convention completed, the Committee considered that it would be useful to examine a series of issues by having papers presented for discussion at the eighth session, in 2012. The question of whether to create subcommittees or working groups would be considered as part of that discussion. In that regard, the Committee decided that:
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> - Victor Thuronyi would provide a paper on hybrid entities, focusing on the classification of non-resident entities [….]

4. Mr. Thuronyi provided a paper for the Committee entitled "Note on Coordination Rules as a Solution to Tax Arbitrage" (E/C.18/2012/CRP.7) for the eight annual session of the Committee in 2012. The Report for that annual session records the discussions of the note and outcomes as follows:

> 87. The main finding of the paper was that international arbitrage, based on situations where a transaction, for tax purposes, is treated differently by the countries having an interest in the transaction will become more frequent as the taxpayer(s) seek to take advantage of that inconsistent tax treatment across different tax jurisdictions. In his paper Mr. Thuronyi proposed that even in the case of different tax policies, countries may reduce such arbitrage by instituting harmonization or coordination rules. Such rules would, in particular, seek to eliminate dual residency issues.
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> 88. The participants recognized the issue of arbitrage in relation to hybrid entities as an important one that needs to be studied further. There was caution within the Committee, however, about at addressing the issue too broadly. After some discussion, it was agreed that the immediate way forward was to first tackle the problem within the application of a treaty and country experience, including the

experiences of developing countries. Henry Louie, a Vice-Chair of the Committee, offered to produce a paper presenting how treaty provisions are applied in this context, within the United States of America, including examples where benefits are given or denied, and why. Mr. Louie's offer was accepted. It was decided that Mr. Thuronyi's paper would also be made available at the ninth session as a useful elaboration of some of the issues. He was thanked for his contribution.

(ii) Article 5 (permanent establishment)

(a) the meaning of "connected projects"

5. As part of its desire to consider a series of issues in 2012, the Committee (at its seventh session in 2011) requested a paper from the then Committee member Ms.Claudine Devillet on the meaning of "connected" in relation to article 5. It noted in its Report of the annual session that:

> 31. It was necessary to clarify in paragraph 12, the meaning of the word "connected" to describe projects that were sufficiently related to be added together, and it was decided to include that question in the catalogue of issues.

6. The paper that resulted from the Committee's request was "Note on United Nations Model Tax Convention Article 5: The Meaning of 'Connected Projects" E/C.18/2012/CRP.5. The paper was considered by the Committee and the Report of the eighth annual session in 2012 notes:

> 64. The discussion on the topic of connected projects was facilitated by a note prepared by Claudine Devillet (E/C.18/2012/CRP.5), which addressed the provision in article 5 (3) (b), which states that:
>
> > "3. The term 'permanent establishment' also encompasses: […]
> > "(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 within any 12-month period commencing or ending in the fiscal year concerned."
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> 65. In presenting her note, Ms. Devillet recalled the mandate given by the Committee at its previous session that a note be prepared to clarify the meaning of "connected projects" within the context of article 5 (3) (b). She mentioned that the main finding of the Subcommittee on the Taxation of Services was that the term was used as a criterion to determine whether or not there was a permanent establishment when services are performed in the source country by employees or other personnel of a non-resident entity for a period determined by the threshold, which in this case was a threshold presence of more than 183 days. In this regard, the question whether different projects could be grouped together is vital for the purposes of the "presence test".

66. Ms. Devillet indicated, however, that another member of the Committee and the Subcommittee, Anita Kapur, had a different understanding about the physical presence of personnel rendering services in a source country, and she invited Ms. Kapur to outline her position. Ms. Kapur indicated that she agreed that the service has to be furnished to an entity in the source State, but she disagreed with the fact that the performance of the service had to take place in the source State. Ms. Kapur considered that the physical presence of personnel or employees is not required by the wording of the article, which talks about where the service is furnished and not where it is performed. The requirement that "activities of that nature continue within a Contracting State" did not, in her view, imply "performance" in that State — it would meet this test if the service was furnished to the Contracting State. There was some discussion about these two interpretations, but no conclusion was reached.

67. Ms. Devillet also indicated that article 7 (1) (c) of the United Nations Model Convention, which deals with "force of attraction", might eventually be the appropriate place to resume with Ms. Kapur's concerns. Ms. Devillet further pointed out that the purpose of the paper is to explain the meaning of connected projects in the context of article 5 (3) (b).

68. The nature and forms of providing services has changed over the years. In this context, it is not uncommon for services to be furnished in a country by an entity from outside that country after a physical presence of a short duration of time, sometimes only to ensure the installation of equipment. In such cases, some speakers argued that the wording of the Model text may establish the existence of a permanent establishment if other necessary conditions are met, but other participants expressed the view that such an interpretation could not be supported by the language of article 5 (3) (b) and sound treaty interpretation. Some speakers also explained that they, as treaty negotiators, had agreed to the language of article 5 (3) (b) with the understanding that it required that the services require a physical presence in the source State for a service permanent establishment to exist.

69. In the discussion, a majority of those speaking considered that a physical presence was required by article 5 (3) (b). There were, however, speakers who considered that the text of article 5 (3) (b) was not so clear and who suggested that countries that want to make sure that a physical presence is required should use a text that clearly makes such a requirement, for example the alternative text in the OECD Model. There were other speakers who did not consider a physical presence as necessary to apply the provision.

70. A member of the Committee suggested that the session should not just try to avoid difficulties or dismiss concerns raised by a number of countries as these diverging views on interpretation may potentially end up in conflicts, or in court, with costly financial implications for taxpayers and national administrations. The work of the Committee ought to be focused on assisting countries by pointing out these diverging views so that when countries enter bilateral tax treaty negotiations these matters can be discussed and resolved. A paper discussing these options was recommended.

71. Following that recommendation, Ms. Devillet explained why the use of the provision "same or connected projects" should be regarded from the point of view

of the enterprise furnishing the service and not from the perspective of the consumer, a view which is consistent with the OECD commentary. In fact, she argued, if an enterprise provides services to a consumer for two different projects through two different departments using different personnel, then the two projects are not related and therefore the provision on “same or connected projects” cannot be applicable. She indicated, however, that two members of the Subcommittee disagreed with that understanding.

72. The comment provided by Liselott Kana concerned the fact that in the OECD commentary, the point of view of the enterprise furnishing a service is considered only in the case of the “same” project, therefore the point of view could not automatically be assumed to be valid for the case of “connected projects”. The second comment from Ms. Kapur is that both the points of view of the enterprise furnishing the service and of the consumer should be considered in order to determine if “the same or [a] connected” project exists.

73. While some Committee members and other participants held the same view as Ms. Devillet, others thought the purpose of the provision on “same or connected projects” was to avoid a situation where an enterprise that does not want to have a permanent establishment in a country where it provides service would just split projects up into different parts and seek to avoid the threshold of the 183 days in any 12-month period. With this in mind, it seems logical to look at the provision from the consumer’s point of view, rather than that of an enterprise that is trying to avoid the provision. Other members argued that the difficulties and restrictions implied by using the wording “the same or a connected project” could be avoided by simply not including such wording in the treaty text and that their view should also be reflected in the paper.

74. Ms. Kapur clarified her position by explaining that when it is obvious that two projects are not connected to each other both from the perspectives of the enterprise and of the consumer there is no problem. However, she continued, in the hypothetical case of a company from a source country buying machinery from a non-resident company and also retaining services from the same company to provide software to run the machinery, this is clearly the same project, or at least the two projects are connected from the perspective of the consumer. However, the machinery and the software may be provided by two different departments of the provider. In this case, she concluded, the provision should apply to determine that there is a permanent establishment once other criteria are met.

75. In the end it was recommended that Ms. Devillet redraft the paper, including the type of situation described by Ms. Kapur and taking into account other comments made. In drafting the paper within the Subcommittee, Ms. Kana agreed to give her contribution so that her comments on separating the cases of “the same project” and “connected projects” would also be dealt with.

(b) whether a satellite in a geostationary orbit could constitute a permanent establishment;

7. The background to this issue is that for the 2010 version of the OECD Model Tax Convention on Income and on Capital (the OECD Model) paragraph 5.5 was added to the Commentary on article 5 of the OECD Model. It provides:

> 5.5 Clearly, a permanent establishment may only be considered to be situated in a Contracting State if the relevant place of business is situated in the territory of that State. The question of whether a satellite in geostationary orbit could constitute a permanent establishment for the satellite operator relates in part to how far the territory of a State extends into space. No member country would agree that the location of these satellites can be part of the territory of a Contracting State under the applicable rules of international law and could therefore be considered to be a permanent establishment situated therein. Also, the particular area over which a satellite's signals may be received (the satellite's "footprint") cannot be considered to be at the disposal of the operator of the satellite so as to make that area a place of business of the satellite's operator.

8. When the Committee was considering possible revisions to the Commentary to article 5 in the UN Model, at its 2011 annual session, it did not include a paragraph dealing with geostationary orbits. As noted in the Report of that annual session:

> 30. It was decided to delete the proposed quoted OECD paragraph 5.5, dealing with whether a satellite in geostationary orbit could constitute a permanent establishment, and to instead include the discussion of the matter in the catalogue of issues.

(c) permanent establishment issues in international value added tax cases;

9. At its seventh annual session in 2011, the Committee noted (as indicated in the Report of that session) that:

> 118. With the latest update of the United Nations Model Convention completed, the Committee considered that it would be useful to examine a series of issues by having papers presented for discussion at the eighth session, in 2012. The question of whether to create subcommittees or working groups would be considered as part of that discussion. In that regard, the Committee decided that: […]
>
> - Jürg Giraudi would present a scoping paper on value-added tax, addressing cross-border issues related to permanent establishments

10. Mr. Giraudi made a presentation to the Committee at its eighth annual session in 2012, and the Report of that Session noted:

> 89. As decided by the Committee at its seventh session, Jürg Giraudi presented a paper on the topic of permanent establishment issues in international value-added tax cases (E/2011/45, para. 118). Mr. Giraudi reminded the Committee of its broader mandate, which goes beyond tax treaties. More than 150 countries have a value-added tax (VAT) or goods and service tax (GST) in place. VAT/GST is an important revenue creator for tax administrations, with less distortionary effects on economic growth than income taxes. To date, there is little coordination in terms of indirect taxation: aside from the Ottawa Taxation Framework Conditions (1998),

> which focus on taxation issues arising from e-commerce, Mr. Giraudi mentioned the OECD International VAT/GST Guidelines (2011) and the first meeting of the OECD Global Forum on VAT, held in November 2012. He expressed the view that international consensus on some VAT issues is lacking and that there is scope for additional work while expressing caution that work carried out by other organizations, such as OECD, must not be duplicated. The focus of the work of OECD has been on VAT on services and intangibles however, rather than VAT on the supply of goods.
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> 90. Mr. Giraudi introduced VAT as an indirect tax on consumption. The financial burden is borne by the final consumer according to the destination principle. Imports of goods are subject to an import VAT, VAT on local supplies underlies local VAT regimes and exports are zero rated.
>
> 91. Subsequently, Mr. Giraudi introduced some examples displaying problems that could arise from VAT when companies engage in cross-border trade. He posed some questions concerning VAT, such as whether a VAT registration of a non-resident seller could trigger a permanent establishment, and thus income taxes. Moreover, he questioned what kind of consequences arise, in terms of VAT, from transfer pricing adjustments. Finally, Mr. Giraudi proposed that a group should be established to study cross-border VAT implications, including different practices, and that the group should ultimately make recommendations for the adoption of best practices.
>
> 92. The members of the Committee showed support for further work on the issues raised by Mr. Giraudi. It was agreed, however, that future work in this area should not only focus on goods but also on services. There was agreement that Mr. Giraudi and Marcos Pereira Valadão, as members of the Committee, should work together to produce a note on cross-border VAT issues to be presented at the ninth session of the Committee, drawing upon other expertise, as needed. Mr. Giraudi was thanked for his work and the secretariat remarked that the Committee was now considering VAT and GST for the first time since its establishment — a potentially important development in the history of the Committee.

11. A separate note on the issues is expected for the ninth annual session.

(iii) Article 7 (business profits): "force of attraction" — consideration and explanation of its operation;

12. This issue was addressed in the "Note on Tax Treaty Issues Arising from the Granting and Trading of Emissions Permits and Emissions Credits under the UN Model Tax Convention" (E/C.18/2012/CRP.6) which notes:

> 88. A bilateral treaty that follows the UN Model will contain a "limited force of attraction" rule. Under such a rule, the other Contracting State (the PE State) may also tax profits attributable to (i) sales of goods or merchandise in that State of the same or similar kind as those sold through the PE and (ii) other business activities carried on in that State of the same or similar kind as those effected through the PE. The question may therefore arise whether the profits derived from the sale of

emissions permits/credits in the other Contracting State that are not attributable to a PE may be taxed in that State on the basis of the “limited force of attraction” rule.

89. The “limited force of attraction” covers the “same or similar” activities as those carried on through the PE. The activities carried on through a CDM/JI project PE are activities resulting in a reduction of greenhouse gas emissions which gives rise to the grant of credits if the necessary conditions are fulfilled. These activities generally do not include the trading, as such, of emissions credits for the enterprise. This means that the “limited force of attraction” rule would not apply if an enterprise operating a CDM/JI project PE in a Contracting State directly sold, in that State, emissions credits purchased on the secondary market or issued with respect to a CDM/JI project carried on in another State. Such a sale would indeed not be identical or similar to a possible sale through the CDM/JI project PE of credits granted in respect of the activities carried on through the CDM/JI project.

90. The activities carried on through a PE which is required to hold emissions permits (i.e. to participate in an emissions trading programme) are generally industrial activities giving rise to polluting emissions. These activities generally do not include the trading of emissions permits for the enterprise as a whole (as opposed to the trading of emissions permits in connection with the PE’s own compliance obligations). The direct sale by the enterprise, in the PE State, of emissions permits granted to or acquired by the enterprise in connection with polluting activities carried on through other parts of the enterprise would therefore not be similar to the sale through the PE of “excess” emissions permits relating to the emissions produced through the PE.

91. The “limited force of attraction” rule would only apply if the functions of the PE encompassed the management and trading of emissions permits/credits for different parts of the enterprise. In such a case, the profits attributable to the management and trading functions exercised by the PE could be taxed in the PE State, as well as profits relating to trading functions performed directly by the enterprise in the PE State without the involvement of the PE.

> The “limited force of attraction” rule is only found in a limited number of treaties. Its operation depends upon the existence of a similar rule in domestic law so that, even if it would be included in a treaty, it may not be operative in practice. The Commentary on article 7 of the UN Model does not address the operation of the rule in any great detail. There is, consequently, no certainty as to exactly which transactions the rule could apply. The application of the “limited force of attraction” rule to income derived in connection with emissions permits/credits could therefore be clarified in the UN Commentary.

13. “Force of attraction” was considered in the discussion of that paper at the eighth annual session of the Committee. It was included in the catalogue of issues on a more general basis as follows (as noted in the Report of that annual session):

44. A bilateral treaty that follows the United Nations Model Convention may contain a “limited force of attraction” rule. The question may therefore arise whether the profits derived from the alienation of emission permits and credits in the other Contracting State that are not attributable to a permanent establishment may be taxed in that State on the

basis of that rule. There was general agreement to add the issue of "force of attraction" to the catalogue of issues.

(iv) Article 8 (shipping, inland waterways transport and air transport): the meaning and coverage of the term "auxiliary activities";

14. At its seventh annual session in 2011, the Committee noted (as indicated in the Report of that session) that:

> 37. Several members expressed concern over the comprehensive changes proposed in the commentary on article 8. It was argued that the changes would widen the scope of the article and therefore needed to be discussed in detail in order to assess their implications.
>
> 38. Consequently, the OECD commentary paragraphs added in 2005, which referred to the income from directly connected and ancillary activities of shipping and air transport enterprises, were removed. It was decided to include in the catalogue of issues for future discussion the term "auxiliary" in the context of the auxiliary activities that would come within the operation of the article.
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> 39. It was agreed to delete the proposed paragraph 8 on the issue of including fishing, dredging or hauling activities on the high seas under the commentary on this article. Concerning paragraphs 12 and 13 it was agreed to retain the text in strikethrough in the update, which meant that the correct reference for quoted paragraphs 4 to 14 would be to the 2003 OECD commentary.

15. Mr. van der Merwe and the Secretariat prepared a note for the Committee's annual session entitled "Auxiliary activities under article 8" (E/C.18/2012/5). The note was discussed at that session and the Report of the Session noted:

> 93. As requested by the Committee, Ron van der Merwe, with Michael Lennard of the secretariat, introduced a note on auxiliary activities under article 8 (E/C.18/2012/5). It was noted that at the seventh session of the Committee concern had been expressed about updating the commentary on article 8 (Shipping, inland waterways transport and air transport) on the "auxiliary activities" sufficiently closely connected to the direct operation of ships and aircraft to come within the ambit of the article. Some members felt that updating the commentary in a way that was similar to the updates made to the OECD Model could, in effect, broaden the scope of the article and give a greater exception to the normal treatment under articles 5 and 7 than was justified.
>
> 94. In his presentation, Mr. Lennard compared the current wording used in both the United Nations Model and the OECD Model commentaries, highlighting that OECD refers to "ancillary" activities rather than "auxiliary" activities, perhaps in order to distinguish these activities from the "preparatory or auxiliary" activities under article 5(4) of its Model. He indicated that some usages in the commentary, such as references to advertising as "propaganda" and single-use hotels, as well as to containerization as a recent phenomenon, clearly needed updating.
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> 95. During the discussion, some Committee members expressed the view that the terms "auxiliary" and "ancillary" are not interchangeable and that referring to the latter would broaden the scope of application of the aforesaid provision, and thus reduce source State

taxing rights. In addition, it was stated that “auxiliary”, being a more precise word, was easier to interpret than “ancillary”. Others expressed support for updating the terminology in the Model commentary along the lines of the current language adopted in the OECD Model commentary, thus referring to “ancillary” activities instead of “auxiliary” activities. As a result, the Committee agreed to ask the secretariat to revise the abovementioned note in order to reflect those views, and to that end it invited comments by the end of 2012. Moreover, as the current membership of the Committee is due to expire on 30 June 2013, it was agreed to include the aforesaid issue of revising the commentary in relation to “auxiliary activities” in the catalogue of issues to be further considered by the members of the Committee at the next annual session. Mr. van der Merwe and the secretariat were thanked by the Committee for their work on the matter.

(v) Article 9 (associated enterprises): update of its Commentary;

16. Consideration of revisions to the Commentary on article 9 were deferred by the Committee until the Practical Manual on Transfer Pricing for Developing Countries, and then placed on the agenda of this annual session after. The background to this agenda item is discussed in more detail in a separate note from the Secretariat (E/C.18/2013/4)

(vi) Article 12 (royalties): general consideration, including equipment-related issues;

17. This was included in the catalogue of issues at the time when the 2011 Model Update was completed. The Report of the seventh annual session noted:

> 47. It was noted that the consideration of article 12 was difficult for the purposes of the update, owing to the fundamental differences in approaches between the United Nations Model Convention and the OECD Model Convention with regard to the taxation of royalties. Nevertheless, article 12 had not been fully considered by the Committee, and it was agreed that it would be included in the catalogue of issues for future discussion. Concern was expressed about the last part of paragraph 11, which limited the relevant scope of information to that arising from previous experience. A new sentence was drafted to reflect the minority view and adopted for inclusion immediately following quoted paragraph 11 of the commentary. A view was also expressed that payments referred to in quoted paragraphs 14, 14.1, 14.2, 14.4, 15, 16, 17.2 and 17.3 might constitute royalties. A new sentence was drafted to acknowledge that view and was adopted for inclusion.

(vi) Article 13 (capital gains): the practical implications of paragraph 4;

18. As noted by the commentary to the UN Model[2], “[t]his 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.”

[2] At paragraph 8.

19. The Committee has recognised that there will be issues in applying article 13(4) in practice, and in its 2011 Report it noted that:

> 48. […] The practical implications of paragraph 4 of article 13 would be included in the catalogue of issues for future discussion.
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> 49. Many administrative issues involved in the implementation of the article would be addressed in the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries.

20. A paper on some of the compliance issues relating to this paragraph was presented to the eighth annual session in 2012 as "Note on United Nations Model Tax Convention article 13(4): Compliance Issues" (E/C.18/2012/CRP.10)

(viii) Article 23 (methods for the elimination of double taxation): conflicts of qualification and conflicts of interpretation;

21. This issue arose as part of the consideration of climate change related issues, but has a potentially wider significance, especially as the UN Committee has not considered in depth the issues raised by the OECD Partnerships Report[3] and the changes made to the OECD Model Commentary to article 23 as a result of that.

22. The Note on Tax Treaty Issues Arising from the Granting and Trading of Emissions Permits and Emissions Credits under the UN Model Tax Convention (E/C.18/2012/CRP.6), presented to the eighth annual session in 2012, addresses this issue as follows:

> 124. A "conflict of qualification" arises where, due to differences in the domestic law characterisation of an item of income in the State of source and the State of residence, the State of source applies (with respect to that item of income) a different treaty provision than the State of residence would have applied. Such conflicts may occur in the following cases:
>
> - one State considers that gains from trading emissions permits/credits are covered by paragraph 1 of article 13 (because the emissions permits/credits constitute "immovable property" according to the domestic law of that State) and the other State disagrees; or
> - one State considers, in accordance with its domestic law, that profits or gains realized by an NGO or a Government upon the first sale of emissions credits are business income dealt with under article 7 or gains dealt with under paragraph 2 of article 13 whilst, under the domestic law of the other State, the income realised upon such alienation is not business income but a gain to which paragraph 6 of article 13 is applicable; or
> - one State, in accordance with its domestic law, treats the income realised by an NGO or a Government upon the issuance of emissions credits as other income to which paragraph 3 of article 21 is applicable whilst the other State, in accordance with its domestic law, does not recognise income upon the issuance of emission credits but treats the income realised

[3] The Application of the OECD Model Tax Convention to Partnerships (OECD, 1999, Paris).

upon their alienation as a gain to which paragraph 6 of article 13 is applicable.

125. Paragraphs 32.1 through 32.7 of the Commentary on Articles 23 A and 23 B of the OECD Model contain guidance on how relief from double taxation is to be provided under the OECD Model in cases of conflicts of qualification. Where the OECD Model permits the source State to tax an item of income, as that item of income is characterised under the domestic law of the source State, the residence State is obliged under article 23A or 23B to relieve any double taxation of such income, even if the residence State characterises the income differently under its domestic law and would thus apply a different article of the Model. In these situations, the OECD Commentary considers that the State of source has taxed the item of income "in accordance with the provisions of this Convention".

126. The Commentary on article 23 of the UN Model contains no such guidance. During the seventh meeting of the Committee of Experts on international cooperation in tax matters, there was no consensus with respect to the opportunity for the UN Model to endorse the OECD Commentary on conflicts of qualification. Due to lack of time, it was decided not to cover this issue in the 2011 version of the UN Model but to include it in the catalogue of items for future discussion and work. If the State of residence were to disagree with the guidance found in the OECD Commentary on how relief from double taxation is to be provided in a case where there is a conflict of qualification, the case would need to be resolved under article 25 (Mutual Agreement Procedure) or the affected taxpayer would have to pursue judicial or administrative remedies in the State of residence.

> The elimination of possible double taxation resulting from differences of characterization in the domestic law of the State of source and the State of residence should as far as possible be sought. If any double taxation would arise, the trading of emissions permits would be hindered and would not be as efficient as expected under the Kyoto Protocol. Therefore, the application of paragraphs 32.1 through 32.7 of the OECD Commentary under Articles 23A and 23B of the UN Model should be discussed as soon as possible in order to reach a consensus in this respect.

(ix) Article 26 (exchange of information);

23. The Exchange of Information article was changed as part of the 2011 Update of the UN Convention. The discussion of the issue at the 2012 annual session outlines some of the purposes of this inclusion on the catalogue of issues and agenda, especially in the light of the importance of this issue to both developing and developed countries and current international developments. The Report of that session notes:

62. Robin Oliver, a member of the Committee, provided an update on the exchange of information. After recalling that the Committee had focused its work in this area on updating article 26 of the United Nations Model Convention, he reported on some relevant developments within the OECD. The following three main issues on the exchange of information were highlighted and discussed by the Committee:

(a) The meaning of "foreseeably relevant", in paragraph 1 of the article;
(b) Requests for information regarding groups of taxpayers;

(c) Automatic information exchange, as opposed to information exchange on request.

63. Recognizing that these issues required further analysis, and given that the current members of the Committee will finish their terms on 30 June 2013, the Committee agreed to include the issues in a catalogue of issues recommended for further consideration by the new membership. One Committee member referred, in the context of issue (b) above, to the importance of implementing taxpayer registration in order to take full advantage of the automatic exchange of information. Another Committee member suggested considering the issue of the use of information for purposes other than taxation, and this was added to the list of issues for consideration by the new membership.

(x) Various articles: taxation of services — provision on taxation of fees for technical services;

24. This agenda item will be dealt with separately by a paper for the ninth annual session (E/C.18/2013/CRP.5).

(xi) Various articles: United Nations Model Convention and climate change mechanisms;

25. This work was commenced in 2010 by the Committee after some work by the OECD and papers from the UN Secretariat on "Tax Cooperation on Climate Change" (E/C.18/2010/CRP.12 and E/C.18/2011/CRP.9). At the seventh annual session in 2011, a Subcommittee was set up to consider the issue in more detail.

26. At its 2012 annual session, the Committee considered a paper on "Tax Treaty Issues Arising from the Granting and Trading of Emissions Permits and Emissions Credits under the UN Model Tax Convention" (E/C.18/2012/CRP.6). The Report of the annual session noted the discussion in some detail. The result will be a slightly modified new draft version of the paper for consideration at the ninth annual session, and the areas where changes will be made as well as relevant passages indicating the work's status are highlighted below by ***bold italics***:

25. The Coordinator of the Working Group on Tax Treaty Issues related to Climate Change Mechanisms, Claudine Devillet, introduced the note on tax treaty issues arising from the granting and trading of emission permits and emission credits under the United Nations Model Convention (E/C.18/2012/CRP.6). Ms. Devillet noted that she was presenting a first draft prepared by a small working group, which placed special emphasis on issues about which clarifications and feedback were needed. The draft reflected some divergent views as between different members of the Working Group. The Coordinator expressed her hope that the discussion of the subject would be useful and that comments received could be incorporated into the draft, which would be made publicly available through the Committee's website. The Working Group would also seek written feedback from the members of the Committee. ***An updated draft would be presented at the ninth annual session of the Committee in 2013.***

26. The substantive issues discussed were based on the market-based mechanisms established under the Kyoto Protocol, such as emissions trading, the Clean Development Mechanism, the Joint Implementation Mechanism and activities related to land use, land use change and forestry. Other cap-and-trade systems would, however, be similar enough

to allow for the tax-treaty analysis of the market-based mechanisms to serve as a basis for the analysis of those systems as well.

27. The discussion focused on potential tax treaty issues that could arise in connection with the granting of emission permits by national or regional authorities, the trading of such services across borderland the issuance and trading of certified emission reductions, emission reduction units and removable units. It was noted that such permits might be auctioned, otherwise sold or granted for free, and that there are different ways in which countries might consider activities relating to emissions permits as sources of income.

Granting of emission permits and credits

28. Ms. Devillet noted that when an emission permit is granted for free, a minority of countries considers this to be taxable income at the moment of granting. A majority of countries considers emission permits as income at the specific time when they are sold or used, and they tax them at that point in time.

29. She observed that, in general, article 7 of the United Nations Model Convention (business profits) would apply when an emission permit was granted for business activities. Profits arising at the time of the granting would be taxable on a residence basis unless they were attributable to a permanent establishment situated in the other Contracting State. Consequently, where an enterprise exercises activities generating polluting emissions in the other Contracting State, those activities would generally be exercised through an installation constituting a permanent establishment and the profits from the granting of an emission permit would be attributable to that establishment and would be taxable in the State where it was situated.

30. Ms. Devillet clarified that the granting of emission permits to business for free by Governments was included in the analysis due to the fact that during the initial trial period of the cap-and-trade system of the European Union (the European Union Emissions Trading Scheme) emission permits had been granted for free. This was done to establish an adequate number of emission permits and to grant European businesses time to adapt to a market-based emissions trading system.

31. Ms. Devillet noted that since the beginning of 2012, emissions from all domestic and international flights arriving or departing to or from airports within the European Union have been covered by the trading scheme.[4] According to article 8 of the United Nations Model Convention, a foreign enterprise engaged in such transportation activities would therefore be taxable on any profits that could be recognized as a result of the granting of emission permits by a government free of charge only in the State of its place of effective management, regardless of whether or not such profits might be attributable to a permanent establishment in another State.

32. Theoretically, emission permits could be granted to owners of immovable property, but not because of business activities undertaken. ***Income arising at the time a permit is granted for free would consequently fall under article 6 of the United Nations Model***

[4] The application of the scheme to flights into and out of the European Union has since been delayed: see http://ec.europa.eu/clima/news/articles/news_2012111202_en.htm.

Convention as income from immovable property. It was agreed that an example should be provided to clarify the issue.

33. Article 6 would also apply to income arising from the granting of a permit in relation to agriculture or forestry activities expressly covered under paragraph 1 of article 6. ***There was some disagreement with the suggestion in the note that income from mining activities would be treated differently from income from agriculture or forestry activities in article 6. Ms. Devillet agreed to investigate the issue and to suggest appropriate wording for the matter.***

34. Ms. Devillet noted the view expressed in the note that articles 12 and 14 of the United Nations Model Convention referring to royalties and independent personal services do not apply to the granting of emission permits.

35. Income arising at the time a permit is granted for free would generally be covered either by articles 6, 7 or 8 of the United Nations Model Convention. Article 21 would, however, apply in cases where the emissions of greenhouse gases with respect to which permits are granted did not result from the carrying on of a business. Ms. Devillet agreed to research whether this issue is pertinent to the Model, especially in so-called “triangular” cases.

36. The granting of emission credits was not discussed separately from emission permits due to analogies in terms of potential tax treaty issues.

Trading of emission permits and credits

37. There are no internationally recognized definitions of emission permits and credits. Generally, domestic accounting and tax laws have to be consulted to ascertain if emission permits and credits are to be treated as commodities or intangible assets. Agreement was reached that in future the deliberations of the working group should include work on definitions and characterizations of emission permits and credits. In addition, there was agreement that the word “alienation” instead of “sale” should be used in the context of trading in order to capture the fact that there might be circumstances under which emission permits and credits have to be handed over to authorities.

38. The trading of emission permits and credits and the taxation of income, which depend on treatment under domestic law, are covered by articles 6, 7 and 8 of the United Nations Model Convention. Under some circumstances, income from the alienation of emission permits and credits may also be categorized as capital gains from intangible property, in which case article 13 would apply.

39. Income derived by an enterprise of a Contracting State from the alienation of an emission permit or credit directly granted to the enterprise in connection with polluting activities carried out by it through a permanent establishment situated in the other Contracting State would generally be attributable, in whole or in part, to that establishment.

40. Income derived by an enterprise from the alienation of an emissions permit directly granted to that enterprise in connection with polluting activities carried out by it through a permanent establishment would generally be attributable to that establishment even if it

had not been involved in the alienation. With respect to permits acquired on secondary markets, there are no specified rules. The taxation thereof would thus depend on circumstances.

41. In cases in which an enterprise of a Contracting State has been granted emission permits in connection with the emissions of a permanent establishment in another Contracting State and transfers those permits to another part of the enterprise, the fair market value of the permit at the time of the transfer might be taken into consideration in order to determine the profits attributable to that permanent establishment.

42 The income derived by a foreign enterprise from the alienation of emissions credits granted to it with respect to a project that it owns (in whole or in part) may be taxed in the host country where the project constitutes a permanent establishment. Such income may also be taxed in the host country where the foreign enterprise has performed services under a project development agreement through a fixed place of business and the profits from the alienation are attributable to that permanent establishment.

43. ***Profits related to the alienation of emission credits acquired on the secondary market by an enterprise are not attributable to a permanent establishment constituting part of a Clean Development Mechanism project. In such a case, no direct link exists between the credits and the Clean Development Mechanism project that has generated them. A majority of the members of the Working Group considered emissions credits to be fungible instruments.***

44. ***A bilateral treaty that follows the United Nations Model Convention may contain a "limited force of attraction" rule. The question may therefore arise whether the profits derived from the alienation of emission permits and credits in the other Contracting State that are not attributable to a permanent establishment may be taxed in that State on the basis of that rule. There was general agreement to add the issue of "force of attraction" to the catalogue of issues.***

45. Article 6 of the United Nations Model Convention applies to income generated from immovable property, with particular reference to income from agriculture or forestry activities, and thus applies when enterprises trade emission permits and credits relating to their income generated by immovable property and agricultural or forestry activities. The note concluded that it would not apply to profits from subsequent resale of these permits and credits by persons for whom those profits would not constitute income from their agricultural or forestry activities. ***Ms. Devillet agreed to introduce a clarification or to reflect the fact that various members of the Committee considered that income from mining activities is also covered by article 6.***

46. Given that the emissions from shipping activities are not covered under cap-and-trade mechanisms, article 8 of the United Nations Model Convention does not currently apply to the trading of emission permits and credits. ***There was agreement that the Working Group would consider the application of article 8 in terms of water transportation after the update of the commentary on that article was decided upon.***

47. ***In respect of the definition of immovable property, it was agreed that a note of advice would be added indicating that during treaty negotiations contracting parties***

should clarify in which cases they would consider emissions permits/credits as immovable property covered by article 6 or by paragraph 1 of article 13.

48. In the case that non-profit establishments would alienate emission permits or credits, paragraph 6 of article 13 would apply, unless paragraph 1 of that article would be applicable.

49. ***The question of whether leasing of emission permits or credits would fall under article 12 was also discussed. The leasing of permits or credits would not, however, make sense under the cap-and-trade system of the Kyoto Protocol. Ms. Devillet agreed to clarify the issues in the revised note. With regard to transfer pricing, the Working Group asked for guidance from transfer pricing experts in order to complete the note on this issue.***

50. Ms. Devillet and others who worked on the paper were thanked for their detailed consideration of the issues.

C. Common Issues for Consideration

27. The matters for the Committee in relation to the updating of the Model include under the various Agenda sub-items include:

1. The priority that should be accorded to particular elements of this work;
2. The relationship to work being conducted by other organizations and entities;
3. Which issues should have Subcommittees formed to consider them and which issues should be deferred or else dealt with by a general update Subcommittee;
4. The extent to which any such Subcommittee should be asked in their mandates to consider certain issues, while leaving it open for the Subcommittee to recommend further such issues for consideration;
5. The Coordinator for any such Subcommittees (traditionally usually chosen from among Members of the Subcommittees where possible);
6. The extent to which the membership of any such Subcommittee should be determined at the annual session or else could be agreed later or left to the discretion of Coordinators, bearing mind the need for broad and balanced representation in practical terms; and
7. The need for different Subcommittees to consult on issues where there are obvious "cross-cutting" issues.