

United Nations

# Manual for the Negotiation of Bilateral Tax Treaties

between Developed and  
Developing Countries



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**Manual for the  
Negotiation of  
Bilateral Tax Treaties**

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## Preface

Domestic resource mobilization, including tax revenues, is central to achieving sustainable development. Taxes represent a stable source of finance that, complemented by other sources, is critical to financing the 2030 Agenda for Sustainable Development, including the Sustainable Development Goals (SDGs). Taxation is essential to providing public goods and services, increasing equity and helping manage macroeconomic stability. SDG 17 on the means of implementation and global partnership for sustainable development calls on the international community to strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection.

Mobilizing domestic public revenue for investment in sustainable development has featured prominently on the financing for development agenda since the 1990s. The Addis Ababa Action Agenda (AAAA) of the Third International Conference on Financing for Development (Addis Ababa, 13 – 16 July 2015) provides a new global framework for financing sustainable development by aligning all financial flows and policies with economic, social and environmental priorities. The AAAA, with its more than 100 concrete actions and commitments that Member States of the United Nations have pledged to undertake, highlights the need to strengthen tax administration, implement policies to generate additional resources, and combat corruption and illicit financial flows. Recognizing the limits to what individual Governments can accomplish in a globalized economy, it further calls for increased capacity-building and strengthened international tax cooperation.

The AAAA stresses that efforts in international tax cooperation should be universal in approach and scope and should fully take into account the different needs and capacities of all countries. While many countries have made improvements in their tax administrations in recent years, establishing and maintaining a sustainable source of revenues to fund domestic expenditures remain a challenge for many developing countries. Significant gaps persist in the capacities of developed and developing countries to raise public financial resources, including through modernized tax systems, improved tax policy and

efficient tax collection, as well as through combating tax evasion and tax avoidance. It is important to support national efforts of developing countries by providing technical assistance and enhancing international tax cooperation.

Tax treaties play a key role in international cooperation on tax matters. On the one hand, they encourage both investment by reducing tax barriers, including double taxation, and the transfer of skills and technology; on the other, they seek to reduce cross-border tax avoidance and evasion through exchange of tax information and mutual assistance in the collection of taxes. Tax treaties can benefit both developed and developing countries. However, developing countries, especially the least developed among them, often lack the adequate skills and experience to effectively negotiate and administer tax treaties that encourage international investments while protecting their tax base.

The present publication, entitled *United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*, seeks to contribute to strengthening the technical expertise of tax officials in developing countries. It provides practical guidance to treaty negotiators in developing countries, in particular those who use the *United Nations Model Double Taxation Convention between Developed and Developing Countries*.<sup>1</sup> We see this *Manual* as an important contribution to the implementation of the AAAA and hope that it will serve as a useful and relevant tool in assisting developing countries to foster their sustainable development efforts.



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<sup>1</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (United Nations publication, Sales No. 12.XVI.1). Available at [http://www.un.org/esa/ffd/documents/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf).

# Introduction

## Mandate

Economic and Social Council resolution 2004/69 of 11 November 2004 mandated the Committee of Experts on International Cooperation in Tax Matters (the Committee) to “keep under review and update as necessary the *United Nations Model Double Taxation Convention between Developed and Developing Countries* and the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*”. The most recent issue of the *Manual* was issued as ST/ESA/PAD/SER.E/37.<sup>2</sup>

## Historical background

From 2005 to 2011, work on updating the *Manual* was undertaken by the first Subcommittee on a Manual for the Negotiation of Tax Treaties.<sup>3</sup>

In order to broaden this work and to ensure that it responds to the needs of developing countries, the Committee, at its eighth session (Geneva, 15 – 19 October 2012),<sup>4</sup> requested the secretariat “to seek additional resources to advance the work” in this area. Accordingly, a number of initiatives have been undertaken by the Financing for Development Office (FfDO) of the United Nations Department of Economic and Social Affairs (UN-DESA).

The work was launched at an expert group meeting on “Tax Treaty Negotiation and Capacity Development” (New York, 13 and 14 December 2012), and benefited from the participation of several members of the Committee, as well as former and present treaty

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<sup>2</sup> Available at <http://www.un.org/esa/ffd/wp-content/uploads/2014/09/UNPAN008579.pdf>.

<sup>3</sup> The mandate and composition of the former Subcommittee is available at <http://www.un.org/esa/ffd/tax-committee/tc-psubcommittee-tax-treaties.html>.

<sup>4</sup> The report of the eighth session is available at <http://www.un.org/esa/ffd/events/eighth-session-tax.html>.

negotiators from developed and developing countries. The goal of the meeting was to analyse existing tools available to developing countries and assess the most effective resources needed to strengthen their capacity to negotiate tax treaties. One of the proposals resulting from the meeting was to draft a series of practical papers on relevant issues in tax treaty negotiation from the perspective of developing countries.

The draft papers were presented with a view to seeking feedback from developing countries during a technical meeting on “Capacity Building on Tax Treaty Negotiation and Administration” (Rome, 28 and 29 January 2013).<sup>5</sup> Further discussion among 32 representatives from developing countries, who attended a technical meeting on “Tax Treaty Administration and Negotiation” (New York, 30 and 31 May 2013),<sup>6</sup> led to the publication of these papers as *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*<sup>7</sup> (the *Papers*). This collection of papers was then presented to the ninth session of the Committee (Geneva, 21 – 25 October 2013),<sup>8</sup> as a possible input into the work of the Committee in this area.

## Recent work

On that occasion, the Committee decided to establish a Subcommittee on Negotiation of Tax Treaties—Practical Issues (the Subcommittee),<sup>9</sup> comprising the following Members: Mr. Wolfgang Lasars (Coordinator) (Germany); Mr. Mohammed Baina (Morocco); Mr. El Hadji Ibrahima Diop (Senegal); Ms. Liselott Kana (Chile); Mr. Cezary Krysiak (Poland); Ms. Carmel Peters (New Zealand); and Mr. Ulvi Yusifov (Azerbaijan).

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<sup>5</sup>The report of the meeting is available at <http://www.un.org/esa/ffd/events/event/meetings-on-capacity-building-on-tax-treaty-negotiation-and-administration.html>.

<sup>6</sup>Available at <http://www.un.org/esa/ffd/events/event/technical-meeting-on-tax-treaty-administration-and-negotiation.html>.

<sup>7</sup>Available at <http://www.un.org/esa/ffd/publications/papers-ntt.html>.

<sup>8</sup>The report of the ninth session is available at <http://www.un.org/esa/ffd/events/ninth-session-tax.html>.

<sup>9</sup>The mandate of the Subcommittee is available at <http://www.un.org/esa/ffd/uncategorized/tc-subcommittee-tax-treaties.html>.

The Subcommittee was mandated to develop a practical manual on the negotiation of bilateral tax treaties informed by the following principles:

- That it be a compact practical training tool for beginners or tax officials with limited experience and reflect the realities for developing countries at their relevant stages of capacity development.
- That it reflect the current version of the United Nations Model Convention<sup>10</sup> and the relevant Commentaries thereon, as well as ongoing decisions of the Committee leading to changes therein.
- That it draw upon the previous work done by the Committee and any other relevant inputs, as well as work being done in other fora.

As a first step, the Subcommittee prepared an outline of the *Manual* and, in accordance with its mandate, requested the Capacity Development Unit of FfDO/DESA to work with consultants to develop a first draft of the *Manual* on the basis of this outline. Secretariat support was provided by FfDO staff, including Ms. Dominika Halka, Mr. Harry Tonino, Ms. Elena Belletti, Ms. Mary Nolan, Ms. June Chesney and Ms. Leah McDavid, in their respective roles.

Mr. Ron van der Merwe, former Senior Manager, International Treaties Division, South African Revenue Service, and former member of the Committee, and Ms. Ariane Pickering, former Chief Tax Treaty Negotiator, Australian Department of the Treasury, were contracted to prepare the first draft of the *Manual*. To this end, they were asked to draw, to the extent possible, upon the previous edition of the *Manual* and the work done on its update by an earlier Subcommittee, as well as to summarize the content of the *Papers*.

A first draft of the *Manual* was discussed and comments were provided by the Subcommittee at its meeting held in Paris on 27 September 2014; it was then discussed at the tenth session of the

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<sup>10</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (United Nations publication, Sales No. 12.XVI.1). Available at [http://www.un.org/esa/ffd/wp-content/uploads/2014/09/UN\\_Model\\_2011\\_Update.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/09/UN_Model_2011_Update.pdf).



Committee (Geneva, 27–31 October 2014)<sup>11</sup> in follow-up to a presentation of a progress report on the relevant work by the Coordinator of the Subcommittee. Subsequently, a revised draft of the *Manual*, taking into account the comments received, was first circulated within the Subcommittee and then, after further revision, to all the members of the Committee, with a view to seeking their inputs and feedback and reflecting them in the *Manual*. Thereafter, with the assistance of the Capacity Development Unit of FfDO, the *Manual* was finalized, edited and presented to the Committee for adoption at its eleventh session (Geneva, 19–23 October 2015).<sup>12</sup> The Committee adopted the text and recommended it for publication.

## Overview and structure

While every country should form its own policy considerations and define its objectives in relation to tax treaties, the *Manual* seeks to provide practical guidance on all aspects of tax treaty negotiation, including on how to prepare for and conduct negotiations. Treaty negotiators in developing countries, especially those with limited experience, are therefore encouraged to use this *Manual* in preparing for tax treaty negotiations, in the light of their country's policy framework and the intended outcomes they wish to achieve.

Although the *Manual* provides a description of the Articles of the United Nations Model Convention, it is not intended to replace the Commentaries thereon; these will remain the final authority on issues of interpretation and should be consulted in parallel with this publication.

Section I of the *Manual* introduces the main principles which underlie double tax treaties, including the concepts of residence and source. Tax treaties aim to address issues related to double taxation, as well as other tax barriers which can act as a deterrent to cross-border

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<sup>11</sup> The report of the tenth session is available at <http://www.un.org/esa/ffd/events/event/tenth-session-tax.html>.

<sup>12</sup> The report of the eleventh session is available at <http://www.un.org/esa/ffd/events/event/eleventh-session-tax.html>.

trade and investments. This section deals with methods for the elimination of double taxation, as well as the risks associated with excessive source taxation, tax discrimination and uncertainty and complexity in the tax environment. In addition, it prefaces how tax treaties may help in addressing tax avoidance and evasion and in preventing tax base erosion and double non-taxation.

Section II of the *Manual* is based on and summarizes the content of the *Papers*. First, it addresses a fundamental question: Why negotiate tax treaties? Then, it elaborates on the importance of developing a tax treaty policy framework and a country model before entering into negotiations. Finally, this section provides a comprehensive overview of the practical steps to be taken before, during and after the negotiation of each tax treaty.

The core of the *Manual* is contained in section III, which introduces the different Articles of the United Nations Model Convention. This section is not intended to replace the Commentaries on the Articles of the Model Convention, but rather to provide a simple tool for familiarizing less experienced negotiators with the provisions of each Article. Following the structure of the Model Convention, the Articles are organized in seven chapters, as follows:

- Chapter I (Scope of the Convention) presents Articles 1 and 2, which deal with persons and taxes covered.
- Chapter II (Definitions) analyses the definitions of key terms used in the United Nations Model Convention, as provided in Articles 3 to 5. These include the definitions of “Resident” and “Permanent establishment” (PE). Negotiators are encouraged to exercise particular care when defining terms, in order to avoid unintended consequences, in particular where differences exist between the United Nations Model Convention and the OECD Model Tax Convention on Income and on Capital<sup>13</sup> (OECD Model Convention).
- Chapter III (Taxation of income) deals with the distributive rules contained in Articles 6 to 21, which determine the

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<sup>13</sup>Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

allocation of the taxing rights between the treaty parties with respect to different categories of income. Special attention is devoted to some of the most controversial aspects of tax treaty negotiations, including the issues regarding the concept of PE and its application for the purpose of taxing business profits, and the determination of rates of withholding taxes applicable on payments of dividends, interest and royalties.

- Chapter IV (Taxation of capital) briefly describes the provisions contained in Article 22 dealing with taxes on capital.
- Chapter V (Methods for the elimination of double taxation) illustrates the operation of Article 23, which requires the country of residence of the taxpayer to provide relief from double taxation by one of two methods, that is to say, either the exemption method or the credit method.
- Chapter VI (Special provisions) analyses Articles 24 to 27, including the provisions dealing with non-discrimination, mutual agreement procedure and exchange of information.
- Chapter VII (Final provisions) covers the procedures of entry into force and termination of treaties, as included in Articles 29 and 30.

Section IV of the *Manual* deals with the issue of improper use of tax treaties, which may occur, for instance, when taxpayers perform certain transactions specifically for the purpose of obtaining treaty benefits which would not otherwise be available to them. This section of the *Manual* encourages countries to consider carefully how to prevent these behaviours—which are contrary to the spirit of the provisions included in a treaty—while ensuring a stable and certain legal framework. To this end, it provides an overview of a number of approaches that can be applied to address the improper use of tax treaties, including specific and general legislative anti-abuse rules or judicial doctrines found in domestic law and specific and general anti-abuse rules found in tax treaties.

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The electronic version of this *Manual* is available, free of charge, at <http://www.un.org/esa/ffd/wp-content/uploads/2016/05/manual-btt.pdf>.

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In the future, FfDO will continue working on capacity development activities in the area of tax treaties, including by making use of this *Manual* and other relevant publications, with a view to strengthening the capacity of developing countries and promoting South-South cooperation and sharing information in this area. More information about ongoing FfDO capacity development activities may be found at <http://www.un.org/esa/ffd/topics/capacity-development.html>.

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## Section I — General introduction

### A. Introduction

*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.*

— *United Nations Model Double Taxation Convention between Developed and Developing Countries, Introduction*

The aim of the present Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (Manual) is to provide a guide to all aspects of treaty negotiation, including a brief description of the Articles of the *United Nations Model Double Taxation Convention between Developed and Developing Countries*<sup>1</sup> (United Nations Model Convention), to negotiators with little or no experience in the negotiation of treaties. There are many references to the Commentaries on the United Nations Model Convention; however, this Manual is not intended to replace them, and they remain the final authority on issues of interpretation.

From early in the twentieth century, there has been an exponential growth in cross-border trade and investment, resulting today in a highly integrated, mobile and complex global economy. No country is insulated from international trade and investment, whether it be cross-border trade in goods or services, foreign investment, transfer of technology or movement of people. All countries, whether developed or developing, require rules to address the ever-increasing number of international tax issues that arise as a result of such activities.

International income taxation revolves around two main concepts—the concept of source and the concept of residence. Under

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<sup>1</sup>United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries* (United Nations publication, Sales No. 12.XVI.1).

their domestic tax law, countries will assert the right to tax income arising (or sourced) in their jurisdiction, and most countries will seek to tax residents on their income.

If more than one country asserts the right to tax the same income, for example, where income having its source in one country is derived by a resident of another country, international double taxation can arise.

It is in the interests of both taxpayers and Governments to remove unnecessary tax barriers to cross-border trade and investment while ensuring that domestic tax systems can be properly applied and administered, notwithstanding the globalization of the economy. Tax treaties may assist in the elimination of double taxation and in addressing other tax barriers. Treaties may also assist in combating both international tax evasion and double non-taxation.

## **B. Concepts and issues**

### **1. Concept of residence**

Under the residence principle, a country's claim to tax income is based on the residential status of the person deriving that income. Where the person is regarded as a resident for tax purposes, the country may tax the income of that person, regardless of where the income has its source. Most countries tax their residents on their worldwide income, although a few countries will tax their income only if it is derived from sources in that jurisdiction (so-called territorial taxation).

Domestic law rules for determining residence for tax purposes differ from country to country. With respect to individuals, physical presence in a country is an important indicator of residence. Other factors may include the existence of a place of abode in that country, or family or financial ties to that country. In the case of legal entities, such as companies, residence may be based on the place of incorporation, the location of the head office or place of management or other criteria that indicate a strong connection with a country.

Where individuals or legal entities have links to several countries, they may be regarded as a tax resident of more than one country,

and hence liable to tax on their worldwide income in those countries. Tax treaties can assist in eliminating resulting double taxation by providing tie-breaker rules to allocate tax residence to only one country.

## **2. Concept of source**

Income tax is also imposed under the domestic law of a country if the income is considered to have its source therein (“source principle”). Rules for determining the source of income vary, but source taxation is generally applied where the income has a relevant connection (or nexus) with that country. For example, income from the extraction of mineral deposits located in a jurisdiction would clearly have a strong connection with that country and would be regarded as having its source in that country.

Other income will typically be taxed in accordance with the source principle where the assets or activities that generate the income are located within a country. For example, dividend or interest income from capital invested in a jurisdiction will usually be regarded as having a source in that country. Similarly, wages paid to an employee in respect of work performed in a country are likely to be taxed there on the basis that it is where they have their source.

Some countries have statutory rules for determining the source of income for tax purposes. These rules may provide an exhaustive list of all items of income that will be treated as sourced in that country, or may be merely indicative of common situations where the income will be regarded as having its source there. Some countries do not have statutory source rules, and rely solely on general source principles.

In some cases, the income may have a connection with more than one country. For example, royalties may be paid by a resident of one country in respect of intellectual property used in another country. In another example, income may be derived by an enterprise from sales activity in one country in respect of goods it manufactures in another country. In these situations, both countries may seek to tax the income on the basis of the source principle. Tax treaties may assist by deeming the income to arise in only one country, or by allocating each country taxing rights over an appropriate part of the income.

Countries will generally tax income from sources in their jurisdiction, regardless of whether that income is derived by a resident or a non-resident.

## **C. International double taxation**

Double taxation can take different forms and can occur in different situations. Cases where a taxpayer is taxed in two countries on the same income are referred to as juridical double taxation. Cases where the same income is taxed in two different countries, but is treated by them as deriving from different taxpayers, are known as economic double taxation. Tax treaties seek to eliminate (or at least reduce) double taxation in a number of ways.

### **1. Residence/residence juridical double taxation**

As noted above, residence/residence juridical double taxation can occur where a person is taxed on worldwide income or capital in more than one country on the basis that the person is regarded as a resident for tax purposes in each of them. Such double taxation is dealt with under tax treaties by the inclusion of tie-breaker rules, such as those contained in Article 4 (Resident), paragraphs 2 and 3, of the United Nations Model Convention. These rules deem the person to be, for purposes of the treaty, a resident of only one of the countries.

This ensures that, at least between the two treaty partner countries, the person is taxed only on a source basis in one country with relief from double taxation being provided by the other country.

### **2. Source/residence juridical double taxation**

Source/residence juridical double taxation arises where the same income is taxed in both the country where it arises and in the country of which the person deriving the income is a resident. This form of double taxation is addressed under treaties by the allocation of exclusive taxing rights over income or capital to one of the treaty partner countries, or, where taxation is permitted in both countries under the treaty, by requiring the country of residence to provide relief for tax imposed by the source country.

The allocation of taxing rights over income and capital is found in the distributive rules of treaties, that is to say, Articles 6 to 22 of the United Nations Model Convention. These are discussed further in sections III.C and D.

### **3. Source/source juridical double taxation**

Double taxation may arise where more than one country regards the same income as having a source in its territory under domestic law. For example, one country may regard income from certain services as being sourced in its territory if the activities are performed there, while another country may treat the same income as sourced in its territory if the services are paid for by a resident of that country.

For certain categories of income, such as dividends, interest and, in treaties that follow the United Nations Model Convention, royalties, a tax treaty will provide explicit rules for determining the source of income for treaty purposes.

For other categories of income, such as business profits, there are no explicit source rules included in the treaty. By limiting the circumstances in which source taxation may be imposed, however, the United Nations Model Convention and the Organisation for Economic Co-operation and Development *Model Tax Convention on Income and on Capital*<sup>2</sup> (OECD Model Convention) will often provide solutions to problems of double taxation based on source.

### **4. Economic double taxation**

Tax treaties seek to address problems of economic double taxation (where the same income or capital is taxed in more than one country in the hands of different taxpayers) only in certain limited circumstances.

The most common form of economic double taxation arises where associated enterprises are treated in different countries as having accrued the same profits. By putting in place an “arm’s length”

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<sup>2</sup> Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital* (Paris: OECD, 2014).

standard for transactions between the associated enterprises, treaties help to ensure that profits are subject to neither double taxation nor less-than-single taxation.

Economic double taxation may also be dealt with under a treaty to the extent that Article 25 (Mutual agreement procedure) allows the competent authorities of the treaty partner countries to “consult together for the elimination of double taxation in cases not provided for in the Convention”.<sup>3</sup>

Economic double taxation can also arise where corporate profits are taxed when derived by the company and then again when distributed as dividends to shareholders. Some countries address such double taxation under their domestic law, for example, by exempting the dividends (typically where a substantial shareholder is a resident of the same country as the paying company) or by providing imputation credits for taxes paid at the company level. Some treaties extend such treatment to cross-border situations.

## **5. Elimination of double taxation**

When international juridical double taxation arises, many countries (though not all) provide at least some relief under their domestic law. Where such unilateral relief is granted, it usually applies in the same way in respect of income from all countries and may include limitations on the amount of relief that will be provided.

Two main methods are commonly used for this purpose. Under the exemption method, a country will exempt certain items of income derived by its residents in another country. Under the credit method, a country will give a credit against its normal tax claims on its residents for tax that those residents have already paid to the source State on income or profits derived from that State.<sup>4</sup>

Treaties can assist in eliminating juridical double taxation by ensuring that, where the treaty permits both countries to tax the

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<sup>3</sup> See paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraphs 10–12 of the Commentary on Article 25 of the OECD Model Convention.

<sup>4</sup> These methods are discussed in section III.E.

income, the country of residence of the taxpayer is required to provide relief for that double taxation.

## **D. Other tax barriers to cross-border transactions**

### **1. Excessive source taxation**

Very high levels of source taxation can be a deterrent to international trade and, in particular, to investment. These can occur not only when the headline tax rate is high, but also where the effective rate is excessive, for example, where tax is imposed on a gross basis without allowance for deductions for costs incurred in deriving the income. Notwithstanding that the taxpayer's country of residence may provide double tax relief, whether by exemption or by credit, in cases where the source State tax exceeds the tax imposed in the country of residence, the overall tax burden on the taxpayer is likely to discourage foreign investment in the source State.

Tax treaties can facilitate cross-border trade and investment by limiting source taxation that might otherwise act as a deterrent to that trade or investment. This is typically found with respect to categories of income that are subject to withholding tax on a gross basis, such as dividends and interest or, in many treaties, royalties and fees for technical services.

### **2. Tax discrimination**

Discriminatory tax rules can be a significant deterrent to foreign investment, for example, where foreign businesses or investment are subject to higher taxation than local enterprises or investors.

Tax treaties aim to remove these obstacles to cross-border activities by addressing some common forms of tax discrimination. Countries that wish to remove this kind of tax barrier in order to attract foreign investment could do so unilaterally, and many countries seek to ensure that their domestic tax laws are non-discriminatory; however, by including non-discrimination provisions in tax treaties, countries are able to provide a measure of certainty to potential investors that

they will not be subject to tax discrimination in the event of future changes to domestic law.

### **3. Uncertainty and complexity**

One of the main ways in which a developing country can attract foreign investment is by ensuring that the tax environment for investors is clear, transparent and certain.

Tax treaties can assist in achieving this by setting well-recognized and widely adopted rules for the allocation of taxing rights over different types of income and for the determination of profits attributable to a permanent establishment or in transactions between related enterprises. Such rules can help to reduce complexity for taxpayers with cross-border activities, particularly where the treaty provides for taxation only in one country. These rules are discussed further in section III.

If the internationally accepted wording in tax treaties contained in the United Nations and OECD Model Conventions and in alternative provisions in their Commentaries is followed, it will help to ensure consistent interpretation of treaty provisions, and thereby increase certainty for taxpayers and tax administrations.

As tax treaties are usually in effect for an extended period (often 15 years or more), they also provide a level of comfort to taxpayers that the tax treatment afforded to the income from their activities or investments in the other country will be reasonably stable.

Importantly, tax treaties also provide a mechanism for tax administrations to agree on how to interpret or apply treaty provisions, and to resolve disputes.<sup>5</sup>

### **E. Tax avoidance and evasion, and double non-taxation**

Globalization of the economy can result in difficulties in applying domestic tax regimes because of problems in obtaining relevant information or in collecting taxes where taxpayers or their assets are located

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<sup>5</sup> See the discussion in section III.F.2.



abroad. It is in the interests of both developed and developing countries to minimize cross-border tax evasion and avoidance as all countries are vulnerable to capital flight and erosion of their tax revenue bases.

One of the main reasons that a country may wish to enter into a tax treaty with another country is to improve coordination and cooperation between tax administrations in order to address tax avoidance or evasion. Tax treaties provide for exchange of tax information, which may help ensure that a country that taxes its residents on worldwide income is aware of (and can therefore tax) income arising in a treaty partner country. They also contain rules to avoid profit shifting between jurisdictions in the case of multinational enterprises. Through the exchange of information and, in some cases, assistance in collection of taxes, tax administrations are able to assist each other in ensuring the proper application of tax treaties, as well as enforcement of domestic laws.

Recently, Governments have also focused on addressing gaps in the interaction of domestic tax systems or in tax treaties that may lead to income not being taxed in any country (double non-taxation), or being subject to less-than-single taxation.<sup>6</sup> The G20 Leaders endorsed the OECD Action Plan on Base Erosion and Profit Shifting (BEPS) and encouraged all interested countries to participate in the OECD/G20 BEPS Project.<sup>7</sup>

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<sup>6</sup>See, for example, OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015). Available from <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm>.

<sup>7</sup>Available from <http://www.oecd.org/g20/meetings/saint-petersburg/>.

## **Section II — Treaty policy; country model; negotiations**

### **A. Why negotiate tax treaties?**

Countries entering into tax treaty negotiations need a good understanding of why they are doing so, and of the benefits and costs that arise from having tax treaties.

Developing countries will often negotiate tax treaties in order to attract foreign investment, sometimes in conjunction with investment protection and promotion agreements. In some cases, there may be pressing reasons of diplomacy, for example, as a response to pressure from another country. Sometimes they are negotiated because an adviser has suggested that it would be a good thing to do. On the other hand, some developing countries may be hesitant to have tax treaties, either generally or with particular countries, because of a fear of reduced revenue as a result of the limitations on source taxation that such treaties impose.

The decision to enter into treaty negotiations with another country is not one to be undertaken lightly, especially for developing countries. There are both benefits and potential costs to developing countries from concluding a tax treaty, therefore it is desirable to have a comprehensive tax treaty strategy, agreed (if possible) across the whole of government (especially with ministries of foreign affairs), before embarking on tax treaty negotiations.

Having an understanding of the potential costs and benefits of tax treaties, and the ways in which treaties operate to achieve intended outcomes, will assist in ensuring that the right negotiations are given priority and that particular negotiations result in the most beneficial outcomes. By comprehending the reasons for entering into a treaty, tax treaty negotiators, tax administrations and taxpayers will have a better understanding of the policy framework underpinning their own, and the other country's, tax treaties.

Countries enter into tax treaties for a variety of reasons. For each country, and indeed for each treaty entered into by that country,

the reasons are likely to be different, depending on the economic and political situation of the country and its relations with the potential treaty partner country. The priority that would be given to each reason will differ, depending on the circumstances prevailing in each country, and having regard to the relationship between the two countries. In some countries, the desire to attract foreign investment will be paramount, whereas in other countries, revenue or political considerations may be more important.

The most common reasons why a country would enter into a tax treaty with another country may include some or all of the following:

- (a) To facilitate outbound investment by residents;
- (b) To facilitate and encourage inbound investment and inbound transfers of skills and technology by residents of the other country;
- (c) To reduce cross-border tax avoidance and evasion;
- (d) Political reasons.

The importance of each of these reasons will be different in each situation. Motivations may vary depending on whether a country is a net exporter of capital (typically a developed country) or a net importer of capital (typically a developing country). It is important to understand all perspectives when considering a negotiation request from another country or designing a broader tax treaty strategy.

In a developing country, there may be little outbound investment by its residents. For such countries, the main reasons for entering into treaty negotiations are commonly:

- (a) To attract foreign direct investment;
- (b) To attract inbound transfers of technology or skills;
- (c) To respond to political or other pressure from other countries.

The benefits of increased tax cooperation, such as exchange of information and assistance in collection, should also be taken into account by developing countries.

It should be noted that even if one country has concluded that it would serve its interests to enter into a tax treaty with another country,

that other country may not be willing or able to commence negotiations. Before treaty negotiations can commence, both countries must consider that a tax treaty would benefit them, and must be in a position to start them.

Section I of the present Manual outlines some of the common issues that arise as the result of the overlap of taxes imposed in different countries. It also discusses issues that may arise in connection with tax discrimination, complexity and uncertainty. The main benefit of tax treaties is that they remove or reduce these barriers to cross-border investment and the transfer of knowledge and skills.

For developing countries, however, there may be other benefits to be gained from tax treaties. For example, negotiation of treaties by a developing country may be seen by other countries as an expression of its willingness to conform to international tax norms, such as non-discrimination, the arm's length principle and exchange of information. It may also signal a close political and/or economic relationship between two countries, or form part of a network of relationships, for example, within a region. Sometimes, a tax treaty may be negotiated as part of a suite of bilateral treaties aimed at closer ties between the countries.

## **1. Summary of benefits and costs to developing countries of having tax treaties**

### ***Benefits:***

- Increased foreign investment as a result of removal or reduction of tax barriers
- Greater access to foreign technology and skills
- Flow-on benefits to the local economy from increased foreign investment
- Increased certainty for both taxpayers and tax administrations
- Improved consistency of tax treatment
- Protection for investment abroad
- Avoidance of fiscal evasion

**Costs:**

- Immediate revenue cost
- Affect or limit on the operation of certain domestic tax laws
- Risk of treaty-shopping and treaty abuse
- Risk of double non-taxation
- Need for changes and/or clarifications to domestic law to conform with tax treaties
- Challenges to tax administration capacity to negotiate and administer tax treaties, including obligations under the mutual agreement procedure, exchange of information and, in some treaties, assistance in the collection of taxes

While tax treaties can be beneficial to developing countries, there are also significant costs to entering into such treaties. By understanding what outcomes are desired, and how treaties can assist in achieving those outcomes, countries are better able to determine whether or not to enter into treaty negotiations.

Understanding the reasons for entering into treaty negotiations will also help those countries to design treaty policies that are best suited to achieving their desired outcomes.

New negotiators are advised to read the section on why countries may want to negotiate tax treaties, which is contained in *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*.<sup>8</sup>

Section C (Tax policy considerations that, in general, countries should consider before deciding to enter into a tax treaty with another country) of the OECD report on *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances* gives valuable guidance in this regard.<sup>9</sup>

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<sup>8</sup> Ariane Pickering, “Why negotiate tax treaties?”, *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*, (New York: United Nations, 2014).

<sup>9</sup> OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015). Available from <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm>.

## **B. Policy framework and country model**

### **1. Policy framework for developing countries**

All countries would find it beneficial to develop a tax treaty policy framework and a model treaty before entering into negotiations. A country has to “know what it wants”.

The policy framework should set out the main policy outcomes that a country wishes to achieve under its tax treaties. It should identify:

- (a) Policy outcomes that are the most beneficial to the country;
- (b) Outcomes that must be achieved in any negotiation; and
- (c) How much flexibility negotiators have on other issues, including what their “bottom line” is (that is to say, the minimum outcome that must be achieved).

The model treaty should reflect the country’s key policy and drafting preferences, having regard to international treaty norms and to domestic law.

### **2. General considerations**

As far as practicable, countries should follow the international norms for tax treaties (that is to say, the United Nations and OECD Model Conventions, and regional models) with respect to structure and policy positions, as well as drafting of the treaty provisions.

It is important for developing countries to strike the right balance between protecting revenue (by maintaining source taxing rights) and encouraging inbound investment (by reducing tax barriers). To achieve this, tax treaties of most developing countries generally follow the United Nations Model Convention, rather than the OECD Model Convention.

The policy framework of a country should take account of key aspects of its economy, including its main sources of revenue and areas of current or potential foreign investment.

Tax treaty policy should take account of domestic law. The interaction between domestic law and treaties is important.

The tax treaty policy of regional economic communities should also be taken into account as in some cases a common approach would have been agreed upon.

Similarly, it is advisable to know the treaty policy and practice of neighbouring countries because a foreign investor looking for investment opportunities is likely to compare the conditions in a region.

Countries should take into account the ability of their tax administrations to comply with treaty obligations.

### **3. Designing a policy framework**

A developing country's tax treaty policy framework should take into account international norms, in particular those set out in the United Nations Model Convention. At a minimum, the treaty should cover elimination of double taxation on income, non-discrimination, mutual agreement procedure and exchange of tax information. The provisions of the United Nations and OECD Model Conventions on these aspects of a tax treaty should be accepted as being representative of the international standard by any country if it wishes to enter into tax treaties, although there may be room for negotiation with respect to specific details.

Other aspects of a tax treaty may be open to negotiation, such as coverage of capital taxes, and levels of source taxation permitted under the treaty. Departures from the international models will almost always increase the difficulty of negotiating a satisfactory treaty. Accordingly, countries, especially those with limited negotiating capacity, should deviate from the international norms only sparingly, that is to say, where there is a clear national interest in doing so. On these aspects, each country should determine:

- (a) Its preferred position;
- (b) The priority the country places on achieving that position; and
- (c) The degree of flexibility available to negotiators and any fixed "bottom line".

### *Distributive rules*

The allocation of taxing rights between the source and residence countries is generally the most controversial part of tax treaty negotiations. The distributive rules will often result in a limitation of the source-State tax but the treaty will impose an obligation on the residence State to eliminate any double taxation. The distributive rules of a treaty, which are set out in the United Nations Model Convention, Articles 6 to 22, determine how the taxing rights will be allocated with respect to different categories of income. In developing its tax treaty policy framework, it is important that each country decide on its preferred position on the balance between source and residence taxation, the priority it gives to maintaining that preferred position and, where flexibility is appropriate, the bottom line for negotiators. It is also important to bear in mind that while a treaty will give a right of taxation to one or both countries, that right may be exercised only if there is a charging provision in domestic law.

With respect to each category of income, developing countries may find it helpful to analyse the distributive rules of the United Nations Model Convention — and the OECD Model Convention — in the context of their own circumstances. In particular, they may wish to consider:

- (a) *Category of income*: Does the treaty classification of income give rise to difficulties in applying the treaty, or to unacceptable policy outcomes?
- (b) *Tax treatment*: Can taxing rights allocated under a tax treaty be exercised in the country? Such rights can be exercised only if tax is imposed under domestic law. If not, consideration should be given to whether this is an outcome that the country wishes to provide for under a treaty.
- (c) *Ease of administration*: Does the proposed treatment present any particular difficulties for the tax administration of the country? Such difficulties may include issues relating to administrative burden, especially where tax liability is determined by assessment by tax authorities (rather than self-assessment or withholding), or relating to interpretation or application of treaty provisions.



- (d) *Ease of compliance*: Does the proposed treatment place an onerous compliance burden on taxpayers? This can be a particular problem where taxpayers are required to keep detailed records that they would not ordinarily keep, or meet strict information disclosure requirements in order to obtain treaty benefits.

Countries are well advised to follow the provisions of the United Nations or OECD Model Conventions as closely as possible for the reasons outlined above. Having regard to their particular circumstances, however, countries may determine that these Model Conventions do not fully meet their needs, or that certain provisions of one or other of them cause unacceptable difficulties. By developing a policy framework, these countries will be able to decide in advance what rules will best serve their country's interests, and how important those rules are to that country.

In deciding to move away from a policy position endorsed in the United Nations Model Convention, or the OECD Model Convention, countries should, in relation to each policy issue, consider the matters mentioned above. In addition, they should consider:

- (a) *Reason*: Is there a compelling reason for the departure from the policy position found in the international models? Such reasons may include protection of a significant source of revenue in the country, desire to attract investment in an area of the country's economy that the Government is seeking to develop, significant difficulties for the tax administration or taxpayers in administering the usual treaty approach in the context of the domestic law, or the particular circumstances of the bilateral relationship, especially having regard to the other country's tax system.
- (b) *Priority*: How much of a priority is it for the country that this outcome be achieved vis-à-vis other issues? Is this an outcome that must be achieved, or something that is highly desirable but not essential, or is achieving this outcome not of particular importance to the country?
- (c) *Achievability*: Is this treatment likely to be readily accepted by the treaty partner country? Is it consistent with regional

norms? Have other countries sought or accepted this approach in their treaties?

- (d) *Flexibility*: Is the Government prepared to allow negotiators any flexibility on this issue? Is this a deal-breaker? Is there scope for compromise, for example, a different time threshold, a different rate limit, the exclusion/inclusion of certain provisions?
- (e) *Fallback positions*: If there is scope for compromise, what fallback positions would be acceptable to the Government? What is the bottom line?

Finally, countries should be forward-looking in designing their policy framework and model. Treaties usually last for many years — often decades. Renegotiation of a treaty is time-consuming and expensive, thus it is worthwhile to consider policies that are robust and sustainable in the long term, and that have regard to likely developments within the country and in the international tax context.

If possible, the policy framework and the model should be agreed on a whole-of-government basis. In particular, if the Ministry of Finance does not negotiate tax treaties by itself but has transferred the authority to negotiate to a tax authority, its support and that of the Treasury is important for that tax authority in ensuring that the treaty policy is consistent with the Government’s objectives. Other ministries, such as those responsible for foreign policy or trade, may also be relevant.

### ***Protocol***

Some countries like to append a Protocol to their tax treaties, setting out important interpretations and/or administrative provisions. Such Protocols are generally negotiated at the same time as the tax treaty and have the same legal status as the tax treaty.

### ***Conclusions***

By developing a tax treaty policy framework, countries will be in a much better position to “know what they want” out of treaty negotiations and to achieve outcomes that are in the best interests of the

country. Such a framework will also assist countries in designing their country model, which should reflect the policy outcomes sought.

Both the policy framework and the country model should be reviewed regularly to ensure that future tax treaties continue to provide beneficial and appropriate outcomes for the country and remain up to date with international developments.

New negotiators are advised to read the section on a tax treaty policy framework and country model in *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*.<sup>10</sup>

### **C. Preparing for tax treaty negotiation**

Once a country has developed its tax treaty policy framework and its country model, and has determined an order of priority of the countries with which it intends to have tax treaties, as discussed above, it will be in a position to start preparations for actual negotiations with another country.

Preparations are an extremely important part of the negotiation process. Without adequate preparations, the team will be at a disadvantage during the negotiations and will most probably not achieve an optimal result for the country it is representing.

The purpose of the following observations is to outline some of the important steps that should be taken by developing countries prior to the commencement of tax treaty negotiations.

#### **1. Obtaining authority to negotiate**

In most countries, authorization from the Government is required for each negotiation with another country. Sometimes a new approval is required for each round of negotiations.

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<sup>10</sup> Ariane Pickering, “Tax treaty policy framework and country model”, *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014).

The relevant authority to give approval for negotiations will usually be the Minister of Finance, or an authority approved by the Minister of Finance. The Ministry of Foreign Affairs should be consulted before any decision is made.

## 2. Logistics

Both countries will need to agree on:

- The dates on which the negotiations will take place
- Where the negotiations are to take place:
  - In most cases, each country will take it in turn to host the negotiations
- The language in which the negotiations will be conducted
- The language(s) in which the two draft treaties should be prepared

Each country will need to decide on:

- The number of members to be included in the negotiating team
- The persons to be included as members of the negotiating team:
  - They will generally include officials from the Ministry of Finance and the tax administration. Some countries may also wish to include officials from the ministries of foreign affairs, justice or economic affairs
  - If it is intended that persons who are outside consultants are to be present during the negotiations, this should be discussed and agreed upon with the other country in advance of the negotiations
  - As a matter of courtesy, the names, titles and contact details of each team member should be provided to the other country

The host country will need to arrange for:

- The venue for the negotiations:
  - A suitably sized meeting room
  - If possible, electronic equipment to record and project a draft treaty text

- Refreshments such as water, tea and coffee and light snacks for morning and afternoon breaks
- Any security passes or escorts necessary to allow the other team access to the venue:
  - Directions on how to find and access the venue should be provided to the other team
- A draft agenda showing the starting and finishing times for each negotiation session, refreshment and meal breaks, formal meals, tours, and so forth

The visiting country will need to arrange for:

- Travel authorizations and, if necessary, visas
- Travel arrangements such as flights, trains, and so forth
- Accommodation
- Notification to its embassy in the country of the visit and its purpose

### **3. Defining the roles of each member of the team**

In the preparations for the negotiations, as well as during them, it is important that all members of the team know which duties they are allocated, and what their roles will be:

(a) *Leader of the team:*

- The leader of the team should be a senior official with the authority to make important decisions during the negotiations.
- Preferably, the leader should have comprehensive knowledge of domestic tax legislation and its interaction with domestic legislation and tax treaties.
- It would be highly desirable for the leader to be experienced in tax treaty negotiations.
- He/she should lead the discussions and present the team's arguments.

(b) *Adviser(s)*:

- Most negotiating teams include at least one or two members of the team who advise the leader on technical issues.
- These advisers generally have a good knowledge of tax treaties and domestic tax legislation. They may have specialist knowledge of certain areas of domestic law or of their country's tax treaty practice.
- The advisers may, if invited by the leader, lead the discussion on specific parts of the treaty.
- The advisers usually have primary responsibility for preparing the comparison of the two countries' treaty models and developing the team's negotiating positions.

(c) *Notetaker*:

- Normally, the host country team should record all agreements or changes to the official draft agreement. This record should be added to the agreed minutes after every round of negotiations and provided to both teams.
- At least one of the members of each team should be responsible for taking notes of the arguments presented in the discussions and of any agreements reached during the meetings for later internal review.
- Responsibility for taking notes should not be given to a junior without experience because such a person will often have difficulties in understanding and deciding on what is important and what is of lesser significance.

#### **4. Consulting business and relevant ministries and agencies**

When preparing for negotiations with another country it is prudent to consult with business and relevant ministries and agencies:

- A request for negotiation of a tax treaty may be initiated by a business in one or both countries, for example, to address problems they have met or are anticipating when engaging in cross-border activities.

- Consultation with business will, in most cases, provide the team with important information on economic areas where it will be important to take special care during the negotiations.
- Relevant ministries and agencies, such as the ministries responsible for foreign affairs or trade, may also have information of importance to the negotiations. For example, they may have information on areas where they would like to encourage outbound investment or areas to which they would like to attract foreign investment.
- It may also be advisable to consult with the embassy in the other country. It may have important information on economic as well as non-economic areas that could be of value in the preparations.

## **5. Preparing the draft model used for a particular negotiation**

The team must prepare a draft model which they will use as the basis for the negotiation:

- Many countries will always use their general model treaty (see section II.B). Other countries will adapt their model to take into consideration particular inputs they have received, such as previous negotiations or public submissions. Some developed countries may use a different draft model where the proposed treaty partner is a developing country.
- It is important to understand all the articles of the draft model and how they interact. The model may have been changed in some areas following previous negotiations. The team should be aware of where and why such changes have been made, and of their effects.
- The team should have a clear understanding of why the articles have been drafted the way they are and be able to explain them.

## **6. Preparing alternative provisions**

Where the draft model includes provisions that are likely to be controversial, it is advisable to prepare alternative provisions that may be acceptable to both countries:

- These may be provisions that have been accepted in negotiations with other countries, or provisions that the other country has previously accepted in treaties with other countries, or may be unique provisions intended to specifically address concerns expressed by the other country.
- It will be easier to have alternative provisions accepted when they are presented in writing rather than orally.
- This can also indicate a willingness to reach a compromise where necessary.

## **7. Non-negotiable provisions**

In the preparation of the negotiations it is also important to clarify internally which provisions are non-negotiable (that is to say, provisions that reflect strongly held policy or technical positions, and that must be included in any treaty concluded by the country):

- A distinction should be made between provisions that are genuinely non-negotiable and provisions which are only a strong preference but which, under certain circumstances, can be flexible. Provisions that are only a strong preference should not be presented as completely non-negotiable.
- To be prepared for the positions of the other country, it is helpful to check Reservations, Observations and Positions, set out in the Commentaries to the OECD Model Convention. While these do not always reflect a non-negotiable position, they are a very valuable indicator of strongly held positions.

## **8. Interaction between domestic legislation and treaty provisions**

It is important to have a clear understanding of the interaction between domestic legislation and treaty provisions:

- During negotiations, a team may be asked how the domestic legislation interacts with the provisions proposed in the draft model.
- It is also important for understanding the costs or benefits of a treaty provision.



- For the same reason, it is advisable for a team to study the interaction between the treaty provisions and the domestic legislation of the other country.

## **9. Transmitting a short explanation of the domestic tax system and the model to the treaty partner**

Many countries prepare a short explanation of their domestic tax system, especially if there is something in the legislation that would need clarification:

- A short explanation of the main points in the legislation will make it easier to understand why some articles need special drafting and will also identify issues that need to be considered.
- To facilitate the negotiations, a short explanation of the domestic legislation and a draft model should be sent to the treaty partner well in advance of the meeting. At the same time, a similar explanation and a draft model may be requested from the treaty partner.

## **10. Preparing a comparison of the respective models**

### *Identifying issues*

- Identifying issues may be done in several ways, but using colours simplifies the identification of the differences between the models.
- All differences between the two drafts should be identified beforehand because all differences, whether on major or on minor items, have to be agreed upon during the following negotiations.
- It is advisable to decide which differences are important and which are of less importance.
- Important issues should be discussed internally to find arguments to be used and to determine what tactics should be followed in the process of trying to convince the treaty partner to accept a proposal.

***Identifying provisions proposed in the two model drafts that deviate from provisions agreed in treaties with third countries***

- A team should be aware of treaties its country has entered into with third countries because if provisions in such treaties are more beneficial than those in the draft model, the treaty partner country is likely to ask for similar treatment.
- It is advisable to be prepared either to accept the same solution or to explain why it was acceptable when negotiating with the third country but not in the present situation.
- Treaties entered into by the other country with countries which are comparable (economically or regionally) with one's own should be studied, as these will give an indication of what the other team may be willing to accept. They may also indicate how strongly the other team is likely to argue in favour of its own position.
- If the proposed treaty partner is a developed country, a comparison with treaties it has entered into with other developing countries will be of more value than a treaty entered into with another developed country.
- Recent treaties entered into by the other country are more valuable than older treaties and may also help the team to develop drafting that is likely to be acceptable to that other country.

**11. Studying the culture and customs of the other country**

It is advisable to have some knowledge about the country with which one is going to negotiate:

- Consideration should be given to that country's economic situation, its gross national product (GNP), important industries and its relations with other countries.
- There should be an awareness of local customs and sensitive issues, for example, regarding particular foods, alcohol, religious beliefs, and behaviours that may be considered offensive. Consultation with one's embassy in the other country may help to avoid incidents.

- Potential language problems may require the services of an interpreter.

More guidance on how to prepare for treaty negotiations may be found in *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*.<sup>11</sup>

## **D. Conduct of negotiations**

The way in which treaty negotiations are conducted is vital to achieve a treaty that is beneficial to both countries and meets the interests of each side as far as possible. In particular, it is important that the negotiations be conducted in a cooperative atmosphere that is conducive to reaching agreement on balanced outcomes that are expressed in well-drafted, effective provisions that will stand the test of time.

### **1. Working draft**

The two teams will first need to decide which model draft should be used as the working document:

- It is an advantage to have one's own model draft accepted as the working document.
- The host team will usually ask for its draft to be the working document. In many cases, this request will be accepted by the visiting team. Both drafts will be on the table, however, and should be taken into consideration during the discussions.

### **2. Negotiation style**

Negotiation style is very important and can vary from soft to aggressive:

- A “soft” negotiator seeks to reach agreement on all articles as soon as possible. This may lead to the negotiator making unnecessary concessions.

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<sup>11</sup>Odd Hengse, “Preparation for tax treaty negotiations”, *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014).

- An “aggressive” negotiator insists on his/her proposals and demands concessions. This style may result in the other side pushing back or even refusing to continue the negotiations.
- A negotiation style somewhere in between is obviously desirable. A negotiator should be consistent in the approach adopted, but always polite. He/she should be prepared for the negotiation, knowing what is important for his/her country and proposing and explaining the preferred solutions without being aggressive.

Whatever the approach, a negotiator must remember that his/her style should take into account the goal of the negotiations, which is to achieve a mutually beneficial treaty.

### **3. Trust**

To achieve a productive atmosphere during the negotiation process, it is necessary to gain the trust of the other team:

- Explanations by a team must be truthful, complete and correct:
  - If a team is in doubt about an item, it should say so to the other team and seek clarification
  - Members of a team should be transparent and never lie
  - Poor disclosure can be very harmful
  - It is easier to lose than to gain credibility.

### **4. Building a relationship**

- Prior to the first meeting, a check should be made to see whether there are matters to be aware of which should be taken into consideration. These could be related to food, alcohol, religious beliefs or what is looked on as bad conduct.
- Formality is appropriate even if one already knows the members of the other team:
  - Informal discussions or contacts taking place during a break, or at lunches or dinners, however, also contribute to building a good relationship
  - All interaction plays a part in the negotiations.

- Punctuality:
  - If one is late for some reason, an apology should be made and an explanation provided.
- Respect for the leader's role:
  - The leader decides what to say and by whom it should be said
  - No other member of the team should take the floor without being invited by the leader
  - When speaking, the other party's leader should be addressed unless it is obvious that it would be correct to address someone else.
- Arguments put forward should be listened to with respect — even if one is not in agreement with them:
  - One should not interrupt, shake one's head or tell the other team that they are wrong
  - One should be polite in explaining to the other team why one has a different opinion or prefers a different solution.

## 5. Discussions

At the beginning of the negotiations, both leaders should introduce themselves and their team so that both delegations know who is present and what the role of each team member is:

- The leader from the host country will usually open discussions.
- There should be agreement on the agenda.
- There should be agreement on the process for the discussions:
  - For the first round of negotiations, it is usually desirable to work quickly through all articles one by one without in-depth discussions, to resolve minor issues and identify difficult or important ones for further discussion
  - Understanding the value of the issues to the other side is essential when trying to make a compromise or a trade-off.
- When all the articles have been worked through, it is time to concentrate on solving the remaining difficult issues:
  - This may be done during the first round of negotiation but will most likely be postponed to a second round

- Even if one team has no serious objections to a proposal by the other team, for example, because the item is not particularly important to them, it may defer acceptance of the proposal in the hope of achieving something in return at a later stage in the negotiations
- If a provision mostly relates to one of the countries, or is a clarification of the wording of an article, it may be better to include the provision in a Protocol rather than try to draft wording to that effect in the treaty itself
- Even if the issues are important, it is not necessarily difficult to find solutions, for example, if the two teams seek similar outcomes. If, however, both teams regard an issue as important, but disagree on the solution, a compromise may be difficult (but not impossible) to find.
- For an effective discussion to take place, one should introduce the item and present one's position clearly.
- The reactions of the other team should be noted carefully. It may be found from time to time that its proposal is actually advantageous and better than one's own.
- A team should be prepared to make counter-offers:
  - If it seems difficult to get acceptance for the proposal that is being discussed, alternatives should be sought. These may have been prepared before the negotiations, or may have been developed during the process. Alternatives may also be found in the Commentaries to the United Nations and the OECD Model Conventions. They may also be found in one of the countries' treaties with other countries.
- An extraordinary way to try to solve a difficult issue is to propose a "most favoured nation" (MFN) clause:
  - An MFN clause may also be included in a Protocol to the treaty and may be restricted to treaties entered into with a group of countries, such as member countries of the OECD or countries within a region
  - The MFN clause may operate automatically or may require the country to enter into negotiations to provide the same treatment

- MFN clauses should be used, however, only with great caution. They chain the country granting them and can hinder its ability to agree on compromises with third countries in later negotiations.
- A different way of dealing with difficult issues is to propose a “sunset clause”, which limits the period for which a controversial provision will apply.
- A third way of dealing with difficult issues may be a “grandfathering clause”, which allows a provision from a treaty that is being replaced to continue to apply to persons already benefiting from the existing one.
- A fourth way of dealing with difficult issues may be to agree that a provision or an article shall not become effective at the same time as the rest of the treaty, but at a later stage to be agreed upon between the competent authorities.
- One country may be prepared to accept a proposal from the other country but at the time of negotiations does not have the legislative instruments in place to give effect to the provisions. If the legislation is expected to be in place within a reasonable period of time, a solution might be to accept the article but defer its entry into force.
- During the discussions, compromises will often be suggested:
  - Unless the compromises represent well-known positions and wording, it is advisable to be very careful. Compromises drafted across the table are not always of the best quality. Even if the proposed wording seems to solve a problem, the best way to handle such compromises is to put them in brackets for further consideration.
- If one team believes that the other team has misunderstood the meaning or effect of a proposal, the issue should be raised again:
  - If the misunderstanding is not recognized during the negotiations, but before signature, a delicate situation may arise if the country concerned refuses to sign the treaty or insists on renegotiation.
- If a team at any time during the negotiation wishes to clarify issues or discuss arguments within the team, it should do so and ask for a timeout.

- If the official language of one of the teams is different, then it is important for that team to indicate any words or phrases which, when translated, could lead to difficulties in interpretation or result in a different interpretation from that of the other team.
- If an issue is agreed upon, both teams should accept it explicitly and only then move forward.
- To avoid unnecessary misunderstandings, it is important that both teams send correct signals on their attitude to the proposals put forward:
  - The reaction of the members of the other team to arguments put forward in the discussion and also when proposals are put on the table should be observed.
- Notes should always be taken during the meeting:
  - Notes are extremely important if a second round of negotiations is needed
  - Notes are also useful when drafting compromises, discussing positions with qualified persons or producing proposals for approval
  - Notes are also important when preparing the treaty for signature or explaining the solutions agreed upon to the minister or at a hearing in the parliament
  - Notes can also be valuable to the competent authority at a later stage in interpreting issues arising from the treaty.

## 6. Arguments

Teams should be prepared to present relevant arguments to explain the proposal put forward in the different articles of the draft presented:

- This is true of all articles, but is essential where the wording of an article deviates from what is common wording in international models.

Alternative provisions found in the Commentaries are easier to explain. There are different kinds of arguments commonly used:

- The policy argument plays on reason and sound policy. It is often based on economic arguments and is closely linked to a revenue argument.



- A reason often used in support of a proposal is the precedent argument, where a team shows that other countries have accepted the wording of an article. For a developing country negotiating with a developed country, such an argument will be of greater value if they can show that other developed countries have accepted the wording. It may also be the other way around. The team of one country may be asking for a wording the other country has accepted in treaties with third countries. It may point to those treaties and ask the other team why such wording is no longer acceptable.
- A further argument along the same lines is that by accepting a certain provision with a country to which one would prefer to be compared, business in one's country will be disadvantaged unless the same benefits are obtained.
- In several cases, a provision may be asked for to prevent abuse, for example, to introduce specific anti-abuse provisions in these treaties. Examples should be used to illustrate why the proposal is necessary.
- An argument may be that a proposal is based on firm policy. Some countries have non-negotiable provisions in their model. It is, however, important to distinguish between provisions that are genuinely non-negotiable and those which are only strongly preferred.
- Two arguments are of little or no value unless they are substantiated, namely: "We need this wording because we are a developing country" and "We need this wording because we have such a provision in our domestic legislation." In both cases it is important to explain clearly why special wording is needed.

## 7. Record of discussions

- During the discussions, the working draft should be projected on a screen that is visible to both teams, if possible.
- When going through the working draft article by article, all wording that is not agreed upon should be put in brackets:
  - To be on the safe side, the other team should be asked for an explicit agreement and only then should the brackets be deleted.

- If there is no screen, the text should be read before moving on to the next issue.
- Highlight colours may be used to identify each country's proposals.
- At the end of the meetings, it should be ensured that there is agreement on which issues have been resolved, and which are postponed for a second or subsequent round of negotiations. Both teams should have a printed version of the working draft as it stands at the end of discussion.
- When the two teams have agreed that the working draft is in accordance with what has been agreed upon, the two leaders should initial it.

Before ending the meetings, it is advisable to produce agreed minutes. All major outstanding issues should be noted in this document, as well as any agreed interpretations. A tentative date for future negotiations, if required, should also be noted. Further information on how to conduct tax treaty negotiations can be found in *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*.<sup>12</sup>

## **E. Post-negotiation activities**

After agreement has been reached on all issues on the treaty text, the next steps are the preparations for signature, including translation (if necessary), obtaining authority to sign, and the actual signature formalities. Clarification should be sought in advance on whether the Ministry of Finance or the Ministry of Foreign Affairs is in charge of the signing procedure in one's country. A checklist of activities leading up to signature, as well as bringing the treaty into force, is shown below.

### **1. Preparing for signature**

When the two heads of the delegations have initialled the agreed draft, the next step is to prepare the treaty for signature:

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<sup>12</sup>Odd Hengsle, "How to conduct tax treaty negotiations", *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014).

- In the signature texts, one's country should be mentioned first in the Title, Preamble and signature block in one's own copy (or copies, if in more than one language). The other country should be mentioned first in their copy or copies. There should be no alternation in the rest of the text.
- The time gap between initialling and signing should be as short as possible.
- The draft treaty should be thoroughly proofread prior to the preparation of the texts for signature.
- The draft treaty should be treated as confidential until it has been signed, unless the two teams agree to an earlier date of publication. If, prior to signature, one or both countries want to issue a press release informing the public that an agreement has been reached and that it is being prepared for signing, it may be advisable that the two teams agree on its wording.
- In some countries, the procedures before signing are comprehensive and time-consuming:
  - Some countries must submit the initialled draft for comments or approval by a legal authority before they can begin the preparations for signature; such an authority may be the Ministry of Foreign Affairs, the Ministry of Justice, the Supreme Court or an authority established for the purpose of commenting on new tax legislation proposals as well as initialled tax treaties
  - To get an idea of the time usually required for preparing the treaty for signature, it is recommended that information be exchanged during the negotiations on the procedures that are needed to get approval for signing.

## 2. Translation

When the initialled draft treaty is not negotiated in the official language of one or both States, each country has to translate the draft into its own language:

- A thorough proofreading of the text should be done prior to translation. Any corrections must be agreed to in writing between the two parties.

- Who does the translation may vary from one State to another. In some States, the negotiators themselves do the translation; in others, an office in a ministry or a governmental agency undertakes that task, or a private translation office is engaged.
- The terms used in any translation should be checked to ensure that they are consistent with the international standards used in the United Nations and OECD Model Conventions (for example, “permanent establishment”).
- When the treaty has been translated into an official language, it should be transmitted to the other country for approval. It is important that the translation be done correctly and that all official versions of the treaty have consistent wording, even if the languages are different.
- Both countries must agree that the translated drafts completely and accurately reflect the initialled draft text.
- The Ministry of Foreign Affairs should be consulted regarding what official languages must be used in the official texts of the tax treaty:
  - Only the signed treaty texts are regarded as authoritative
  - A treaty may be negotiated in a third country’s language, for example, the English language, even if the two countries are not English-speaking countries. In such a situation, both countries generally agree to have three official languages, and the third country’s language (for example, the English language) shall prevail in case of differences in interpretation of the texts in the other official languages.
- In its signature text, a country will always have its official language mentioned first, the language of the other treaty partner mentioned second and, if necessary, the prevailing language last.
- If a treaty is signed in two languages, both of them will be equally authentic.

### **3. Signing of the treaty**

When any necessary translations have been completed and agreed upon by the two countries, the next step will be to seek the approval of each Government to sign the treaty:

- To get approval, the (translated) treaty and a technical explanation will generally have to be brought before the Minister of Finance and other relevant ministers. The procedures for approval, however, vary from one country to the other.

Once approved, the text would generally be transmitted to the Ministry of Foreign Affairs, which is usually the government agency responsible for arranging the signing ceremony and for deciding who will sign the treaty on behalf of the State:

- In most cases, only the Head of State, Head of Government and the Minister of Foreign Affairs have full powers to bind a country by signing a treaty. If the Minister of Finance, or any other minister or person is the one signing the treaty, that person will need to produce a written authorization that they have been given the appropriate full powers to sign.
- If the tax authority is in charge of the signing procedure — as may be the case — and there is doubt about the authority of the person of the other country who is going to sign the treaty, the Ministry of Foreign Affairs should be consulted in advance.
- There are always at least two originals of the treaty to be signed, one of which will be retained by each State. Where the official text is in more than one language, there will be two originals of the treaty in each official language to be signed. Each country should have a signed version of the treaty in all official languages.
- There are no set rules about where the signing ceremony should take place. It should be signed where it is most convenient to the two countries.

To avoid delays in the entry into force of a treaty, it should be signed as soon as possible.

#### **4. Post-signing activities**

In almost all countries, the signed treaty has to be presented to the parliament for final approval:

- The Ministry of Finance or the authorized agency which negotiated the tax treaty will usually prepare a technical explanation of the treaty.

- The signed treaty, often together with an accompanying domestic law and the explanation, will then be sent to the parliament, where the treaty will usually be considered by a committee. It will then be presented to parliament with a recommendation for its approval:
  - In the rare case where the treaty is not approved, the other country has to be informed and the problems explained. The negotiators will then meet to see if a solution can be achieved.
- The procedures for dealing with the treaty in the parliament may differ from one country to another. It is advisable to clarify the proper procedure in one's country in advance through a consultation with the office of the President or Prime Minister or Finance Minister, or the administrative office of the parliament.

The last step in the process of the entry into force of a tax treaty is to inform the Ministry of Foreign Affairs that all legal procedures for the entry into force have been dealt with and ask it to inform the other State, in accordance with the article on entry into force:

- The treaty provisions may require a formal exchange of instruments of ratification, or an exchange of notes through diplomatic channels.
- Lengthy delays between approval by the parliament and entry into force should be avoided if possible. Some countries register their treaties with the Secretariat of the United Nations in accordance with Article 102 of the Charter of the United Nations.

## **5. After entry into force**

The tax administration should be informed of the existence and contents of the treaty through an explanatory note:

- This may be done, for example, as a separate paper, or as a reproduction of earlier explanatory notes such as those produced for parliament.

Industries and other taxpayers should also be made aware of the new tax treaty, for example, through a press release, public gazette notice or on the website of the tax administration or the Ministry of Finance.

## 6. New legislation

The treaty will apply to new taxes introduced after entry into force if those taxes are “identical or substantially similar” to existing taxes covered by the treaty.<sup>13</sup>

- When new taxes are introduced, all treaty partners should be informed. Some countries ask their treaty partners if they can agree that the new taxes are of an identical or substantially similar nature.

When, after the entry into force of a treaty, a State makes significant changes in its domestic tax legislation, it should inform its treaty partners of such changes:<sup>14</sup>

- The competent authority should inform its counterpart in the other country of important new legislation; some countries might inform its treaty partners also about significant judicial decisions, administrative rulings, and so forth.

More information on these activities may be found in the section on post-negotiation activities in *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*.<sup>15</sup>

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<sup>13</sup> United Nations Model Convention, Article 2 (4).

<sup>14</sup> Ibid.

<sup>15</sup> Odd Hengsle, “Post-negotiation activities”, *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014).

## **Section III – Treaty provisions**

### **A. Chapter I – Scope of the Convention**

Articles 1 and 2 specify to whom the treaty applies and the taxes that it covers.

#### **1. Article 1 – Persons covered**

Article 1 of the United Nations Model Convention specifies the persons to whom the tax treaty applies.

The Article states that the treaty applies to persons who are residents of one or both Contracting States.

It is important to remember that the application of the treaty relates to residents and, consequently, in treaties that follow the United Nations and the OECD Model Conventions, nationality is of no relevance other than in the application of the tie-breaker rules in Article 4 (Resident), paragraph 2, Article 19 (Government service) and Article 24 (Non-discrimination).

“Person” is defined in Article 3 (General definitions) of the United Nations Model Convention to include “an individual, a company and any other body of persons”. “Any other body of persons” has a wide meaning and would include legal entities other than companies, as well as partnerships, unincorporated associations such as sporting or educational clubs, charities, organizations and statutory bodies.

Issues commonly arise as to how treaties apply to different types of non-corporate entities and arrangements. While some of these issues are discussed in the Commentaries on the United Nations and OECD Model Conventions, negotiators should consider how treaties would apply to entities and arrangements existing in their country. Where doubt exists, it may be useful to clarify in the treaty whether an entity is to be regarded as a “person” or a “resident” for treaty purposes.

An example of these issues is that of partnerships. Some countries treat partnerships as taxable entities; others do not tax the



partnership as such and tax only partners on their shares of partnership income. If Contracting States differ in their treatment of partnerships under domestic law, they may consider that different articles of the treaty apply to the same transaction. Questions therefore arise as to whether and when a partnership should be allowed treaty benefits. Like the OECD Model Convention, the United Nations Model Convention does not contain any special provisions relating to partnerships. The Commentary leaves countries free “to agree upon such special provisions as they may find necessary and appropriate”.<sup>16</sup>

Negotiators would find it useful to read paragraphs 4 to 7 of the Commentary on Article 1 (Persons covered) of the United Nations Model Convention, as well as the OECD Commentary on Article 1 where it deals with the application of the Convention to partnerships.<sup>17</sup> For further guidance, the 1999 OECD report entitled *The Application of the OECD Model Tax Convention to Partnerships*<sup>18</sup> provides detailed examples of the application of tax treaties to partnerships.

Information on the application of treaties to collective investment vehicles is also included in the OECD Commentary.<sup>19</sup>

## 2. Article 2 — Taxes covered

Article 2 (Taxes covered) of the United Nations Model Convention identifies the taxes to which the treaty applies. Taxes on estates and inheritances and on gifts are excluded.<sup>20</sup>

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<sup>16</sup>See paragraph 4 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>17</sup>See paragraphs 2–6.7 of the Commentary on Article 1 of the OECD Model Convention.

<sup>18</sup>OECD, *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation, No. 6 (Paris: OECD, 1999). Available from [http://www.oecd-ilibrary.org/taxation/the-application-of-the-oecd-model-tax-convention-to-partnerships\\_9789264173316-en](http://www.oecd-ilibrary.org/taxation/the-application-of-the-oecd-model-tax-convention-to-partnerships_9789264173316-en).

<sup>19</sup>See paragraphs 6.8–6.34 of the Commentary on Article 1 of the OECD Model Convention.

<sup>20</sup>See paragraph 1 of the Commentary on Article 22 (Capital) of the United Nations Model Convention.

Clearly, the treaty is not intended to apply to certain charges such as, for example, mandatory contributions to social security schemes, consumption taxes and user charges such as those levied by local authorities. Certain provisions of the treaty, however, such as Articles 24 (Non-discrimination) and 26 (Exchange of information), apply to all taxes, regardless of whether they are included as covered taxes in Article 2.

### ***Paragraph 1***

Paragraph 1 describes the taxes to which the treaty will apply, that is to say, taxes on income and on capital imposed in the Contracting States by any level of government (for example, national Government, state or provincial government or local government), irrespective of the method by which these taxes are imposed, for instance, by withholding or by assessment. The terminology relating to the taxes covered by a treaty must be clear, precise and as comprehensive as possible.<sup>21</sup>

Some countries, however, prefer not to cover capital taxes, and some prefer to limit the application of the treaty to national-level taxes.

### **Capital taxes**

While both the United Nations and OECD Model Conventions cover capital taxes, in practice many treaties do not. The decision whether to include capital taxes in a tax treaty depends on whether they are imposed in both treaty partner countries. If both countries do so, then double taxation can arise where elements of capital belonging to a resident of one country is taxed by the other country. In these circumstances, provisions to eliminate such double taxation should be included in a treaty between the two countries following the text of Article 22 of the United Nations Model Convention.

Not all countries, however, impose capital taxes under their domestic law. Double taxation of capital will not arise if one of the treaty partner countries does not impose capital taxes, or if neither does. In either case, it is a policy decision whether a country that does

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<sup>21</sup> See paragraph 2 of the United Nations Commentary on Article 2 of the United Nations Model Convention.

not impose capital taxes would want to include an article dealing with them in its treaties. That decision would be part of the development of a policy framework and country model mentioned in section II.

Coverage of capital taxes would ensure that, if a country subsequently introduces such taxes, any double taxation arising in respect of those taxes would be relieved, because their imposition in the future would be limited in accordance with the treaty provisions.

If a country that does not currently impose capital taxes decides to cover such taxes, and is concerned about how the treaty may limit their imposition, one option may be to address the issue in negotiation of the provisions of Article 22 (Capital).<sup>22</sup>

### **Subnational taxes**

Coverage of taxes should be comprehensive so as to ensure that all double taxation imposed on income or capital is relieved as much as possible. Where there are constitutional or other reasons for wishing to limit the scope of the treaty to taxes imposed by the national Government, however, some countries may prefer to delete the reference to political subdivisions and/or local authorities in paragraph 1. In this case, however, it should be noted that the treaty would not apply to subnational taxes imposed by the other State, which may result in unrelieved double taxation.

### ***Paragraph 2***

Paragraph 2 describes the taxes that are to be treated as taxes on income and on capital for purposes of the treaty. While the definition includes “taxes on the total amounts of wages or salaries paid by enterprises”, the Commentary notes that practices regarding the coverage of such taxes vary.<sup>23</sup> Whether or not such taxes should be covered is a matter for discussion during negotiations. In this regard, negotiators should take account of paragraph 3 of the Commentary on

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<sup>22</sup> See paragraph 4 of Article 22 of the United Nations Model Convention and the Commentary thereon.

<sup>23</sup> See paragraph 4 of the Commentary on Article 2 of the United Nations Model Convention.

Article 2 of the OECD Model Convention,<sup>24</sup> where the scope of such taxes is considered.

### ***Paragraph 3***

Paragraph 3 identifies the existing taxes in each country to which the treaty will apply. Although the list is “not exhaustive”,<sup>25</sup> negotiators should be careful to ensure that the list is as clear, precise and comprehensive as possible.

Some countries do not include paragraphs 1 and 2 of Article 2. They simply provide an exhaustive list of existing taxes and clarify that similar taxes imposed subsequently will also be covered.<sup>26</sup> It should be noted, however, that this may limit the range of future taxes that could come within the scope of the treaty in accordance with paragraph 4. Without the general descriptions provided in paragraphs 1 and 2, it might be more difficult to conclude that a new tax is identical or substantially similar to the listed taxes. For example, a newly introduced capital gains tax may not be regarded as substantially the same as existing income taxes.

### ***Paragraph 4***

Paragraph 4 provides that the treaty will also apply to all subsequently imposed taxes that are identical or substantially similar to those listed in paragraph 3 of the Article.

The competent authorities are required under this paragraph to notify each other of significant changes to their tax laws. Negotiators should discuss when and how notification will take place, and whether other important changes, for example, judicial decisions, significant changes to regulations or procedures, and so forth, should also be

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<sup>24</sup> Referred to in paragraph 4 of the Commentary on Article 2 of the United Nations Model Convention.

<sup>25</sup> See paragraph 5 of the Commentary on Article 2 of the United Nations Model Convention.

<sup>26</sup> See paragraph 6.1 of the Commentary on Article 2 of the OECD Model Convention for drafting of suitable provisions to achieve this outcome.

notified. Some countries provide annual updates to their treaty partners, while others prefer that changes, especially important ones, be notified immediately.

## **B. Chapter II — Definitions**

Articles 3 to 5 include definitions of certain key terms used in the treaty. Other definitions of terms used in treaties are found in the articles to which they are relevant. For example, “immovable property” is defined in Article 6, which deals with income from such property, while dividends, interest and royalties are defined in their relevant Articles (10 to 12, respectively). These other definitions have a direct impact on the taxing rights granted by the respective Articles and care should be taken when deciding on their scope.

### **1. Article 3 — General definitions**

Article 3 provides a definition for a number of terms used in the treaty. The meaning given to the term in this Article applies for all purposes of the treaty, except where the context requires that another meaning be applied.

#### ***Paragraph 1***

Paragraph 1 sets out a number of defined terms that are used in the treaty. Unlike the OECD Model Convention, the terms “enterprise” and “business” are not defined in the United Nations Model Convention. The OECD Model Convention also defines the terms “enterprise” and “business” to clarify the scope of Article 7 (Business profits) after the deletion of Article 14 (Independent personal services). In treaties that follow the United Nations Model Convention, which still includes Article 14, it is not necessary to follow Article 3 of the OECD Model Convention in this respect.

Many treaties include additional definitions in Article 3. For example, definitions of each Contracting State and the territory that they cover (for example, the extent to which continental shelf areas are covered) are frequently included. Where such definitions are included, they should make reference to international law, particularly in respect

of any areas or boundaries that may be contentious or areas beyond the territorial sea, to ensure that the territory described is consistent with international law. For consistency with international law, coordination with the Ministry of Foreign Affairs is required. It is important for treaty negotiators to agree on the scope of the territory where the taxation rules agreed in the treaty should apply.

The meaning given to a term by Article 3 prevails over any domestic law meaning of the same term. For example, the term “company” is defined to include, for treaty purposes, taxable entities that are treated as companies for tax purposes, notwithstanding that a domestic law definition of company does not include such entities.

### *Paragraph 2*

Paragraph 2 provides that terms that are not defined in the treaty are to take the meaning that the term has at the time at which the country applies the treaty under the domestic law of that country, unless the context of the treaty requires that another meaning be applied. Paragraph 12 of the Commentary on Article 3 of the OECD Model Convention<sup>27</sup> notes that 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”. In cases of doubt, the mutual agreement procedure may be used to establish the meaning of a term for purposes of the treaty.

If a treaty term has a domestic law meaning under more than one branch of a country’s law, paragraph 2 provides that the meaning under tax law will prevail over any meaning provided under other branches of that country’s law.

The meaning of specific terms defined in Article 3 is discussed below in the context of the provisions in which they appear.

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<sup>27</sup> See paragraph 12 of the Commentary on Article 3 of the OECD Model Convention as endorsed in paragraph 14 of the Commentary on Article 3 of the United Nations Model Convention.

## 2. Article 4 — Resident

Article 4 defines the term “resident of a Contracting State” for purposes of the treaty, including in cases where a person is a resident under the domestic law of both countries. This definition is of course vital in interpreting the treaty as it determines who will be treated as residents of the treaty partner country in accordance with Article 1.

### *Paragraph 1*

The definition in paragraph 1 refers to the concept of residence under domestic law. Thus, the starting point for determining whether a person is a treaty resident is to ascertain whether that person is a resident for tax purposes under the domestic law of either country. The definition focuses on certain specified criteria, however; that is to say, domicile, residence, place of management, place of incorporation<sup>28</sup> or any other criterion of a similar nature. For countries where a person is treated as a resident on the basis of other criteria that may not be regarded as “of a similar nature” to the listed criteria (for example, where a company is treated as resident if its head office is located in the country, or where the majority of the voting power in a company is held by residents of that country), these criteria should also be discussed in negotiations and listed, where appropriate. In general, any criteria that result in a person being fully liable to tax as a resident in a country would be acceptable.<sup>29</sup>

The treaty definition in paragraph 1 requires that the person be “liable to tax” in that State by reason of domicile, residence, place of incorporation, place of management or any other criterion of a similar nature. This generally means that the person is liable to the most comprehensive taxation imposed by that country, such as taxation on worldwide income or, in the case of countries operating territorial taxation systems, to full taxation under that tax law. Difficult questions

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<sup>28</sup> While “place of incorporation” is not included in the specified criteria in Article 4 of the OECD Model Convention, it is frequently found in treaties negotiated by OECD member countries.

<sup>29</sup> See paragraph 4 of the Commentary on Article 4 of the OECD Model Convention.

can arise in respect of persons for which exemption from taxation is provided, for example, charities or educational institutions, sovereign wealth funds, pension funds or flow-through entities. These issues are discussed in paragraphs 4 and 6 of the Commentary on Article 4 of the United Nations Model Convention. Where doubt exists, countries may wish to clarify the position of particular types of entities, either in this Article of the treaty or through the mutual agreement procedure.

The definition in paragraph 1 specifically includes the phrase “that State and any political subdivision or local authority thereof”. This ensures that Governments of a Contracting State are treated as residents of that State for treaty purposes, irrespective of whether those Governments are taxed under domestic law.

### *Paragraph 2*

Paragraph 2 deals with the situation where the domestic law of both countries treats the same individual as its own resident, for example, where the person is considered for tax purposes to be a resident of one country because he or she is domiciled there, and is also a resident of the other country because they are present in that country for an extended period. Similar situations can arise with companies and other tax entities.

It is necessary, for example, for purposes of avoiding residence/residence double taxation described in section I, to assign residence for treaty purposes to only one of the Contracting States.

Paragraph 2 sets out a number of rules (known as “tie-breaker rules”) for determining in which State a dual resident individual will be deemed to be a resident for purposes of the treaty. It should be noted that these tie-breaker rules apply only for the purposes of the treaty and do not affect the person’s residential status for domestic law purposes, which continues to be determined in accordance with each country’s domestic law.

Each of the tie-breaker rules should be discussed during negotiations to ensure that both sides share the same understanding of their operation. The Commentaries to Article 4 of the United Nations and OECD Model Conventions will assist negotiators in reaching a shared



understanding. Questions frequently arise, however, as to the application of the “permanent home available” and “habitual abode” tests, thus it is especially useful to discuss the meaning of these terms at the time of negotiation.<sup>30</sup>

### ***Paragraph 3***

Paragraph 3 addresses the situation of dual residence of persons other than individuals. Tax entities such as companies and other bodies of persons can also be treated as residents of more than one State, for example, where the entity is incorporated or established in one country and is managed in the other country. In these cases, paragraph 3 deems the entity to be a resident only of the Contracting State in which it has its place of effective management. The meaning of the term “place of effective management” and the factors that may be relevant in determining where that place is situated are discussed in paragraph 10 of the Commentary on Article 4 of the United Nations Model Convention.

Notwithstanding that paragraph 3 of Article 4 of both the United Nations and the OECD Model Conventions use the place of effective management tie-breaker rule for persons other than individuals, a number of countries prefer to use other tests, such as place of incorporation. The Commentaries on the United Nations and OECD Model Conventions, however, warn against attaching importance to “a purely formal criterion like registration”. Nevertheless, countries where incorporation is the sole test for residence of companies will often be reluctant to accept the place of effective management test as this would always operate against them in assigning treaty residence in case of dual residence.

An alternative approach, which is sometimes also used to address dual residence of persons other than individuals, is to leave the matter to be resolved by competent authorities under the mutual agreement procedure. As these cases are relatively rare, some countries consider that a case-by-case approach may be preferable to a formal criterion, or to the place of effective management test. A draft provision to give

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<sup>30</sup> See paragraph 7 of the Commentary on Article 4 of the United Nations Model Convention, quoting paragraphs 9–20 of the Commentary on Article 4 of the OECD Model Convention.

effect to this approach, and factors for consideration by the competent authorities, are set out in paragraph 10 of the Commentary on Article 4 of the United Nations Model Convention.

### 3. Article 5 — Permanent establishment

Article 5 defines the term “permanent establishment” (PE), which is a key concept in tax treaties. This concept determines when a country may tax business profits of a non-resident enterprise. Moreover, it is relevant to determining taxing rights over dividends, interest, royalties, capital gains and other income, as well as to determining source (Articles 11 and 12) and entitlement to non-discriminatory treatment (Article 24).

The term permanent establishment describes the presence of a foreign enterprise in a State and is intended to establish the threshold for taxation of business profits of the enterprise in that State. The term “enterprise” is not itself defined in the United Nations Model Convention because “the question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been determined according to the provisions of the domestic law of the Contracting States”.<sup>31</sup> Nevertheless “enterprise of a Contracting State” is defined in Article 3 (General definitions) to mean an enterprise carried on by a resident of a Contracting State.

The definitions of permanent establishment differ in a number of important respects between the United Nations and OECD Model Conventions.<sup>32</sup> As the United Nations Model Convention provides a broader definition of permanent establishment, resulting in greater taxing rights for the source country than is provided under the OECD Model Convention, negotiation of Article 5 is often controversial, particularly in negotiations between developing and developed countries.

Interpretation and application of the definition can also give rise to difficult issues. For example, some countries do not agree with

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<sup>31</sup> See paragraph 6 of the Commentary on Article 3 of the United Nations Model Convention.

<sup>32</sup> These differences are outlined in paragraph 1 of the Commentary on Article 5 of the United Nations Model Convention.

the Commentary with respect to certain interpretations relating to the application of the definition in the context of electronic commerce.<sup>33</sup> It would be useful for negotiators to discuss this matter during negotiations to ensure a shared understanding.

### ***Paragraph 1***

Paragraph 1, like paragraph 1 of Article 5 of the OECD Model Convention, defines permanent establishment to mean a fixed place of business through which the business of an enterprise is wholly or partly carried on.

It follows that, for a permanent establishment to exist under paragraph 1, three conditions must be met, that is to say:

- There must be a “place of business”
- That place of business must be “fixed” with regard to duration and location, and
- The business of the enterprise must be carried on through that place

As the text of paragraph 1 is the same in the United Nations and OECD Model Conventions, guidance on the interpretation and application of paragraph 1, based on guidance in the Commentary on paragraph 1 of Article 5 of the OECD Model Convention,<sup>34</sup> is particularly useful.

### ***Paragraph 2***

Paragraph 2 lists a number of places that commonly give rise to a permanent establishment. These places will constitute a permanent establishment, however, only if they meet the requirements of paragraph 1, that is to say, where there is a fixed place of business through which the enterprise carries on business. The paragraph is identical to paragraph 2 of Article 5 of the OECD Model Convention.

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<sup>33</sup> See paragraphs 36 and 37 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraphs 42.1 – 42.10 of the Commentary on Article 5 of the OECD Model Convention.

<sup>34</sup> See paragraphs 3 – 11 of the Commentary on Article 5 of the OECD Model Convention.

Treaty practice shows that some countries like to add other places to the list in paragraph 2, for example, places for the exploration of natural resources, warehouses, or agricultural or forestry properties. While these additions may emphasize their importance to that country, their inclusion makes no difference in substance, as they will in any event constitute a permanent establishment if, and only if, they meet the “fixed place of business” test of paragraph 1.

### ***Paragraph 3***

Paragraph 3 deals with construction activities and, unlike the equivalent provision of the OECD Model Convention, also addresses the furnishing of services. The paragraph provides that these activities may constitute a permanent establishment where a time threshold has been met. This outcome obtains, even if the requirements of paragraph 1, that is to say, the “fixed place of business” test, are not met.

Countries that are concerned that the time threshold may be open to abuse (for example, by splitting projects or contracts between related enterprises) could address this through a provision that aggregates time spent on connected activities by related parties. More information on this problem, and proposals, can be found in section C (Other strategies for the artificial avoidance of PE status), subsection 1 (Splitting-up of contracts), of the OECD report on BEPS Action 7: *Preventing the artificial avoidance of PE status*.<sup>35</sup>

### **Construction activities**

Subparagraph (a) of paragraph 3 covers building sites, construction, assembly and installation projects as well as connected supervisory activities, where those sites, projects or activities last more than six months.

This subparagraph appears to be broader than paragraph 3 of Article 5 of the OECD Model Convention, which does not refer

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<sup>35</sup> OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015). Available from <http://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm>.

to assembly projects or supervisory activities. The Commentary on Article 5 of the OECD Model Convention suggests, however, that these differences are not significant, as it states that on-site planning and supervision are covered by paragraph 3<sup>36</sup> and cites an assembly project as an example of a construction or installation project.<sup>37</sup> Nevertheless, developing countries may wish to clarify the position by following the United Nations Model Convention in this regard.

The OECD provision also has a 12-month threshold instead of the 6-month test found in the United Nations provision. Even a significant minority of OECD member countries, however, will generally propose a six-month threshold.<sup>38</sup> The majority of treaties between developing countries, or between a developed and a developing country, provide a time threshold of less than 12 months. Most provide for six months, but some have a threshold as low as three months, while others provide for nine months.<sup>39</sup> While some developing countries seek a shorter period for this paragraph, the six-month test provides approximate symmetry with the permanency test for a fixed place of business under paragraph 1 of this Article, which will generally not constitute a permanent establishment if it lasts for less than six months.<sup>40</sup> Negotiators should also take into account that the chosen time threshold should not be less than any domestic time threshold for taxation of such activities, as this could lead to double non-taxation of income of non-resident construction or assembly enterprises in treaties with countries that apply an exemption system (that is to say, where income that may be taxed in the host State under the treaty is exempted from tax in the other State). This is because, while the treaty

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<sup>36</sup> See paragraph 17 of the Commentary on Article 5 of the OECD Model Convention.

<sup>37</sup> See paragraph 20 of the Commentary on Article 5 of the OECD Model Convention.

<sup>38</sup> See paragraphs 57 and 62 of the Commentary on Article 5 of the OECD Model Convention.

<sup>39</sup> See Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997 – 2013”, *Bulletin for International Taxation*, No. 3 (2014), section 2.1.3.1.

<sup>40</sup> See paragraph 1 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 6 of the Commentary on Article 5 of the OECD Model Convention.

accords the host State the right to tax the income, that State would not be able to exercise that right if the construction site lasts less than the domestic law time threshold.

There are different views as to whether paragraph 3 operates as a deeming provision such that the relevant activities will always constitute a permanent establishment when the time threshold is exceeded, or whether the requirements of paragraph 1 must also be met.<sup>41</sup> While there seems to be little doubt that a building site or construction, installation or assembly project that lasts at least six months would be a “fixed place of business” for purposes of paragraph 1, some countries may wish to make it explicit in the preamble to this paragraph that such activities are deemed to constitute a permanent establishment.

### **Furnishing of services**

Subparagraph (b) of paragraph 3 provides for certain services activities to give rise to a permanent establishment where these activities continue within a country for a period or periods of more than 183 days in aggregate in any 12-month period.

There is no equivalent provision in Article 5 of the OECD Model Convention. However the OECD Commentary on that Article includes an alternative provision dealing with services.<sup>42</sup>

While both provisions are intended to achieve a similar outcome (a permanent establishment where services are provided in a country for more than 183 days in any 12-month period), there are substantive differences between the two drafts.

In the first place, the OECD alternative provision explicitly deems activities that meet the conditions of the provision to be carried on through a permanent establishment notwithstanding that there may be no fixed place of business. While the United Nations Model Convention provision does not explicitly deem the activities to

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<sup>41</sup>See paragraph 7 of the Commentary on Article 5 of the United Nations Model Convention.

<sup>42</sup>See paragraphs 42.11 – 42.48 of the Commentary on Article 5 of the OECD Model Convention. The draft alternative provision is at paragraph 42.23 of that Commentary.

give rise to a permanent establishment, it is generally understood to provide for this outcome. The OECD alternative provision also puts beyond doubt that the services must be physically performed in the country — it is not sufficient that the services (or the benefit of the services) be rendered to a resident of that State.

Subparagraph (b) of the United Nations Model Convention is limited to services provided by an enterprise through its employees or other personnel engaged by the enterprise for this purpose. This may not cover services such as independent personal services provided by an individual directly which, under the United Nations Model Convention, are dealt with under Article 14. As Article 14 has been deleted from the OECD Model Convention, the OECD alternative provision makes it clear that independent personal services are addressed in this paragraph.

While Article 14 has been retained in the United Nations Model Convention, the Commentary includes alternative provisions that should be inserted in Article 5 by countries that wish to delete Article 14, as well as a list of consequential changes that should be made to other articles.<sup>43</sup> In particular, a new subparagraph (c) should be included to deem a permanent establishment to exist where an individual meets a 183-day length of stay test.<sup>44</sup> Developing countries that do not include Article 14 in their treaties, but who wish to provide for source-country taxing rights over independent personal services income when those services are provided over an extended period in their country, should ensure that these services are covered by the inclusion of both paragraphs (b) and (c) when negotiating paragraph 3 of Article 5.

Finally, the OECD alternative provision, in paragraph 42.23 of the Commentary, deals with two separate situations: Subparagraph (a) deals primarily with an enterprise carried on by a single individual. In these circumstances the provision includes both a “length of stay” test (similar to that in subparagraph (b) of Article 14 (1) or the alternative provision subparagraph (c) of Article 5 (3) of the United

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<sup>43</sup> See the discussion in paragraphs 15.1 – 15.26 of the Commentary on Article 5 of the United Nations Model Convention.

<sup>44</sup> For wording, see paragraph 15.7 of the Commentary on Article 5 of the United Nations Model Convention.

Nations Model Convention) and an additional requirement that more than 50 per cent of the gross revenues of the enterprise attributable to active business activities of the enterprise be derived from the services performed by that person during his or her stay. This second condition is intended to ensure that where the person is present in a country for an extended period but derives little income from the provision of services in that country (for example, where the person's visit is primarily for the purpose of vacation), taxing rights will not arise in that country. There is no equivalent to the second condition in either Article 14 or in subparagraph (c) of paragraph 3 of the alternative provision on services of Article 5 of the United Nations Model Convention.

The second situation dealt with under the OECD alternative provision is where an enterprise provides services in a country through one or more individuals (generally employees, but it may also refer to partners or dependent agents). Like subparagraph (b) of Article 5 of the United Nations Model Convention, the services must be provided for "the same or connected projects" during at least 183 days in any 12-month period, though they may be provided by different employees or other personnel on behalf of the enterprise. This condition ("for the same or a connected project") is included because, as paragraph 12 of the Commentary on Article 5 of the United Nations Model Convention mentions, "it is not appropriate to add together unrelated projects in view of the uncertainty which that step involves".

Some countries do not wish to limit source taxation of services income to the extent provided under the United Nations Model Convention, however, and seek to remove the "same or a connected project" requirement or reduce the time threshold in subparagraph (b) and alternative subparagraph (c) of paragraph 3. Negotiators encountering these proposals are advised to read the relevant parts of the Commentary on Article 5 of the United Nations Model Convention.<sup>45</sup>

A number of countries, including some OECD member countries, seek to include special provisions in their treaties dealing with

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<sup>45</sup> See the discussion on "same or a connected project" in paragraph 12 of the Commentary on Article 5 of the United Nations Model Convention, and discussion on time thresholds in paragraph 10 of the Commentary on Article 5 of the United Nations Model Convention.



exploration for or exploitation of their natural resources, especially hydrocarbons. This preference may be reflected in specific provisions in Article 5 which would deem a permanent establishment to exist<sup>46</sup> or, in the case of offshore activities, in an additional article dealing specifically with those activities. Often a permanent establishment will be deemed to exist in respect of these activities after only a short time, for example, 30 days.<sup>47</sup>

#### **Paragraph 4**

Paragraph 4 describes a number of places which are regarded as permanent establishments under paragraph 1, but through which activities are conducted that are either specifically mentioned or are generally considered to be preparatory or auxiliary. This paragraph deems these places not to constitute a permanent establishment of an enterprise as attribution of profit will either be minimal or difficult to ascertain. This paragraph mirrors paragraph 4 of Article 5 of the OECD Model Convention, with the exception of the reference to “delivery” in subparagraphs (a) and (b). As many developing countries consider that delivery may form a substantial part of the business activities of an enterprise in their country, the reference to “delivery” is omitted in the United Nations provision. This question is also discussed in section B (Artificial avoidance of PE status through the specific activity exemptions) of the OECD report on BEPS Action 7: *Preventing the artificial avoidance of PE status*.<sup>48</sup>

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<sup>46</sup> See paragraph 4 (a) of Article 5 of the Agreement between the Government of the Republic of South Africa and the Government of New Zealand for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, of 6 February 2002. Available from [www.sars.gov.za](http://www.sars.gov.za).

<sup>47</sup> See Article 21 of the Convention between the Kingdom of Norway and the Republic of South Africa for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with respect to Taxes on Income, of 12 February 1996. Available from [www.sars.gov.za](http://www.sars.gov.za).

<sup>48</sup> OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015). Available from <http://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm>.

Nevertheless, the omission of “delivery” is not universal, even in treaties between developing countries. In deciding whether to omit the reference to “delivery” in their treaties, negotiators should also consider whether a significant amount of profit can be attributed to that warehouse or stock of goods or merchandise in relation to the delivery activity.<sup>49</sup> Notwithstanding the omission of “delivery”, a warehouse or stock of goods maintained for this purpose will constitute a permanent establishment only if the requirements of paragraph 1 are met.

### *Paragraph 5*

Paragraph 5 deems a permanent establishment to exist where a person acting on behalf of an enterprise (commonly referred to as a “dependent agent”) involves that enterprise in substantial economic activity in a State. Where the conditions of paragraph 5 are met, a permanent establishment for the enterprise will exist, even if neither the enterprise nor the dependent agent has a fixed place of business in that country. This paragraph does not apply, however, if the person is an independent agent to whom paragraph 7 of the Article applies.<sup>50</sup>

This paragraph is effectively the same as paragraph 5 of Article 5 of the OECD Model Convention, except that the United Nations provision includes an additional set of circumstances, set out in subparagraph (b), in which a dependent agent will be deemed to create a permanent establishment for the enterprise.

Subparagraph (a) of paragraph 5 refers to the situation where the dependent agent is authorized to, and habitually does, conclude contracts in the name of the enterprise, unless the activities of the agent are preliminary or auxiliary activities of the kind referred to in paragraph 4 of the Article. The Commentary clarifies that the contracts do

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<sup>49</sup> See paragraphs 20–21 of the Commentary on Article 5 of the United Nations Model Convention.

<sup>50</sup> The scope of paragraph 6 of Article 5 regarding independent agents is discussed in paragraph 30 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraphs 36–38.8 of the Commentary on Article 5 of the OECD Model Convention.

not literally have to be “in the name of the enterprise” provided they are binding on the enterprise.<sup>51</sup>

Subparagraph (b), which has no equivalent in the OECD Model Convention, deems a dependent agent to be a permanent establishment where that person habitually maintains a stock of goods or merchandise from which they regularly deliver on behalf of the enterprise. This is consistent with the view that a warehouse or stock of goods maintained by the enterprise itself in a country for delivery could give rise to a permanent establishment.

The Commentary notes, however, that if all sales-related activities take place outside the host State and only delivery by an agent takes place there, this would not lead to a permanent establishment.<sup>52</sup>

Treaty practice shows that a few countries go beyond the understanding explained in the United Nations Commentary and include other circumstances within the scope of this paragraph, for example, where the agent habitually secures orders for sales of goods in the State, wholly or almost wholly on behalf of the enterprise or on behalf of the enterprise and other enterprises related to it. Moreover, some treaties include the situation where a dependent agent manufactures or processes goods belonging to the enterprise.

### ***Paragraph 6***

Paragraph 6 addresses the particular situation of an insurance enterprise which, through the activities of another person, collects

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<sup>51</sup> See paragraph 23 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 32.1 of the Commentary on Article 5 of the OECD Model Convention. More information on this item can also be found in OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015), section A (Artificial avoidance of PE status through *commissionaire* arrangements and similar strategies). Available from <http://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm>.

<sup>52</sup> See paragraph 26 of the Commentary on Article 5 of the United Nations Model Convention.

premiums or insures risks in a State. Unless the person is an independent agent to whom paragraph 7 applies, the insurance enterprise will be deemed to have a permanent establishment in that State. Reinsurance activities of an insurance enterprise, however, are excluded from the scope of the provision.

Although this paragraph has no equivalent in the OECD Model Convention, the Commentary on Article 5 of that Convention recognizes that foreign insurance enterprises can make substantial profits in a country without establishing a fixed place of business there, or authorizing an agent to conclude contracts on its behalf.<sup>53</sup> The Commentary notes that “[t]he 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”.<sup>54</sup>

The question how to treat insurance enterprises is also discussed within the OECD/G20 BEPS Project.<sup>55</sup>

### ***Paragraph 7***

Paragraph 7 provides that an independent agent who is acting in the ordinary course of their own business will not generally give rise to a permanent establishment of an enterprise for which it acts. The paragraph clarifies that an agent that acts wholly or almost wholly on behalf of the enterprise, and whose dealings with the enterprise do not reflect arm’s length standards, will not be regarded as an independent agent.

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<sup>53</sup> See paragraph 27 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 39 of the Commentary on Article 5 of the OECD Model Convention.

<sup>54</sup> *Ibid.*

<sup>55</sup> See OECD, *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015), section C (Other strategies for the artificial avoidance of PE status), subsection 2 (Strategies for selling insurance in a State without having a PE therein). Available from <http://www.oecd.org/ctp/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report-9789264241220-en.htm>.

The Commentary provides further guidance on how to identify whether a person is an independent agent acting in the ordinary course of his own business.<sup>56</sup>

The specific clarification in the second sentence in paragraph 7 (concerning agents acting wholly or almost wholly on behalf of the enterprise) is not found in the equivalent paragraph (paragraph 6) of Article 5 of the OECD Model Convention. The Commentary recognizes, however, that “[i]ndependent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise”.<sup>57</sup>

### ***Paragraph 8***

Paragraph 8, which is identical to paragraph 7 of Article 5 of the OECD Model Convention, clarifies that a parent/subsidiary relationship between two companies will not automatically make one of those companies a permanent establishment of the other by reason of that relationship.

Nevertheless, a permanent establishment may arise under paragraph 1 if one company has a fixed place of business, through which it carries on its own business, if that place is located on the premises of a related company. Similarly, the provisions of paragraph 5 may apply to deem the activities of one company to constitute a permanent establishment of the other, for example, if one company habitually concludes contracts on behalf of another related company and is thus regarded as a dependent agent.<sup>58</sup>

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<sup>56</sup> See paragraph 30 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraphs 36–38.8 of the Commentary on Article 5 of the OECD Model Convention.

<sup>57</sup> See paragraph 30 of the Commentary on Article 5 of the United Nations Model Convention, quoting paragraph 38.6 of the Commentary on Article 5 of the OECD Model Convention.

<sup>58</sup> See paragraphs 34 and 35 of the Commentary on Article 5 of the United Nations Model Convention.

## C. Chapter III — Taxation of income

One of the main effects of a tax treaty is to allocate taxing rights over income derived by a resident of one treaty partner from sources in the other treaty partner country. Treaties provide for different methods for allocating tax rights and for certain minimum thresholds for taxation of income derived by non-residents. The treaty may allocate exclusive taxing rights to one country (that is to say, the other country is not permitted to tax the income), unlimited primary source taxing rights (where the source country's right to tax is not limited by the treaty, and the residence country is required to relieve any resulting double taxation), limited primary source taxing rights (where the source country must limit its taxation, and the residence country must relieve double taxation) or, in a few treaties, shared taxing rights (where both countries are allocated exclusive taxing rights over an agreed portion of the income). The method and threshold depends on the category of income derived.<sup>59</sup>

Generally, the term “shall be taxable only” in a State signifies that that State has been allocated exclusive taxing rights, while the term “may be taxed” in a State is used where that State is allocated a non-exclusive taxing right. The fact that income “may be taxed” in one State under a provision of the treaty does not affect the other country's right to tax that income.

### 1. Article 6 — Income from immovable property

Income such as rents, agricultural or forestry profits, or other income derived from the use of immovable property, is seen as having a very strong economic link with the country in which the immovable property is situated. Accordingly, Article 6 allocates unlimited taxing rights over this income to the source country and this position should always be maintained.

Article 6 of the United Nations Model Convention differs from that of the OECD Model Convention only in that it refers to “income from immovable property used for the performance of independent personal services” in paragraph 4. This reflects the fact that Article 14

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<sup>59</sup> See distributive rules, section II.B.3 of the present Manual.

(Independent personal services) has been deleted from the OECD Model Convention but not the United Nations Model Convention.

***Paragraph 1***

Paragraph 1 gives the country where the immovable property is located the first taxing right over income derived by a resident of the other Contracting State from that property. This does not mean that the source country has exclusive rights to tax income from immovable property; the country of residence of the person deriving the income may also tax such income. The source country's right to tax is the prior right, however, and is not subject to any limits under the treaty (other than where the taxation would be in breach of Article 24 (Non-discrimination)). The country of residence must provide double taxation relief.

Article 6 does not dictate the method by which such income is to be taxed in the source State. Accordingly, although the Commentary notes that "the object should be taxation of profits rather than of gross income",<sup>60</sup> taxation on a gross basis, or on the basis of estimated or deemed profits, is not precluded. Provision for taxation on a net profits basis is particularly important in the case of income from agriculture and forestry, which activities are likely to incur significant expenses. While such income is specifically included within the scope of Article 6, countries are free to agree in their treaties that income from agricultural or forestry activities is to be dealt with under Article 7 (Business profits),<sup>61</sup> to ensure that the income is taxed on a net (profits) basis.

Income derived from immovable property situated in the country of which the recipient is a resident, or in a third State, is not covered by paragraph 1. Such income is dealt with under paragraph 1 of Article 21 (Other income).<sup>62</sup>

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<sup>60</sup> See paragraph 2 of the Commentary on Article 6 of the OECD Model Convention.

<sup>61</sup> See paragraph 6 of the Commentary on Article 6 of the United Nations Model Convention.

<sup>62</sup> Ibid.

### *Paragraph 2*

The meaning of the term “immovable property” is defined in paragraph 2 by reference to its meaning under the domestic law of the country in which the property is situated. Typically, this will include land, commercial and residential buildings and things attached to the land such as crops and minerals. In countries where immovable property is referred to as “real property” (many common law countries), immovable property may be defined for treaty purposes by reference to the meaning of “real property” in the law of that country.

A number of assets and rights are specifically included in the treaty definition of “immovable property”. These are items that are widely regarded as immovable property, such as property accessory to immovable property, mining rights or other rights relating to the exploitation of natural resources. Income from such assets and rights is covered by Article 6, even if the assets or rights are not encompassed by the domestic law definition of immovable property in the country in which the property is situated.

Some countries specifically include in the definition of “immovable property” rights to the use or enjoyment of immovable property situated in their jurisdiction, where those rights derive from the holding of shares or other corporate rights in the company that owns the property (often time-share rights).<sup>63</sup>

Ships, boats and aircraft are excluded from the treaty definition of “immovable property” in paragraph 2, regardless of whether they are covered by any domestic law definition. Interest from a debt secured by immovable property is not covered by Article 6.<sup>64</sup>

### *Paragraph 3*

Paragraph 3 makes it clear that paragraph 1 applies to income from immovable property, irrespective of how that property has been used

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<sup>63</sup> See paragraph 4 of the Commentary on Article 6 of the United Nations Model Convention.

<sup>64</sup> See paragraph 7 of the Commentary on Article 6 of the United Nations Model Convention. Interest, including interest secured by immovable property, is dealt with under Article 11 of the United Nations Model Convention.



to produce that income, for example, for rental purposes, for the conduct of agricultural or forestry activities or mining, or for the granting of rights to others to use the property or exploit natural resources.

***Paragraph 4***

Paragraph 4 ensures that the provisions of paragraphs 1 and 3 apply to profits derived from the use or exploitation of immovable property of an enterprise and to immovable property used for the performance of independent personal services. Accordingly, the country in which the immovable property is situated may impose tax on the income derived from the use of that property by a resident of the other country, irrespective of whether or not that property is part of a permanent establishment or fixed base situated in the country in which the immovable property is situated.

If the treaty does not include Article 14 (Independent personal services) then paragraph 4 of Article 6 of the OECD Model Convention should be followed, that is to say, the words “and to income from immovable property used for the performance of independent personal services” should be deleted.

**2. Article 7 — Business profits**

Article 7 is a key provision of the treaty in that it allocates taxing rights over business profits derived by an enterprise of a Contracting State. Under this Article, profits of an enterprise of one State may not be taxed in the other State unless the enterprise carries on business through a permanent establishment situated in that other State. Where the business is carried on through a permanent establishment in a country, the Article specifies the profits that may be taxed in that country.

The term “enterprise of a Contracting State” is defined in Article 3 (General definitions) as an enterprise carried on by a resident of that State. “Enterprise” is not defined in the United Nations Model Convention. It is left to the domestic law of each country to determine whether the term refers to a business activity or the person that carries on that business activity.<sup>65</sup> The definition of “enterprise” in the

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<sup>65</sup> See paragraph 6 of the Commentary on Article 3 of the United Nations Model Convention.

OECD Model Convention<sup>66</sup> is merely intended to indicate that professional and other independent activities (which are covered by Article 14 (Independent personal services) in the United Nations Model Convention) are encompassed within that term.

Article 7 of the United Nations Model Convention broadly follows the same Article of the 2008 OECD Model Convention (“former OECD Article 7”). The new version of Article 7 that was included in the 2010 OECD Model Convention (“new OECD Article 7”) has not been adopted in the United Nations Model Convention.<sup>67</sup> The new OECD Article 7 takes into account dealings between different parts of an enterprise to a greater extent than is recognized by the United Nations Model Convention. In practice, treaties of developing countries (and of many developed countries) do not include the new OECD Article 7 and the models of many regional intergovernmental organizations, for example, the Association of Southeast Asian Nations (ASEAN), the East African Community (EAC) and the Southern African Development Community (SADC), generally follow Article 7 as it appears in the United Nations Model Convention.

### *Paragraph 1*

Paragraph 1 sets out the main rule for taxation of business profits. Exclusive taxing rights over such profits are allocated to the country of residence (that is to say, the country of residence of the person carrying on the enterprise). If the enterprise carries on business in the other treaty partner country through a permanent establishment (“PE country”), however, then that country may also tax certain profits. Paragraph 1 of Article 7 of the United Nations Model Convention specifies three categories of profits that may be taxed in the PE country, that is to say, profits attributable to:

- (a) The permanent establishment;
- (b) Sales in the PE country by the enterprise of goods or merchandise that are of the same or a similar kind as those sold through the permanent establishment; or

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<sup>66</sup> See paragraph 1 (c) of Article 3 of the OECD Model Convention.

<sup>67</sup> See paragraph 1 of the Commentary on Article 7 of the United Nations Model Convention.

- (c) Other business activities carried on in the PE country that are the same or of a similar kind as those carried on through the permanent establishment.

The equivalent paragraph in both the former OECD Article 7 and the new OECD Article 7 provide only for taxation in the PE country of profits attributable to the permanent establishment. Many countries will resist the “limited force of attraction” rules, that is to say, the extension of taxing rights to profits from sales and other business activities covered by subparagraphs (b) and (c) above, on the basis that profits from activities that are not part of those carried on through the permanent establishment, and which do not themselves give rise to a permanent establishment, should not be subjected to tax in the PE country. On the other hand, some developing countries consider that, where an enterprise trades in goods or services in their country both directly and through a permanent establishment, the same tax treatment should apply, both to discourage abusive arrangements and to simplify administration.<sup>68</sup>

In practice, in recent years, subparagraphs (b) and (c) have been included in less than 20 per cent of tax treaties, including those of developing countries.<sup>69</sup> In some treaties, taxing rights in the PE country extend to the profits covered by subparagraphs (b) or (c) only in cases of abuse.<sup>70</sup>

## **Paragraph 2**

Paragraph 2, which mirrors paragraph 2 of the former OECD Article 7, determines the meaning of “profits attributable to a permanent establishment”. In effect it requires that the profits be determined in both

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<sup>68</sup> See paragraphs 6 and 7 of the Commentary on Article 7 of the United Nations Model Convention.

<sup>69</sup> Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997 – 2013”, *Bulletin for International Taxation*, No. 3 (2014), section 2.7.2.

<sup>70</sup> An example of relevant wording is as follows: “However, the profits derived from the sales or activities described in subparagraphs (b) and (c) shall not be taxable in the other Contracting State if the enterprise demonstrates that such sales or activities have been carried out for reasons other than obtaining a benefit under this Agreement”.

States in accordance with the arm's length principle, that is to say, for purposes of the Article, profits attributable to the permanent establishment are the profits that it "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".<sup>71</sup>

Most countries consider that the arm's length principle applies to all dealings of the permanent establishment, whether the dealing is with the head office of the enterprise, another part of the enterprise or a separate enterprise or entity.

Paragraph 2 of the new OECD Article 7 also embodies the arm's length principle. In addition, it clarifies that the attribution of profits also applies for purposes of Article 23 (Methods for the elimination of double taxation). While this is how most countries would interpret paragraph 2 of Article 7 of the United Nations Model Convention,<sup>72</sup> the new OECD Article 7 is more specific in this regard.

Paragraph 2 of the new OECD Article 7 also makes specific reference to the method by which profits attributable to the permanent establishment are to be determined, that is to say, by reference to the functions performed, assets used and risks assumed through the permanent establishment and the rest of the enterprise.

Much has been written on the application of the arm's length principle in determining profits of a permanent establishment, including in the Commentaries.<sup>73</sup>

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<sup>71</sup> See paragraph 14 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraph 14 of the Commentary on Article 7 of the 2008 OECD Model Convention.

<sup>72</sup> See paragraph 8 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraph 12 of the Commentary on Article 7 of the 2008 OECD Model Convention.

<sup>73</sup> See paragraph 15 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraphs 12–15.4 of the Commentary on Article 7 of the 2005 OECD Model Convention. See also Jinyan Li, "Taxation of non-residents on business profits", *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (United Nations, Sales publication No. 13.XVI.2).

***Paragraph 3***

Paragraph 3 clarifies, in relation to expenses of the permanent establishment, how the profits are to be determined.

The first sentence of paragraph 3, like paragraph 3 of the former OECD Article 7, provides that deductions are to be allowed for expenses incurred for the permanent establishment, irrespective of where such expenses are incurred.

The Commentary notes that the expenses do not need to be wholly, exclusively and necessarily incurred for purposes of the business carried on through the permanent establishment, but the expenditure must be “relevant, referable and necessary for carrying out the business operations”.<sup>74</sup>

The Commentary also states that paragraph 3 only determines which expenses should be attributed to the permanent establishment. Whether or not those expenses are in fact deductible will depend on domestic law. For example, in some countries, entertainment expenses are not allowed as deductions. Some countries prefer to clarify this principle explicitly in their treaties.<sup>75</sup>

The second and third sentences of paragraph 3 in Article 7 of the United Nations Model Convention provide that deductions are not allowed in respect of any expenses paid between the permanent establishment and any other part of the enterprise by way of intra-enterprise royalties, commissions, management or other services or interest (except in the case of banks), unless the payments were made as reimbursement to the other part of the enterprise for actual expenses incurred. Thus, for example, where an enterprise owns a patent or copyright, no deduction will be allowed, in calculating the profits attributable to the permanent establishment for purposes of Article 7, in respect of any “royalties” charged by the head office or another part of the enterprise to a permanent establishment of the same enterprise.

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<sup>74</sup> See paragraph 17 of the Commentary on Article 7 of the United Nations Model Convention.

<sup>75</sup> See paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraphs 30 of the Commentary on Article 7 of the 2008 OECD Model Convention.

These sentences in paragraph 3 have no equivalent in the former OECD Article 7, although the United Nations Model Convention provision largely reflects the interpretation found in the Commentary on paragraph 3 of the former OECD Article 7.<sup>76</sup> The new OECD Article 7, which has no provision equivalent to paragraph 3, does not limit deductions to actual expenses, and requires the recognition and arm's length pricing of all dealings where one part of the enterprise performs functions for the benefit of the permanent establishment.<sup>77</sup>

Paragraph 3 of the new OECD Article 7 performs a completely different function. It provides for corresponding adjustments to profits where one State adjusts the profits of the permanent establishment. It is intended to ensure that all double taxation is relieved,<sup>78</sup> and operates in a way similar to paragraph 2 of Article 9.

#### ***Paragraph 4***

Paragraph 4 allows countries that customarily determine the profits of a permanent establishment by apportioning the total profits of the enterprise according to a formula (for example, on the basis of receipts, expenses or capital) to continue to do so provided that the method of apportionment provides for a result that is in accordance with the arm's length principle.

In practice, few countries apply formulaary apportionment methods. Even where such methods are used, it is difficult to ensure that the method produces arm's length results. For these reasons, the paragraph, which was also found in the former OECD Article 7, was deleted from new OECD Article 7.<sup>79</sup>

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<sup>76</sup> See paragraph 18 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraphs 34–44 of the Commentary on Article 7 of the 2008 OECD Model Convention.

<sup>77</sup> See paragraphs 38–40 of the Commentary on Article 7 of the 2010 OECD Model Convention.

<sup>78</sup> See paragraphs 44–70 of the Commentary on Article 7 of the 2010 OECD Model Convention.

<sup>79</sup> See paragraph 41 of the Commentary on Article 7 of the 2010 OECD Model Convention.

The Commentary notes that the paragraph may be deleted where neither State uses such methods, and this is sometimes the case in practice.<sup>80</sup>

### ***Paragraph 5***

Paragraph 5, which mirrors paragraph 6 of the former OECD Article 7, is intended to give an assurance of continuous and consistent tax treatment by providing that, unless there is good reason to change, the same method of attributing profits to the permanent establishment is to be used each year. This refers generally to the ongoing use of direct or indirect methods, or of formulary apportionment methods. In most countries, it would be expected that the same method would be used each year even in the absence of this provision.

This paragraph is omitted from the new OECD Article 7 because such fundamentally different methods of attribution of profits are not available under that Article.<sup>81</sup>

### ***Paragraph 6***

Paragraph 6, which is identical to paragraph 7 of the former OECD Article 7 and paragraph 4 of the new OECD Article 7, gives priority to other articles of the treaty where an item of income is dealt with separately in that other article.

For example, dividends or interest dealt with under Article 10 or Article 11, respectively, will be taxed in accordance with the rules of those Articles, rather than Article 7. It should be noted, however, that some articles have a “throwback” rule, such as paragraph 4 of Article 10, that specifies that the provisions of Article 7 are to apply in certain circumstances.

The Commentary notes that while the term “profits” is not defined in the treaty, it is open to countries to agree bilaterally upon

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<sup>80</sup> See paragraph 19 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraphs 52 and 54 of the Commentary on Article 7 of the 2008 OECD Model Convention.

<sup>81</sup> See paragraph 42 of the Commentary on Article 7 of the 2010 OECD Model Convention.

special explanations or definitions concerning this term, for example, where, under domestic law, the term includes special classes of receipts, such as income from the alienation of a business.<sup>82</sup>

### Note

Article 7 of the United Nations Model Convention includes a note indicating that 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 has not been resolved and should be settled in bilateral negotiations. In practice, the majority of treaties include such a provision and this is in line with the provisions of subparagraph (d) of Article 5 (4), which deem a permanent establishment not to exist where its sole activity is the purchase of goods for the enterprise.

The former OECD Article 7 included a provision (paragraph 5) which provided that no profits should be attributed to the permanent establishment in these circumstances and this paragraph should be included when the negotiators agree to this approach in relation to the mere purchase of goods and merchandise.

### 3. Article 8 — Shipping, inland waterways transport and air transport

Article 8 deals with profits from transportation activities in international traffic.

The term “international traffic” is defined in subparagraph (d) of Article 3 (1) to mean transport by ship or aircraft other than local transport within a treaty partner country. It therefore covers transport activities conducted within a country by an enterprise that has its place of effective management in that State, as well as any international transport. Purely local transport within the other State, however, is not covered by the term. It follows that profits derived by the enterprise from transport that is wholly within the other State are not dealt with

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<sup>82</sup> See paragraph 21 of the Commentary on Article 7 of the United Nations Model Convention, quoting paragraphs 59 and 63 of the Commentary on Article 7 of the 2008 OECD Model Convention.



under Article 8 and will instead fall under Article 7 (Business profits). Accordingly, only profits from such local transport that are attributable to a permanent establishment of the enterprise in the other State may be taxed in that other State.

The United Nations Model Convention has two versions of Article 8. Alternative A mirrors Article 8 of the OECD Model Convention in allocating exclusive taxing rights over the profits to the country in which the enterprise has its place of effective management. Alternative B permits limited source taxation over shipping profits. Alternative B, however, is rarely found in practice, even in treaties negotiated by developing countries.<sup>83</sup>

A number of countries prefer to extend the scope of Article 8 to international transport by road or rail and in this case the text of the definition of “international traffic” in Article 3, as well as paragraph 1 of Article 8, paragraph 3 of Article 13 and paragraph 3 of Article 15, should be drafted accordingly to include road or rail transport.

***Paragraph 1 (alternative A), paragraphs 1 and 2 (alternative B)***

Paragraph 1 of alternative A, like paragraph 1 of Article 8 of the OECD Model Convention, allocates exclusive taxing rights over profits from ship and aircraft operations in international traffic to the country in which the enterprise has its place of effective management.

However, treaty practice shows that some countries prefer to allocate exclusive taxing rights to the country of residence of the enterprise, rather than the country in which the enterprise has its place of effective management. Wording to give effect to this preference may be found in paragraph 10 of the Commentary on Article 8 of the United Nations Model Convention.<sup>84</sup>

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<sup>83</sup> Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997 – 2013”, *Bulletin for International Taxation* No. 3 (2014), section 2.10.

<sup>84</sup> Compare also the critique against a “purely formal criterion” in paragraphs 8 and 9 of the Commentary on Article 4 of the United Nations Model Convention.

The profits to which the Article applies are discussed in the Commentaries.<sup>85</sup> The application of the Article to profits from bare-boat charters or from container leasing can be controversial and should be discussed during negotiations. If necessary, the application of the Article to these profits should be clarified.

Under alternative B, the words “ships or” are deleted from paragraph 1, with the result that this paragraph applies only to profits from international aircraft operations. Paragraph 2 of alternative B provides for source-country taxation of profits from the operation of ships in international traffic if the operations in that country are “more than casual”.<sup>86</sup> If the operations are more than casual, an “appropriate allocation of the overall net profits” may be taxed in the source country. The United Nations Model Convention provides for a reduction in the source tax, but does not specify a percentage. A reduction of 50 or 60 per cent is typically provided for in the very small number of treaties that include this provision.<sup>87</sup> Even fewer countries extend the operation of paragraph 2 of alternative B to international aircraft operations.

Countries that are considering using alternative B should ensure that they can effectively administer this provision, that is to say, that they can identify the relevant operations, determine the appropriate allocation of overall net profits, and collect the tax while providing the necessary reductions.

### ***Paragraph 2 (alternative A), paragraph 3 (alternative B)***

Paragraph 2 of alternative A and paragraph 3 of alternative B allocate sole taxing rights over profits from the transport operation of boats on inland waterways to the country in which the place of effective management of the enterprise is situated.

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<sup>85</sup> See paragraphs 10 and 11 of the Commentary on Article 8 of the United Nations Model Convention, quoting paragraphs 4–14 of the Commentary on Article 8 of the OECD Model Convention.

<sup>86</sup> The meaning of “more than casual” is discussed in paragraph 13 of the Commentary on Article 8 of the United Nations Model Convention.

<sup>87</sup> Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997–2013”, *Bulletin for International Taxation* No. 3 (2014), section 2.10.2.

In practice, few countries include this provision in their treaties. The Commentary notes that countries are “free to settle any specific tax problems which may occur with regard to inland waterways transport, particularly between adjacent countries, through bilateral negotiations”.<sup>88</sup>

If the paragraph is included in a treaty which allocates exclusive taxing rights under paragraph 1 to the country of residence of the enterprise (rather than the country in which the place of effective management of the enterprise is situated), this paragraph should also be amended accordingly.

***Paragraph 3 (alternative A), paragraph 4 (alternative B)***

Paragraph 3 of alternative A and paragraph 4 of alternative B provide a deeming rule for determining the country in which the place of effective management of an enterprise is situated in cases where the enterprise is managed from aboard a ship or boat. In these circumstances the place of effective management is deemed to be in the country where the home harbour of the ship or boat is situated or, if it does not have a home harbour, in the country of residence of the operator of the ship or boat.

If paragraph 1 of a treaty allocates the taxing rights to the country of residence (and not the country in which the place of effective management is situated), the paragraph under discussion is not required and should not be included.

***Paragraph 4 (alternative A), paragraph 5 (alternative B)***

Paragraph 4 of alternative A and paragraph 5 of alternative B ensure that where the enterprise participates in pooling arrangements or other similar profit-sharing arrangements with other international transport enterprises, the provisions of Article 8 will also apply to the share of profits derived by the enterprise through those arrangements.

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<sup>88</sup> See paragraph 15 of the Commentary on Article 8 of the United Nations Model Convention.

#### 4. Article 9 — Associated enterprises

The following words from the *United Nations Practical Manual on Transfer Pricing for Developing Countries*<sup>89</sup> highlight the background of Article 9:

A significant volume of global trade nowadays consists of international transfers of goods and services, capital (such as money) and intangibles (such as intellectual property) within an MNE [multinational enterprise] group.... The structure of transactions within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore no longer governed entirely by market forces, but driven by the common interests of the entities of a group.

Article 9 allows a country to adjust, for tax purposes, the profits of an enterprise where those profits have been reduced as a result of non-arm's length transactions with a related enterprise in a treaty partner country. To ensure that the adjustment does not result in economic double taxation, the treaty partner country is generally required to make any necessary corresponding adjustment to the profits of the related enterprise.

The United Nations Model Convention and the OECD Model Convention embody the arm's length principle that forms the basis for allocating profits resulting from transactions between associated enterprises. The *United Nations Practical Manual on Transfer Pricing for Developing Countries* and the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*<sup>90</sup> explain in great detail the application of Article 9.

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<sup>89</sup> United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (United Nations publication, Sales No. 13.XVI.1), chap. 1, paras 1.1.3 and 1.1.5. Available from [http://www.un.org/esa/ffd/documents/UN\\_Manual\\_TransferPricing.pdf](http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf).

<sup>90</sup> Organisation for Economic Co-operation and Development, *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Adminis-*

### ***Paragraph 1***

Paragraph 1 of Article 9 applies to associated enterprises. Enterprises are “associated” if:

- One of the enterprises of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other State, or
- The same persons participate directly or indirectly in the management, control, or capital of both enterprises

In cases of associated enterprises, the tax authorities of the Contracting States 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 those States, that is to say, the internal pricing differs from arm’s length pricing, the pricing that would have been agreed between enterprises that were wholly independent of each other and affected only by market forces.

### ***Paragraph 2***

Paragraph 2 deals with the consequences of a transfer pricing adjustment by a Contracting State (the initial adjustment), namely the requirement to make a corresponding adjustment by the other State to avoid economic double taxation. The requirement to make a corresponding adjustment is not automatic, however. Only when the other State considers the initial adjustment of profits in the first-mentioned State to accurately reflect what the arm’s length amount of profits would have been does the State have to make a corresponding adjustment.

### ***Paragraph 3***

Paragraph 3 (which has no equivalent in the OECD Model Convention) makes an exception to the requirement in paragraph 2 that

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*trations* (Paris: OECD, 2010). Available from <http://www.oecd.org/tax/transfer-pricing/transfer-pricing-guidelines.htm#HowToObtainPublication>.

corresponding adjustments be made. No such adjustment is required where a final ruling in legal proceedings has been made that one of the enterprises involved in the non-arm's length transactions that gave rise to the adjustment under paragraph 1 is liable to penalty for fraud, gross negligence or wilful default.

This paragraph is not widely adopted; one has to keep in mind that it leads to double penalties.<sup>91</sup> Treaty practice shows that a few countries include a variation of this provision that excludes the application of paragraph 2 in cases of fraud, wilful default or negligence even without the link to penalties or legal proceedings.

## 5. Article 10 — Dividends

Article 10 deals with distributions of corporate profits in the form of dividends from a company in one country to its shareholders in a treaty partner country. The dividends may be taxed in both the country of residence of the shareholder (residence State) and the country of which the paying company is a resident (source State). Taxation in the source State, however, is limited if the beneficial owner of the dividends is a resident of the other State.

The Article is similar to Article 10 of the OECD Model Convention except that the limitations provided in paragraph 2 on taxing rights in the source country differ significantly.

### *Paragraph 1*

Paragraph 1 provides that dividends paid from the source State to a resident of the other State may be taxed in that other State, that is to say, in the country of residence of the shareholder. There are no limits imposed under the treaty on the residence State's taxing rights (although the residence State is required to relieve double taxation where the source State is also permitted under the treaty to tax the income).

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<sup>91</sup>See paragraph 8 of the Commentary on Article 9 of the United Nations Model Convention.

## *Paragraph 2*

Paragraph 2 provides that the source State may also tax the dividends, but the rate at which the dividends may be taxed in the source State is limited if the dividends are beneficially owned by a resident of the other Contracting State.

Two different rate limits are provided; one for direct investment dividends (that is, where one company holds a substantial interest in the other company) and another for portfolio investment dividends (that is, where a company holds a small interest in the other company, or where the shareholder is an individual). In both cases, the rate limit is calculated as a percentage of the gross amount of the dividends. This reflects the fact that most countries tax dividends paid to non-residents by means of a withholding mechanism.

The United Nations Model Convention does not provide for specific percentages for limits on dividend withholding tax rates, leaving them for countries to resolve in bilateral negotiations. A rate limit of 5 per cent of the gross amount of the direct investment dividends and 15 per cent for all other dividends is provided for in the OECD Model Convention. Rates in treaties with developing countries commonly vary; a careful design of a country model as described in section II.B and preparation of treaty negotiations as mentioned in section II.C of the present Manual are necessary for each country.

The rate for direct investment is generally lower than that applicable to portfolio investment for a number of reasons. In the first place, the risk of multiple layers of taxation is higher for intercorporate dividends (dividends paid by one company to another). This can lead to excessive taxation of corporate profit and/or unrelieved double or multiple taxation. Second, many developing countries seek to encourage direct investment in preference to more mobile portfolio investment.

Paragraphs 7 to 12 of the Commentary on Article 10 of the United Nations Model Convention discuss some of the policy and technical factors that should be considered by negotiators in setting rate limits on dividend withholding taxes. In particular, developing countries should take into account the total tax that will be imposed on corporate profit, including tax at the company level and tax imposed on successive levels of shareholders. A high level of dividend withholding

tax, while it may act to defer repatriation of profits by local companies to foreign owners, is also likely to discourage foreign investors from establishing or investing in local companies in the first place.

Subparagraph (a) of paragraph 2, which deals with direct investment, specifies a minimum holding of 10 per cent of capital in the paying company as the threshold for that holding to be regarded as direct investment. The Commentary notes, however, that this level is illustrative only.<sup>92</sup> In the OECD Model Convention, the minimum holding is 25 per cent of capital. Treaty practice shows that a few countries prefer criteria other than capital, such as a percentage of voting stock or voting power, to reflect the degree of influence the shareholder may have over the company rather than the amount of capital owned.

To avoid abuse of the holding requirement, some countries include a provision that the minimum level of ownership must have been held for a specified period before the payment of the dividend. Alternatively, an anti-abuse provision could be included that would apply specifically to subparagraph (a)<sup>93</sup> or that would apply to the Article in general.<sup>94</sup>

Some countries seek exemption from source-country taxation in respect of certain categories of dividends, in particular where the dividend recipient is exempt from tax on such income in the recipient's country of residence. The Commentary cites the examples of dividends received by exempt pension funds or by State or State-owned entities (sovereign wealth funds).<sup>95</sup> In these cases, the residence coun-

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<sup>92</sup> See paragraph 6 of the Commentary on Article 10 of the United Nations Model Convention, and paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraph 14 of the Commentary on Article 10 of the OECD Model Convention.

<sup>93</sup> See paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraphs 16 and 17 of the Commentary on Article 10 of the OECD Model Convention.

<sup>94</sup> See paragraph 25 of the Commentary on Article 10 of the United Nations Model Convention.

<sup>95</sup> See paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraphs 13.1 and 13.2 of the Commentary on Article 10 of the OECD Model Convention.



try will generally be unable to relieve tax imposed on the dividends at source. Source countries which do not follow the sovereign immunity principle referred to in this part of the Commentary might ask why they should reduce their source tax because there is no double taxation to be avoided. There may also be other cases where the dividends are exempt in the residence country but the source country does not consider it appropriate to grant the exemption, or even reduce its taxation, for example, where the dividends are paid to a company that is preferentially taxed and owned by residents of a third State.<sup>96</sup> Countries that are concerned about these issues should raise them during negotiations.

A few (mainly developed) countries may wish to include special rules to deal with the particular case of real estate investment trusts. The issues that these raise and possible solutions are discussed in the Commentary on Article 10 of the OECD Model Convention.<sup>97</sup>

While most treaties provide lower rates of withholding on direct investment dividends to reduce the incidence of recurrent taxation, some countries find it difficult to administer the dual rates under their domestic law and prefer to provide for a single rate applicable to all dividends. This approach can of course militate against substantial investments, particularly if the single rate agreed is high.

Dividends to which the treaty applies will mostly arise in the developing country, since the flow of capital is almost exclusively from developed to developing country. Accordingly, the immediate impact of revenue reductions as a consequence of treaty rate limits will fall on the developing country (although there may be long-term revenue gains as a result of increased capital flows). Developing countries will need to decide what rate they can accept in their treaties, bearing in mind that high rates of withholding may deter investment.<sup>98</sup>

All developing countries should aim to have a reasonably consistent treaty practice with respect to dividend withholding tax rate

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<sup>96</sup> See paragraph 22 of the Commentary on Article 10 of the United Nations Model Convention.

<sup>97</sup> See paragraphs 67.1 – 67.7.

<sup>98</sup> See section II.B of the present Manual, on a policy framework and country Model.

limits. If, for example, a developing country agreed to a rate limit in one of its treaties that was significantly lower than usually found in its treaties, then in the absence of special reasons for that rate, negotiators would find it difficult to maintain higher rates in its subsequent treaties. It is also wise to avoid most favoured nation (MFN) provisions that require the country, in the event that it agrees on a lower rate with a third country, to provide similar treatment to its existing treaty partner, since lower rates with that third country may have been negotiated having regard to the overall balance of benefits provided in that treaty (see section II.D.5).

The rate limits provided for in paragraph 2 apply only where the beneficial owner of the dividends is a resident of the treaty partner country. If the dividends are paid to a resident of the other country, but that person is not the beneficial owner of that income, the source country is not obliged to reduce its tax and may apply the rates provided under its domestic law.<sup>99</sup>

The treaty does not prescribe how the rate limit is to be applied. Paragraph 2 authorizes the competent authorities to settle by mutual agreement the mode of application of the limitation. Each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment.<sup>100</sup> Most countries collect tax on dividends paid to non-residents through the imposition of a withholding tax which is deducted by the paying company and remitted by that company to the tax authority of the source State. The source State may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.<sup>101</sup> Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate

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<sup>99</sup> See the discussion of “beneficial ownership” in relation to Article 11 (Interest) below.

<sup>100</sup> See paragraph 13 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraph 18 of the Commentary on Article 10 of the OECD Model Convention.

<sup>101</sup> Paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention expresses a strong preference for application of treaty limits at source, rather than subsequent refund.

of residence from the tax administration or competent authority of their country of residence.

Finally, paragraph 2 clarifies that the limits on source taxation do not affect taxation of the company profits out of which the dividends are paid. The paragraph is concerned only with taxation of the distributions to the shareholder, not with taxation of the underlying company profits.

### ***Paragraph 3***

Paragraph 3 specifies the meaning of the term “dividends” for purposes of the treaty. The definitions in the United Nations and OECD Model Conventions are identical and cover income from all kinds of shares or other rights that participate in profits, as well as income from other corporate rights that are taxed in the same way as dividends in the source State.

In some countries, excessive interest payments between related enterprises may be treated under domestic law as dividend distributions under domestic thin capitalization rules. While the Commentary provides guidance on when the payments may be considered to be dividends for purposes of the treaty, it may be desirable to clarify that the provisions of Article 10 (Dividends) have priority over Article 11 (Interest) in these cases. This is normally achieved by extending the definition of “interest” in paragraph 3 of Article 11 to ensure that this result is obtained, for example, by adding: “The term ‘interest’ shall not include any item of income which is considered as a dividend under the provisions of paragraph 3 of Article 10.”

### ***Paragraph 4***

Paragraph 4, like paragraph 4 of Article 10 of the OECD Model Convention, describes a situation where the rules for allocation of taxing rights over income provided in paragraphs 1 and 2 do not apply. Where the dividends form part of the profits of a permanent establishment situated in the country of which the paying company is a resident (source State), the source State is not required to limit its tax on those dividends. Instead, the source State may tax the income as business profits attributable to the permanent establishment in accordance with

the provisions of Article 7 (Business profits). For treaties that include Article 14 (Independent personal services), paragraph 4 also provides that source-State tax is unlimited if the dividends are attributable to a fixed base in that State.

Paragraph 4 requires that the holding in respect of which the dividends are paid be “effectively connected” with the permanent establishment or fixed base. The meaning of the term effectively connected is discussed in paragraphs 32.1 and 32.2 of the Commentary on Article 10 of the OECD Model Convention. Broadly speaking, paragraph 4 applies only where the holding in respect of which the dividends are paid is a business asset of the permanent establishment or fixed base. Paragraph 4 does not operate as a “force of attraction” rule, that is, the paragraph does not apply where, for example, the shareholder has a permanent establishment or fixed base in the source State but the holding is not a business asset of that permanent establishment or fixed base. An example of an effective connection is the case of an insurance company which is engaged in business operations in the source State through a branch which qualifies as a permanent establishment. Where the income from premiums on policies sold in the source State through the permanent establishment are invested in shares of companies, the shareholding is clearly effectively connected to the permanent establishment as it is a business asset of the branch rather than the head office. As a result, the dividends are taxable in the source State under Article 7 without any limitation imposed by Article 10.

### ***Paragraph 5***

In accordance with paragraph 5, a country may generally tax only its own residents, or permanent establishments situated in its jurisdiction, on dividends paid by a company that is a resident of a treaty partner country. It may not tax other dividends paid by that non-resident company nor impose an undistributed profits tax on any such profits of the non-resident company.

The paragraph is intended to rule out extraterritorial taxation, which may occur if a country subjects dividends to source taxation on the basis that the distributions are paid out of, or the undistributed profits represent, profits sourced in that State.

This paragraph is identical to paragraph 5 of Article 10 of the OECD Model Convention, except insofar as it refers to a “fixed base”. The Commentaries on this paragraph provide guidance on its application to the sometimes difficult issues in the context of domestic controlled foreign corporations legislation.<sup>102</sup>

### ***Branch profits taxes***

Under their domestic law, some countries impose an additional tax on the profits of a local branch of foreign enterprises. This tax is intended to provide broad equivalence between methods of conducting business so that, regardless of whether a foreign enterprise conducts business in the source country through a branch or through a subsidiary, similar levels of source tax are payable. The additional domestic tax may take many forms, including the imposition of a higher rate of tax on branch profits of foreign enterprises, a tax on the after-tax profits of the branch at a similar rate to dividend withholding taxes, or a tax on remittances of branches to their head office.

Neither the United Nations Model Convention nor the OECD Model Convention, however, provides for any additional branch profits tax. Only the countries which can levy an additional tax on the domestic level ask for a provision for branch profits taxation in tax treaties. Therefore, such a clause is sometimes found, particularly in treaties of developing countries. The policy arguments for and against the inclusion of branch profits tax provisions are set out in paragraphs 18 to 20 of the Commentary on Article 10 of the United Nations Model Convention and in paragraph 60 of the Commentary on Article 24 of the OECD Model Convention. Paragraph 21 of the Commentary on Article 10 proposes a paragraph that could be used if countries agree to provide for branch profits taxation in their treaty.

If such a provision is included, the additional tax should be limited to the same rate as that applicable to non-portfolio intercorporate dividends, and should apply to the after-tax amount of the branch

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<sup>102</sup> See paragraph 16 of the Commentary on Article 10 of the United Nations Model Convention, quoting paragraphs 37–39 of the Commentary on Article 10 of the OECD Model Convention.

profits, to ensure maximum consistency between taxation of profits of subsidiaries and branches.<sup>103</sup>

Although the paragraph provides for additional taxation on the profits of the permanent establishment, rather than on any distribution or remittance by the enterprise, this provision is commonly found in Article 10 since its purpose is to provide broad equivalence with taxation of dividends.

Since imposition of a branch profits tax may be inconsistent with the non-discrimination rules of the treaty,<sup>104</sup> some countries include in Article 24 a specific exclusion for branch profits tax. If the provision set out in paragraph 21 of the Commentary is used, such an exclusion is not required, since the provision stipulates “[n]otwithstanding any other provision of this Convention”. In any event, the Commentary on Article 24 makes it clear that measures that are expressly authorized by treaty provisions cannot be considered to violate the non-discrimination rules.<sup>105</sup>

## 6. Article 11 — Interest

Article 11 allocates taxing rights over interest arising in one Contracting State (source State) and derived by a resident of the other Contracting State (residence State). To prevent excessive taxation and to achieve a sharing of revenue from such income between the two countries, source taxation is limited to a percentage of the gross amount of the interest.

It should be noted that the Article does not deal with interest arising in the residence State or in a third State. Such income is dealt with under Article 21 (Other income).

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<sup>103</sup> See paragraphs 22 and 23 of the Commentary on Article 10 of the United Nations Model Convention.

<sup>104</sup> See paragraph 3 of Article 24 of the United Nations Model Convention.

<sup>105</sup> See paragraph 1 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraph 4 of the Commentary on Article 24 of the OECD Model Convention.

***Paragraph 1***

Paragraph 1 provides that interest to which the Article applies is interest which arises in the source State and that interest may be taxed in the residence State. There are no limits imposed under the treaty on the taxing rights of the residence State (although the residence State is required to relieve double taxation where the source State is also permitted under the treaty to tax the income).

***Paragraph 2***

Paragraph 2 provides that the source State may also tax the interest, but the rate at which the interest may be taxed in the source State is limited if the interest is beneficially owned by a resident of the other Contracting State. The United Nations Model Convention does not provide for specific percentages regarding limits on interest withholding tax rates. A rate limit of 10 per cent of the gross amount of the interest is provided for in the OECD Model Convention. Rates in treaties with developing countries vary from full exemption to 25 per cent. Most treaties, however, limit withholding tax on interest to 10 or 15 per cent. Some regional models, such as the Association of Southeast Asian Nations (ASEAN) Model, specify 15 per cent.

Source-country rate limits are often one of the most controversial aspects of a treaty negotiation, especially in treaties between developed and developing countries. It is most important, particularly for developing countries, to achieve a balance between collecting revenue and attracting foreign investment. Interest to which the treaty applies will mostly arise in the developing country, since the flow of capital is almost exclusively from developed to developing country. Accordingly, the immediate impact of revenue reductions as a consequence of treaty rate limits will fall on the developing country (although there may be long-term revenue gains as a result of increased capital flows). Developing countries will need to decide what rate they can accept in their treaties, bearing in mind that high rates of withholding may deter investment or may result in the tax cost being passed on to resident payers through increased interest rates.

A careful design of a country model as described in section II.B and preparation of treaty negotiations as mentioned in section II.C

of the present Manual are necessary for each country. In designing its treaty model and in its treaty negotiations, a country should aim to have a reasonably consistent treaty practice with respect to interest withholding tax rate limits. If, for example, a developing country agreed to a rate limit in one of its treaties that was significantly lower than is usually found in its treaties, then in the absence of special reasons for that rate, negotiators would find it difficult to maintain higher rates in its subsequent treaties. It is also wise to avoid most favoured nation (MFN) provisions that require the country, in the event that it agrees on a lower rate with a third country, to provide similar treatment to its existing treaty partner, since lower rates with that third country may have been negotiated having regard to the overall balance of benefits provided in that treaty.

While negotiators should seek to maintain a consistent general interest rate limit, they may have greater flexibility with respect to certain categories of interest. Consideration should be given to whether a lower rate could be agreed upon or accepted in certain circumstances. Such a lower rate, or exemption, could apply to specified categories of interest, such as those discussed in paragraphs 12 to 17 of the Commentary on Article 11 of the United Nations Model Convention.<sup>106</sup>

In particular, most countries exempt governmental interest from source-country tax, either unilaterally or through treaties, although the scope of that exemption differs.<sup>107</sup> Such exemption may facilitate financing of development projects in developing countries. Reducing or eliminating the withholding tax rate on interest derived by financial institutions may also be beneficial to developing countries (which are generally recipients of foreign capital). Given the cost of funds to financial institutions, and the narrow margins of profit obtained on funds lent by those institutions, even a low rate of withholding on the gross amount of the interest will frequently absorb (or even exceed) the whole amount of the profit on the lending activities. As noted above, this is likely to deter lending by the financial institutions to residents of the other country, or result in a higher rate of

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<sup>106</sup> For drafting options, see paragraph 7.11 of the Commentary on Article 11 of the OECD Model Convention.

<sup>107</sup> See paragraphs 15 and 16 of the Commentary on Article 11 of the United Nations Model Convention.



interest on the debt claim or in the tax burden being pushed back onto borrowers from the developing country. This, of course, increases the cost of borrowing to residents of the developing country. Similar considerations apply to sales on credit.

**Example**

Z Bank, a resident of State Z, lends an amount of 10,000 to X Ltd., a company resident in State X, at an interest rate of 8 per cent. Z Bank's cost of funds is 7 per cent, being the cost of borrowing plus a small amount of administrative costs.

State X imposes withholding tax at the rate of 10 per cent of the gross amount of the interest (800 x 10 per cent). State Z taxes the net interest (800 - 700) at 25 per cent, and allows a tax credit for State X tax up to the amount of State Z tax.

	State X	State Z
Interest derived by Z Bank	800	800
Deductible expenses	0	700
Taxable income	800	100
Tax	80	25
Tax credit	-	25 (max)
Total tax	80	0

The result is that, although the net interest (before tax) derived by Z Bank is 100, the tax paid by Z Bank is 80, an effective tax rate of 80 per cent. To avoid such excessive taxation and to make a reasonable profit from the transaction, Z Bank is likely to require X Ltd. to bear the cost of the State X tax, either directly, or by increasing the interest rate payable on the loan.

The rate limits provided in paragraph 2 apply only where the beneficial owner of the interest is a resident of the treaty partner country. If the interest is paid to a resident of the other country, but that person is not the beneficial owner of that income, the source country is not obliged to reduce its tax, and may apply the rates provided under its domestic law. Thus, for example, if interest arising in State A is paid to a resident of State B, who receives it as agent or nominee for a resident of State C, then State A is not obliged to limit its source taxation under the treaty between State A and State B.

On the other hand, if the resident of State B receives the interest as agent for another resident of State B, and the latter person is the beneficial owner of the interest, then the limits under the treaty between State A and State B do apply, since the beneficial owner is a resident of State B. Where the immediate recipient of the interest (as agent or nominee) is a resident of a third State, the Commentary states that the rate limitation in the source State remains available if the beneficial owner of the interest is a resident of the treaty partner country.<sup>108</sup> This can be made explicit in the treaty if the Contracting States so wish.

Difficult issues can arise in determining who the “beneficial owner” is for purposes of the treaty. Although the term “beneficial owner” is not defined in the Model treaties, it should not be automatically assumed that it takes on any meaning under domestic law that may exist in the law of a State. The Commentaries indicate that the term “is not used in a narrow technical sense, rather, it should be understood in its context and in the light of the object and purpose of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance”.<sup>109</sup> Agents, nominees and persons such as conduit companies that act as a mere fiduciary or administrator are given as examples of persons who would not be regarded as the beneficial owner of income.<sup>110</sup> Work to provide further guidance on the meaning of this concept is currently being undertaken by the OECD. The Commentary on the OECD Model Convention has been amended in the 2014 update.<sup>111</sup> The concept of “beneficial ownership” is also discussed in the OECD/G20 BEPS Project, Action 6: Treaty abuse.<sup>112</sup>

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<sup>108</sup> See paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraph 11 of the Commentary on Article 11 of the OECD Model Convention.

<sup>109</sup> See paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraph 9 of the Commentary on Article 11 of the OECD Model Convention.

<sup>110</sup> See paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraphs 10 and 11 of the Commentary on Article 11 of the OECD Model Convention.

<sup>111</sup> See paragraphs 9.1 and 10.2 – 4 of the Commentary on Article 11 of the OECD Model Convention.

<sup>112</sup> See OECD, *Preventing the Granting of Treaty Benefits in Inappropriate*

Negotiators may find it useful to discuss with their counterparts their understanding of this concept.

The treaty does not prescribe how the rate limit is to be applied. The second sentence in paragraph 2 authorizes the competent authorities to settle by mutual agreement the mode of application of the limitation. Each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment.<sup>113</sup> Most countries collect tax on interest paid to non-residents through the imposition of a withholding tax which is deducted by the payer of the interest and remitted by that payer to the tax authority of the source State. Since withholding tax is generally imposed on the gross amount of the interest, the introduction of a rate limitation does not present particular difficulties. The source State may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.<sup>114</sup> Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

### **Paragraph 3**

Paragraph 3 specifies the meaning of the term “interest” for purposes of the treaty. The definition covers income from debt claims of every kind, including government securities, bonds and debentures.<sup>115</sup> The definition found in the United Nations and OECD Model Conventions

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*Circumstances, Action 6 — 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015). Available from <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm>.

<sup>113</sup> See paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting, in particular, paragraph 12 of the Commentary on Article 11 of the OECD Model Convention.

<sup>114</sup> Paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention expresses a strong preference for application of treaty limits at source, rather than subsequent refund.

<sup>115</sup> See the discussion in paragraph 19 of the Commentary on Article 11 of the United Nations Model Convention.

is exhaustive, so countries that tax items of income, other than those listed in the definition, as interest under their domestic law — for example, amounts payable on certain non-traditional financial arrangements — may wish to define “interest” for treaty purposes by reference to its meaning under domestic law. This may be achieved, for example, by including in the definition a reference to any other amount assimilated to (or subjected to the same tax treatment as) income from money lent under the domestic law of the country in which the income arises.<sup>116</sup> Countries may also wish to make an express reference to certain financial instruments in the definition where the substance, but not the form, of the arrangement is effectively a loan.<sup>117</sup>

Although the United Nations and OECD Model Conventions exclude penalty charges for late payment from the definition of “interest”, some countries prefer to include them, particularly when the charge takes the form of a higher interest rate payable on the remainder of the loan. Negotiators should be prepared to discuss the forms of penalty charges for late payment imposed in their country, and have a view on the extent, if any, to which they should be included within the scope of Article 11.

In some countries, excessive interest payments between related enterprises may be treated under domestic law as dividend distributions. Where this is the case, it is desirable to ensure that the provisions

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<sup>116</sup>Draft wording could be along the following lines: “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, *as well as all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises.* The term ‘interest’ shall not include any item of income which is considered as a dividend under the provisions of paragraph 3 of Article 10. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.”

<sup>117</sup>See paragraph 19.3 of the Commentary on Article 11 of the United Nations Model Convention.

of Article 10 (Dividends), and not Article 11 (Interest), apply to the recharacterized income by giving priority to Article 10.<sup>118</sup>

**Paragraph 4**

Paragraph 4 describes a situation where the rules for allocation of taxing rights over income provided in paragraphs 1 and 2 do not apply. Where the interest forms part of the profits of a permanent establishment situated in the country where the interest arises, the source State is not required to limit its tax on that interest. Instead, the source State may tax the income in accordance with the provisions of Article 7 (Business profits). For treaties that include Article 14 (Independent personal services), paragraph 4 also provides that source-State tax is unlimited if the interest is effectively connected with a fixed base in that State.

Paragraph 4 of the United Nations Model Convention includes a reference to “business activities referred to in (c) of paragraph 1 of Article 7”. Unless the treaty includes this subparagraph (c) in Article 7, negotiators should delete this reference in paragraph 4 of Article 11.

Paragraph 4 requires that the debt claim in respect of which the interest is paid be “effectively connected” with the permanent establishment or fixed base or business activities. The meaning of the term “effectively connected” is discussed in paragraphs 25 to 25.2 of the Commentary on Article 11 of the OECD Model Convention. Broadly speaking, paragraph 4 applies where the debt claim is a business asset of the permanent establishment or fixed base rather than the head

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<sup>118</sup> Draft wording could be along the following lines: “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, as well as all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises. *The term ‘interest’ shall not include any item of income which is considered as a dividend under the provisions of paragraph 3 of Article 10.* Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.”

office of the enterprise. The paragraph does not apply where the loan or other debt claim is not related to a local permanent establishment, fixed base or business activities of the person deriving the interest, that is to say, paragraph 4 does not operate as a “force of attraction” rule. In those treaties where paragraph 4 also applies to business activities referred to under subparagraph (c) of Article 7 (1), the debt claim must similarly be effectively connected with those activities.

### **Example**

A Bank, a resident of State A, has a permanent establishment (branch) in State B. The branch of A Bank enters into loans with its customers in State B and State C, which are managed and funded by the branch and reflected in its books of account. A Bank also makes loans to residents of State B through an online lending service which are transacted directly with the head office of A Bank in State A.

In this situation, the loans made between the branch and residents of State B and State C would be regarded as debt claims which are effectively connected with the permanent establishment. The provisions of paragraph 4 of Article 11 will apply to the interest paid on those loans, with the result that the interest may be taxed in State B in accordance with Article 7. The loans made through the online service, however, are not effectively connected with the branch, so paragraph 4 of Article 11 does not apply. Paragraphs 1 and 2 will continue to apply to the interest paid by State B residents on such loans, that is, State B may tax the interest, but that tax would be limited to the rate specified in paragraph 2.

### ***Paragraph 5***

Paragraph 5 provides a deeming rule for determining, for treaty purposes, whether the interest arises in a jurisdiction, that is, whether it has its source in that country for purposes of the application of Article 11. Although interest income may be considered to have a number of sources under the domestic law of some countries, paragraph 5 provides a simplified rule to solve this issue for purposes of the treaty. The general rule is that interest income is deemed to arise in the country of which the payer is a resident. Where, however, the interest is, in effect, an expense of a permanent establishment or fixed base, that interest is deemed to arise in the country where the permanent establishment

or fixed base<sup>119</sup> is located. This approach will generally ensure that, if the interest payment is a deductible expense of the payer, the source of interest is allocated to the country in which a deduction is allowed, and consequently gives that country a taxing right.

Some difficulties can arise in determining whether a sufficient economic connection exists between the interest and a permanent establishment or fixed base for the application of the exception to the general rule. These difficulties frequently occur, for example, where a loan is contracted by one part of an enterprise (for example, the head office) for funds that are for the use of one or more permanent establishments. The guidance on these issues found in the Commentaries should be followed in these cases.<sup>120</sup>

Finally, if the treaty provides for taxation only in the residence State for all categories of income, it is not necessary to include paragraph 5, since the source of the interest will not be relevant where all taxing rights are allocated exclusively to the residence State. Paragraph 5, however, will remain relevant, and should not be deleted, if only some categories of interest are exempted from source taxation.

### *Paragraph 6*

Treaty benefits such as the reduction of source taxation on interest may lead to attempts by taxpayers to artificially structure their dealings in ways intended to make use of such benefits. Treaties may assist developing countries in dealing with tax avoidance of this kind, even where the domestic law of that country does not have comprehensive transfer pricing rules.

Paragraph 6 deals with profit shifting by persons that seek to reduce their source-country tax burden by inflating interest payments from associates in a treaty partner country. Where interest exceeding an arm's length amount is paid as a result of a special relationship between

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<sup>119</sup> If Article 14 (Independent personal services) is not included in the treaty, the references to "fixed base" should be deleted.

<sup>120</sup> See paragraph 21 of the Commentary on Article 11 of the United Nations Model Convention, quoting, in particular, paragraph 27 of the Commentary on Article 11 of the OECD Model Convention.

the borrower and the lender (or between both of them and a third party), paragraph 6 provides that the treaty limits on source taxation apply only to the arm's length amount, that is, the interest that would have been payable if an arm's length interest rate had applied in respect of the loan.

“Special relationship” commonly refers to the relationship between associated enterprises such as that described in Article 9 (Associated enterprises). It may, however, also refer to relationships between individuals, such as marriage or family, or between individuals and companies, such as a managing director or significant shareholding.

Other approaches to dealing with tax avoidance in relation to interest are also available. The Commentaries discuss amendments to paragraph 6 that could be made to allow reclassification of a part of a loan as an equity contribution.<sup>121</sup> Countries may also find it helpful to include in their treaties a general anti-avoidance provision (a main purpose test) in Article 11 to combat artificial devices designed to obtain the benefits of the Article through the creation or assignment of the debt claim.<sup>122</sup>

## 7. Article 12 — Royalties

Article 12 allocates taxing rights over royalties derived by a resident of one State from sources in a treaty partner country.

The United Nations Model Convention differs from the OECD Model Convention in that the former allows source taxation of royalties, while the latter provides for exclusive residence taxation. Treaties of developing countries almost invariably provide for source taxation, and a significant number of the member countries of the OECD also seek source taxing rights.<sup>123</sup> To prevent excessive taxation and to

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<sup>121</sup> See paragraph 22 of the Commentary on Article 11 of the United Nations Model Convention, quoting paragraphs 35 and 36 of the Commentary on Article 11 of the OECD Model Convention.

<sup>122</sup> See paragraph 23 of the Commentary on Article 11 of the United Nations Model Convention.

<sup>123</sup> See paragraphs 32–37 of the Commentary on Article 12 of the OECD Model Convention.



achieve a sharing of revenue from such income between the two countries, however, source taxation is limited to a percentage of the gross amount of the royalties.

The Article does not deal with royalties arising in the country of residence of the recipient or in a third State. Such income is dealt with under Article 21 (Other income).

***Paragraph 1***

Paragraph 1 of the United Nations Model Convention provides that royalties to which the Article applies may be taxed in the residence State, that is, the country of which the recipient of the royalties is a resident. This differs from paragraph 1 of Article 12 of the OECD Model Convention, which allocates taxing rights exclusively to the residence State.

Paragraph 1 also differs from paragraph 1 of Article 12 of the OECD Model Convention in that it does not limit the scope of the provision to royalties that are “beneficially owned” by a resident of a State.<sup>124</sup> Article 12 of the OECD Model Convention does not apply to royalties arising in one State that are paid to, but not beneficially owned by, a resident of the other State. Such royalties will generally fall instead under Article 7 or Article 21 of the OECD Model Convention.

There are no limits imposed under the treaty on the taxing rights of the residence State (although the residence State is required to relieve double taxation where the source State is also permitted under the treaty to tax the income).

***Paragraph 2***

Paragraph 2 provides that the source State (generally, the country of which the payer is a resident) may also tax the royalties, but the rate at which the royalty may be taxed in the source State is limited if the royalties are beneficially owned by a resident of the other Contracting State.

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<sup>124</sup>In the United Nations Model Convention, this concept is incorporated into paragraph 2 of Article 12.

The United Nations Model Convention does not specify a withholding rate limit on royalties that are beneficially owned by residents of the other country, leaving this for negotiation between treaty partners. In practice, limits in developing-country treaties generally range between 5 and 15 per cent.

Royalties to which the treaty applies will predominantly arise in the developing country, since the flow of technology is almost exclusively from developed to developing country. Accordingly, the immediate impact of revenue reductions as a consequence of treaty rate limits will fall on the developing country (although there may be long-term revenue gains as a result of increased technology flows and flow-on effects to the economy). Developing countries will need to decide what rate they can accept in their treaties, bearing in mind that high rates of withholding may deter the flow of technology or may result in the tax cost being passed on to resident payers through increased royalty charges. When negotiating the rate limit in their treaties, countries are advised to take into account the considerations set out in paragraphs 4 to 11 of the Commentary on Article 12 of the United Nations Model Convention. A careful design of a country model as described in section II.B and preparation of treaty negotiations as mentioned in section II.C of the present Manual are necessary for each country. In designing its treaty model and in its treaty negotiations, a country should aim to have a reasonably consistent treaty practice with respect to royalty withholding tax rate limits. If, for example, a developing country agreed to a rate limit in one of its treaties that was significantly lower than is usually found in its treaties, then in the absence of special reasons for that rate, negotiators would find it difficult to maintain higher rates in its subsequent treaties. It is also wise to avoid most favoured nation (MFN) provisions that require the country, in the event that it agrees on a lower rate with a third country, to provide similar treatment to its existing treaty partner, since lower rates with that third country may have been negotiated having regard to the overall balance of benefits provided in that treaty.

While negotiators should seek to maintain a consistent general royalty withholding tax rate limit, they may have greater flexibility with respect to certain categories of royalties. Consideration should be given to whether a lower rate could be agreed upon or accepted in certain circumstances. Such a lower rate, or exemption, could apply

to specified categories of royalties, such as film rentals, copyright royalties<sup>125</sup> or equipment leasing payments, where significant expenses may be incurred in deriving the income.

The rate limits provided in paragraph 2 apply only where the beneficial owner of the royalties is a resident of the treaty partner country. If the interest is paid to a resident of the other country, but that person is not the beneficial owner of that income, the source country is not obliged to reduce its tax, and it may apply the rates provided under its domestic law.<sup>126</sup> Negotiators may find it useful to discuss with their counterparts their understanding of the concept of beneficial ownership.

The treaty does not prescribe how the rate limit is to be applied. The second sentence in paragraph 2 authorizes the competent authorities to settle by mutual agreement the mode of application of the limitation. As with source tax limits imposed under Articles 10 and 11, each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment.<sup>127</sup> The source State may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.<sup>128</sup> Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

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<sup>125</sup> See paragraphs 10 and 11 of the Commentary on Article 12 of the United Nations Model Convention.

<sup>126</sup> See paragraph 5 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraphs 4–4.2 of the Commentary on Article 12 of the OECD Model Convention, as well as the discussion of “beneficial ownership” in relation to Article 11 (Interest) above.

<sup>127</sup> See paragraph 18 of the Commentary on Article 11 of the United Nations Model Convention, quoting, in particular, paragraph 12 of the Commentary on Article 11 of the OECD Model Convention.

<sup>128</sup> Paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention expresses a strong preference for application of treaty limits at source, rather than subsequent refund.

### *Paragraph 3*

Paragraph 3 specifies the meaning of the term “royalties” for purposes of the treaty. The term generally covers all kinds of payments for the use of, or the right to use, intellectual property such as copyright, patents, trademarks, and so forth, as well as information concerning industrial, commercial or scientific experience (“know-how”). The definition in Article 12 of the United Nations Model Convention, but not in Article 12 of the OECD Model Convention,<sup>129</sup> also includes payments for the use of, or the right to use, films or tapes used for radio or television broadcasting; or for leasing of industrial, commercial or scientific equipment.

While the inclusion of payments for film and tape rentals for use in radio or television broadcasting, and equipment rentals, including container leasing, are quite widely accepted in treaties with developing countries (and even in treaties between OECD member countries),<sup>130</sup> some countries feel strongly that only a very low rate of withholding should apply. Leasing income will have costs associated with it, and even a low withholding tax rate imposed on the gross amount of the income may well result in excessive taxation which would discourage cross-border equipment leasing or may be passed on to resident lessees. A few treaties provide for a limit of about half of the general rate for royalties.

The scope of the definition of “royalties” may give rise to different views, particularly with respect to payments for the use of computer software or for transfers or use of know-how. These issues are discussed in the Commentary.<sup>131</sup> These matters should also be discussed during

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<sup>129</sup>The term “royalties” is defined in paragraph 2 of Article 12 of the OECD Model Convention.

<sup>130</sup>Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997–2013”, *Bulletin for International Taxation*, No. 3 (2014), sections 2.13.2.1 and 2.13.3.1.

<sup>131</sup>See paragraph 12 of the Commentary on Article 12 of the United Nations Model Convention, quoting paragraphs 11.1 to 17.4 of the Commentary on Article 12 of the OECD Model Convention, and paragraphs 14–16 of the Commentary on Article 12 of the United Nations Model Convention.

negotiations and, if necessary, clarifications should be included in the treaty<sup>132</sup> or agreed upon through the mutual agreement procedure.

A significant number of countries include fees for technical services or technical assistance in the definition of “royalties” in their treaties. This subject is being discussed in the context of the United Nations Committee of Experts on International Cooperation in Tax Matters.<sup>133</sup>

#### **Paragraph 4**

Paragraph 4, like paragraph 3 of Article 12 of the OECD Model Convention, describes a situation where the general rules for allocation of taxing rights over royalties do not apply. Where the royalties form part of the profits of a permanent establishment situated in the country of which the payer is a resident (source State), the source State is not required to limit its tax on those royalties. Instead, the source State may tax the income as business profits attributable to the permanent establishment in accordance with the provisions of Article 7. For treaties that include Article 14 (Independent personal services), paragraph 4 also provides that source-State tax is unlimited if the royalties are attributable to a fixed base in that State.

Paragraph 4 of the United Nations Model Convention includes a reference to “business activities referred to in (c) of paragraph 1 of Article 7”. Unless the treaty includes this subparagraph (c) in Article 7, negotiators should delete this additional reference in paragraph 4 of Article 12.

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<sup>132</sup> For example, the royalties Article of the Australia-Canada treaty (as amended in 2002) expressly clarifies that: “Without prejudice to whether or not such payments would be dealt with as royalties under this Article in the absence of this paragraph, the term ‘royalties’ as used in this Article *shall not include payments or credits made as consideration for the supply of, or the right to use, source code in a computer software program, provided that the right to use the source code is limited to such use as is necessary to enable effective operation of the program by the user.*” (Emphasis added)

<sup>133</sup> Report on the tenth session, chap. III, section J. Available from [http://www.un.org/ga/search/view\\_doc.asp?symbol=E/2014/45&Lang=E](http://www.un.org/ga/search/view_doc.asp?symbol=E/2014/45&Lang=E).

The meaning of the term “effectively connected” with a permanent establishment or fixed base is not discussed in the Commentaries on Article 12. The same principles described in relation to paragraph 4 of Article 10 and paragraph 4 of Article 11 will, however, apply. Broadly speaking, paragraph 4 applies only where the right or property in respect of which the royalties are paid is a business asset of the permanent establishment or fixed base. Paragraph 4 does not operate as a “force of attraction” rule, that is to say, the paragraph does not apply where, for example, a copyright owner has a permanent establishment or fixed base in the source State but the copyright giving rise to the royalties is not a business asset of that permanent establishment or fixed base.

### *Paragraph 5*

Paragraph 5 provides a deeming rule for determining, for treaty purposes, the jurisdiction in which the royalties arise. Regardless of any domestic law source rule for royalties, the general rule under this paragraph is that for purposes of the treaty, royalties are deemed to arise in the country of which the payer is a resident. Where, however, the royalties are, in effect, an expense of a permanent establishment or fixed base, those royalties are deemed to arise in the country where the permanent establishment or fixed base<sup>134</sup> is located. This approach will generally ensure that, if the royalties are a deductible expense of the payer, the source of the royalties is allocated to the country in which a deduction is allowed and, consequently, gives it a taxing right.

Article 12 of the OECD Model Convention does not include a provision equivalent to paragraph 5. In treaties that follow paragraph 5 of Article 12 of the OECD Model Convention, most countries do not consider it necessary to include paragraph 5, since the source of the royalties will not be relevant where all taxing rights are allocated exclusively to the residence State.

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<sup>134</sup>If Article 14 (Independent personal services) is not included in the treaty, the references to “fixed base” should be deleted.

***Paragraph 6***

Treaty benefits such as the reduction of source taxation on royalties may lead to attempts by taxpayers to artificially structure their dealings in ways intended to attract such benefits. Treaties may assist developing countries in dealing with tax avoidance of this kind, even where the domestic law of that country does not have comprehensive transfer pricing rules.

Paragraph 6 deals with profit shifting by persons that seek to reduce their source-country tax burden by inflating royalty payments from associates in a treaty partner country. Where royalties exceeding an arm's length amount are paid as a result of a special relationship between the two parties (or between both of them and a third party), paragraph 6 provides that the treaty limits on source taxation apply only to the arm's length amount, that is, the royalties that would have been payable between independent parties.

“Special relationship” commonly refers to the relationship between associated enterprises such as that described in Article 9 (Associated enterprises). It may, however, also refer to relationships between individuals, such as marriage or family, or between individuals and companies, such as a managing director or significant shareholding.

Other approaches to deal with tax avoidance in relation to royalties are also available. Countries may find it helpful to include in their treaties a general anti-avoidance provision (a main purpose test) in Article 12 to combat artificial devices designed to obtain the benefits of the Article through the creation or assignment of the rights in respect of which the royalties are paid.<sup>135</sup>

**8. Article 13 — Capital gains**

Article 13 allocates taxing rights over capital gains from the alienation of property. In general, the country that has primary taxing rights over the income from immovable property, assets of a permanent

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<sup>135</sup> See paragraph 21 of the Commentary on Article 12 of the United Nations Model Convention.

establishment and ships and aircraft used in international traffic is allocated taxing rights over capital gains from the alienation of that property. For other gains, treaty practice varies, as discussed below.

Not all countries tax capital gains, and countries vary in how they apply tax to capital gains under their domestic law, for example, they may be added to other income or they may be subject to a special tax. The treaty does not dictate how the capital gain should be calculated, whether and when it should be taxed or what kind of tax should apply. The treaty only allocates taxing rights between the two treaty partner countries, and within the limits set by the treaty, each country may apply its domestic law in taxing the gain.<sup>136</sup>

If one State does not tax capital gains, or taxes only a limited range of gains, the other country may consider that it should limit its taxation on those gains only to the extent necessary to relieve double taxation, that is to say, only where the treaty partner country exercises its right to tax the gains under its domestic law.<sup>137</sup>

Alienation of property generally refers to a change of ownership of that property, for example, through sale, exchange, appropriation, gift or death. Gains on such alienations, whether they are taxed as income or as a separate category, are covered by Article 13. Issues relating to taxes on capital appreciation, for example, on revaluation of business assets, are discussed in the Commentaries.<sup>138</sup>

### *Paragraph 1*

Under both the United Nations and OECD Model Conventions, the country in which immovable property is situated may tax capital gains from alienation of that property. The gains may also be taxed in the

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<sup>136</sup> See paragraphs 3 and 4 of the Commentary on Article 13 of the United Nations Model Convention.

<sup>137</sup> See paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 21 of the Commentary on Article 13 of the OECD Model Convention.

<sup>138</sup> See paragraph 4 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraphs 4–11 of the Commentary on Article 13 of the OECD Model Convention.



country of which the person alienating the immovable property is a resident (although that country must provide relief for any double taxation in accordance with Article 23).

The term “immovable property” has the same meaning in this Article as it has in Article 6 (Income from immovable property). It may therefore differ from domestic law definitions.<sup>139</sup>

Paragraph 1 applies only to gains derived by a resident of one treaty partner country from immovable property situated in the other country. Gains from alienation of immovable property situated in the alienator’s country of residence or in a third State are dealt with under paragraph 6 of this Article of the United Nations Model Convention.<sup>140</sup>

### ***Paragraph 2***

Capital gains from the alienation of business assets (other than immovable property) of a permanent establishment or, in treaties that include Article 14 (Independent personal services), a fixed base, may be taxed in the country in which the permanent establishment or fixed base is situated. Gains from the alienation of immovable property of a permanent establishment or fixed base are dealt with under paragraph 1 of this Article.

It should be noted that paragraph 2 does not operate as a “force of attraction” rule. Accordingly, gains from other movable property, including assets used for the purposes of activities described in subparagraphs (b) and (c) of Article 7 (1) of the United Nations Model Convention, are dealt with under paragraph 6<sup>141</sup> of Article 13 and not under this paragraph.

### ***Paragraph 3***

Paragraph 3 provides that capital gains arising from the disposal of ships or aircraft used in international traffic, and boats used in inland

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<sup>139</sup> See the discussion on paragraph 2 of Article 6.

<sup>140</sup> See paragraph 5 of the Commentary on Article 13 of the United Nations Model Convention, quoting paragraph 22 of the OECD Model Convention.

<sup>141</sup> See paragraph 5 of the OECD Model Convention.

waterways transport, are generally taxable only in the country in which the place of effective management of the enterprise is situated. This rule applies irrespective of whether Article 8 (alternative A) or Article 8 (alternative B) of the United Nations Model Convention is adopted.

In treaties that allocate taxing rights in Article 8 on the basis of where the enterprise is a resident (rather than where its place of effective management is situated), paragraph 3 should be amended to reflect this wording.<sup>142</sup>

The term “international traffic” is defined in subparagraph (d) of Article 3 (1).<sup>143</sup>

#### **Paragraph 4**

Paragraph 4 addresses the situation where, instead of disposing of immovable property directly, an interest in an interposed entity is alienated. The paragraph ensures that the capital gain, where that gain effectively represents an increase in the value of immovable property held through a company, partnership, trust or estate, may be taxed in the country where the immovable property is situated.

The provision is similar to, but not identical with, paragraph 4 of the OECD Model Convention. That paragraph deals only with alienation of shares in companies, whereas the United Nations Model provision deals with interests in a broader range of entities that may derive their value principally from immovable property.<sup>144</sup> A significant number of OECD countries, however, also refer to interests in other entities in their treaties.<sup>145</sup>

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<sup>142</sup> For drafting, see paragraph 10 of the 2013 public discussion draft on *Proposed changes to the OECD Model Tax Convention dealing with the Operation of Ships and Aircraft in International Traffic*. Available from <http://www.oecd.org/tax/treaties/Discussion-draft-international-taffic.pdf>.

<sup>143</sup> See the discussion on Article 8.

<sup>144</sup> Paragraph 28.5 of the Commentary on Article 13 of the OECD Model Convention provides an alternative provision that broadens the scope of paragraph 4 to “shares or comparable interests”.

<sup>145</sup> Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997 – 2013”, *Bulletin for International Taxation*, No. 3 (2014), section 2.14.2.2.

Under subparagraph (a) of paragraph 4 of the United Nations Model Convention (but not the OECD equivalent provision), entities other than those that manage immovable property are excluded from the scope of the paragraph if the immovable property is used by the entity in its business activities. In practice, this provision is not commonly found in treaties negotiated by developing countries.<sup>146</sup> It represents a considerable narrowing of the scope of the provision, since gains from the alienation of interests in entities that own and run mines, farms, hotels, restaurants, and so forth, are not covered by this paragraph.

### *Paragraph 5*

Paragraph 5 allows a State to tax gains on the alienation of shares in a company that is a resident of that State, where the alienator holds (or has held at any time during the preceding 12 months) a substantial participation in the company. The minimum participation is not specified in the United Nations Model provision, but it is commonly about 25 per cent. The 12-month rule is an anti-avoidance provision designed to ensure that a taxpayer cannot escape source taxation by selling off multiple small parcels of shares that together form a substantial holding.

Treaty practice varies with respect to this provision. Some treaties do not include a minimum participation, although it should be recognized that there are significant administrative and compliance difficulties in enforcing taxation in respect of gains from small shareholdings. Some countries specifically exclude gains from the alienation of quoted shares.<sup>147</sup> Others provide for a concessional rate of tax on gains from the alienation of shares. Still others limit taxing rights over gains from disposal of shares to gains by individuals who are former residents of that State.

Many countries do not include paragraph 5 at all in their treaties. There is no equivalent to paragraph 5 in the OECD Model Convention.

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<sup>146</sup> *Ibid.*, section 2.14.3.1.

<sup>147</sup> See the alternative provision included in paragraph 13 of the Commentary on Article 13 of the United Nations Model Convention.

In deciding their position on this paragraph, countries should take into account their ability to identify, and collect tax on, sales of shares by non-residents.

### ***Paragraph 6***

Paragraph 6 is a “sweep-up” provision allocating taxing rights over all capital gains that are not dealt with in paragraphs 1 to 5. In both the United Nations and OECD Model Conventions, these gains may be taxed only in the country of residence of the alienator.<sup>148</sup>

Some countries, however, including many developing countries, prefer to retain taxing rights over capital gains arising in their State.<sup>149</sup> Since the place where capital gains may be said to “arise” can give rise to difficulties, negotiators should clarify during negotiations how the source of capital gains is to be determined. Generally, it will be intended that both countries be allowed to tax gains to which their domestic law applies, with the country of residence of the alienator providing double tax relief where necessary.

In negotiating provisions on capital gains, countries should consider, in particular, which gains are taxable under their domestic law, and the extent to which their tax administration is able to enforce tax liabilities of non-residents on such gains. For example, some countries seek to preserve taxing rights over an “exit” or “departure” tax that is intended to prevent avoidance of capital gains tax through a change of residence.<sup>150</sup>

## **9. Article 14 — Independent personal services**

Article 14 (which is no longer found in the OECD Model Convention)<sup>151</sup> deals with income from professional services and other independent

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<sup>148</sup> See paragraph 5 of Article 13 of the OECD Model Convention.

<sup>149</sup> For possible drafting, see paragraph 18 of the Commentary on Article 13 of the United Nations Model Convention.

<sup>150</sup> See paragraphs 13 and 44 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>151</sup> Article 14 was deleted from the OECD Model Convention in 2000. Under the current OECD Model Convention, income from independent personal services is dealt with under Article 7 (Business profits).

services such as those of contractors. It does not deal with income from industrial or commercial activities or employment income.<sup>152</sup>

Most countries regard this Article as being applicable to income derived only by individuals, with Article 7 applying to income from services provided by enterprises.<sup>153</sup> This can be placed beyond doubt by adding “an individual who is” before “a resident of a Contracting State” in paragraph 1 of Article 14.

If Article 14 is not included in a treaty, a number of consequential changes need to be made in that treaty. These include deletion of references to Article 14 and to “fixed base” in many other articles. A full list of necessary changes to these articles is included in paragraphs 15.4 to 15.26 of the Commentary on Article 5 of the United Nations Model Convention.

### ***Paragraph 1***

Paragraph 1 limits source taxation of income derived by a resident of a treaty partner country from independent personal services to two situations, namely: where the income is attributable to a fixed base that is regularly available to the person in the source country, or where the person is present in the source country for at least 183 days in any 12-month period and the income is attributable to activities performed in the source country.

The “fixed base” criterion (subparagraph (a) of Article 14 (1)) mirrors the former Article 14 criterion of the OECD Model Convention and is widely accepted in treaties with developing countries, even since the deletion of Article 14 in that Model.<sup>154</sup> Most countries consider the concept of “fixed base” to be essentially the same as the “fixed place of business” concept in the permanent establishment definition, so this

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<sup>152</sup> See paragraph 10 of the Commentary on Article 14 of the United Nations Model Convention, quoting paragraphs 1 and 2 of the Commentary on Article 14 of the 1997 OECD Model Convention.

<sup>153</sup> See paragraph 9 of the Commentary on Article 14 of the 1997 OECD Model Convention.

<sup>154</sup> Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997 – 2013”, *Bulletin for International Taxation*, No. 3 (2014), section 2.16.2.1.

criterion effectively provides the same threshold for source taxation as is provided for income under Article 7 (Business profits).

A length of stay criterion (subparagraph (b) of Article 14 (1)) is found in most treaties with developing countries, although the time during which the person must be present in the source country sometimes varies.<sup>155</sup> As the United Nations Commentary explains, a length of stay criterion for source taxation of independent personal services income is comparable to the 183 day presence test for employment income.<sup>156</sup>

The provision in the current United Nations Model Convention refers to 183 days in any 12-month period beginning or ending in a fiscal year. This ensures that source countries do not lose taxing rights where the 12-month period during which the person is present in that country spans two fiscal years.

It should be noted that even where the agreed period of presence has been exceeded, only income attributable to relevant activities performed in the country may be taxed in that country.

Most, but not all, countries tax the income on a net basis (that is to say, deductions are allowed for expenses). This should be discussed during negotiations and, if necessary, clarified in the treaty or through the mutual agreement procedure.

### *Paragraph 2*

Paragraph 2 provides a non-exhaustive definition of “professional services”. It clarifies that services such as independent scientific, literary, artistic, educational and teaching activities are covered, as well as traditional professions such as doctors and lawyers. Income of an entertainer that is dealt with by Article 17 (Artistes and sportspersons) is, however, not covered by Article 14.<sup>157</sup>

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<sup>155</sup> Ibid., section 2.16.2.2.

<sup>156</sup> See paragraph 6 of Article 14 United Nations Model Convention.

<sup>157</sup> The provisions of Article 17 include ordering rules which give priority to Article 17.

## 10. Article 15 — Dependent personal services

Article 15 deals with income from employment (also known as dependent personal services). Generally, such income may be taxed in the country in which the employment is exercised. The income will, however, be exempt from taxation in that country where all the conditions specified in paragraph 2 are met.

The Article is identical in all material respects (other than the title and references to “fixed base”) to Article 15 (Income from employment) in the OECD Model Convention.

The position of teachers and professors requires special mention. The majority of countries apply the provisions of Article 15 to remuneration of teachers and professors. A significant minority of countries, however, prefer to include a special provision granting exemption from source taxation for a limited period to this category of employment. This is discussed further in a subheading under Article 20.

### *Paragraph 1*

Paragraph 1 sets out the general rule that income from employment may be taxed in the country where the employment is exercised, that is to say, where the services are performed by the employee.

The term “salaries, wages and other similar remuneration” is generally understood to include payments in kind (sometimes called “fringe benefits”) in respect of employment, such as use of cars, health insurance, stock options, and so forth. If necessary, in order to avoid doubt, the treaty can specify that the term includes particular types of benefits; or this can be clarified by mutual agreement.

### *Paragraph 2*

Paragraph 2 provides an exception to the general rule for certain short-term employment activities performed in a State. An exemption from source taxation is provided where three conditions are met, namely:

- The person is present in the source country for no more than 183 days in aggregate in any 12-month period beginning or ending in a fiscal year

- The employer is not a resident of the source country
- The remuneration is not borne by a permanent establishment or fixed base of the employer in the source country

All three conditions must be met. Source taxation may be imposed on employment income derived during a short-term visit if, for example, the employer is a resident of the source country. Similarly, if the employer is a non-resident, but the employment is exercised for the benefit of its permanent establishment or fixed base (which will generally result in a deduction being allowed in the source country in respect of the remuneration), the exception to the general rule in paragraph 1 does not apply.

Difficulties commonly arise in the application of this exception. Negotiators and tax administrators are strongly advised to read the guidance on these issues found in the Commentary.<sup>158</sup>

A few countries disagree with the view expressed in the Commentaries that, in relation to fiscally transparent partnerships, the concepts of “employer” and “resident” in subparagraph (b) of paragraph 2 must be applied at the level of the partnership.<sup>159</sup> Negotiators should discuss this issue during negotiations and, if necessary, provide specifically for this outcome.

Some countries consider that the exemption from source taxation should be available only where the employer is a resident of the treaty partner country. Countries that take this view should adapt subparagraph (b) of paragraph 2 accordingly.<sup>160</sup>

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<sup>158</sup> See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 1 to 12.5 of the Commentary on Article 15 of the OECD Model Convention.

<sup>159</sup> See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraphs 6.1 and 6.2 of the Commentary on Article 15 of the OECD Model Convention.

<sup>160</sup> See paragraph 1 of the Commentary on Article 15 of the United Nations Model Convention, quoting paragraph 6 of the Commentary on Article 15 of the OECD Model Convention.



### *Paragraph 3*

Paragraph 3 deals with income derived from employment aboard a ship or aircraft operated in international traffic or, in treaties that include a provision in Article 8 with respect to inland waterways transport, aboard a boat used for such transport. The paragraph allows the country in which the place of effective management of the employer is situated to tax the employee's remuneration.

Countries that do not address inland waterways transport in Article 8 should delete the reference to boats engaged in such transport.

Countries that allocate, under Article 8, taxing rights over the transport enterprise's profits to the country of residence of the enterprise should make corresponding changes to this paragraph by replacing the words after "may be taxed" with "in the State of residence of the enterprise". In addition, countries which allocate the profits from rail and road transport in international traffic under Article 8 will also need to make corresponding changes to this paragraph.

The domestic law of some countries would not permit taxation of income of non-resident employees simply on the basis that their employer is a resident or has its place of effective management in that State. These countries may wish to amend paragraph 3 to provide for exclusive taxation in the country of residence of the employee.

## **11. Article 16 — Directors' fees and remuneration of top-level managerial officials**

Article 16 allocates non-exclusive taxing rights over directors' fees and wages of top-level managers of companies to the country of residence of that company.

The country of which the director or manager is a resident may also tax the remuneration, but must provide relief from double taxation in accordance with Article 23.

### *Paragraph 1*

Paragraph 1, which deals with directors' fees, is identical to Article 16 of the OECD Model Convention. It applies 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”.<sup>161</sup> The relevant remuneration includes payments in kind (fringe benefits) received in that person’s capacity as a board member, but does not include wages or other remuneration that person may receive from the company in another capacity, for example, as an employee or consultant, except to the extent provided under paragraph 2 of the Article.

Negotiators should clarify during discussions which persons would be regarded as “a member of the Board of Directors” for the purposes of this Article. In some countries, the governing body of the company, that is to say, the ultimate decision-making body which is responsible for setting the policy and direction of the company, may not be a board of directors. In this case, negotiators should ensure that references to relevant bodies are substituted for, or added to, the reference to “the Board of Directors”. In cases of difference, it might be helpful to mention the specific names of the bodies, which should be covered by Article 16.

The domestic law of some countries provides for taxation of directors’ fees only where the services as a director are actually performed in that country. In this case, the text of paragraph 1 could be amended accordingly.<sup>162</sup> Some countries may prefer to omit Article 16 and provide for similar tax treatment of directors’ fees as for employees. In this case, a paragraph should be added to Article 15 to deal with directors’ fees.

### *Paragraph 2*

Paragraph 2, which has no equivalent in the OECD Model Convention, extends the same treatment as that provided for directors to top-level

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<sup>161</sup> Paragraph 2 of the Commentary on Article 16 of the United Nations Model Convention, quoting paragraph 1 of the Commentary on Article 16 of the OECD Model Convention.

<sup>162</sup> Draft wording could be along the following lines: “Directors’ fees and other remuneration derived by a resident of a Contracting State for services rendered in the other 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.”

managers of companies, that is to say, their remuneration may be taxed in the country of residence of the company.

The term “an official in a top-level managerial position of a company” is not defined in the United Nations Model Convention. The Commentary notes, however, that this term “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”.<sup>163</sup>

The provision is rarely included in tax treaties,<sup>164</sup> but it is favoured by a few developing countries whose domestic law provides for taxation of such remuneration on the basis that it is paid by a domestic company and is therefore allowed as a deduction to the company.

Countries that cannot exercise the taxing right provided under paragraph 2 of Article 16 (for example, where they can tax only if the activities are exercised in their jurisdiction) should omit this paragraph. In the absence of this provision, the income of these managers would fall within the scope of Article 15 (Dependent personal services). Under that Article, the remuneration is taxable in the country in which the manager’s activities are exercised (the exemption provided in paragraph 2 of Article 15 does not apply where the employer company is a resident of that State).

## 12. Article 17 — Artistes and sportspersons

Article 17 allows source taxation of income relating to performances by entertainers and sportspersons in that country. Unlike other Articles dealing with the provision of cross-border dependent or independent services, the only threshold condition for source taxation is that the entertainment or sporting activities be exercised in the country.

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<sup>163</sup> See paragraph 5 of the Commentary on Article 16 of the United Nations Model Convention.

<sup>164</sup> According to Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997–2013”, *Bulletin for International Taxation*, No. 3 (2014), section 2.17, less than 10 per cent of treaties include this provision.

The Article does not differ in any material respects from Article 17 of the OECD Model Convention. The Article, however, uses the gender-neutral term “sportsperson” in place of “sportsman”. It also refers to Article 14, which has been omitted from the OECD Model Convention.

### *Paragraph 1*

Paragraph 1 provides that artistes and sportspersons who are residents of one State may be taxed in the other State if their entertainment or sporting activities are performed in that other State.

The provision applies to both independent activities and activities provided as employees. It expressly provides an exception to the rules of both Article 14 (or Article 7 in treaties that omit Article 14) and Article 15. The reference to Article 7, although included in Article 7 of the OECD Model Convention, is not necessary, since paragraph 6 of Article 7 of the United Nations Model Convention<sup>165</sup> gives priority to other Articles.

The Commentary suggests that some countries may wish to apply the rules of Article 17 only in respect of independent services, so that Article 15 applies to income of employed entertainers and sportspersons.<sup>166</sup> This, however, is rarely seen in practice in treaties.

More commonly, an exception is made to the provisions in Article 17 for events supported by government funds of either or both countries, or employees of organizations which are subsidized out of public funds. In these treaties, a specific provision allocates exclusive taxing rights to the entertainer’s country of residence.<sup>167</sup> In some treaties, the exception is limited to such events where they are made under

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<sup>165</sup> See paragraph 7 of the 2008 version of OECD Article 7 and paragraph 4 of the current OECD Article 7.

<sup>166</sup> See paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention, quoting paragraph 2 of the Commentary on Article 17 of the OECD Model Convention.

<sup>167</sup> See paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention, quoting paragraph 14 of the Commentary on Article 17 of the OECD Model Convention, proposes possible drafting for this purpose.

a cultural agreement between the two countries. This is intended to facilitate cultural exchanges.

Article 17 does not specify how the income of the entertainer or sportsperson is to be computed, or whether expenses incurred in deriving the income must be allowed. Some countries that consider taxation of the income on a gross basis, even at a low rate, to be inappropriate prefer to include an option for the taxpayer to be taxed on a net basis.<sup>168</sup> The method by which entertainers' and sportspersons' income is taxed should be discussed during negotiations.

The issue of what income is encompassed within the scope of Article 17 often gives rise to difficulties. In addition to the guidance in the Commentary,<sup>169</sup> further discussion of the topic may be found in the OECD Commentary on Article 17.<sup>170</sup>

### ***Paragraph 2***

Paragraph 2 deals with the situation where the income from the activities of an entertainer or sportsperson accrues, not to the entertainer or sportsperson themselves, but to another person. That other person may be, for example, a management company, a team constituted as a legal entity, or a company owned and controlled by the entertainer (known as a "star company").

In these circumstances, if the State in which the activities are performed cannot "look through" the person receiving the income to the entertainer, it may not be able to tax the income derived from sources in that State in respect of the entertainer's performance. In the absence of paragraph 2, the source State could be precluded from taxing the income derived by the star company, for example, under

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<sup>168</sup> See paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention, quoting paragraph 10 of the Commentary on Article 17 of the OECD Model Convention.

<sup>169</sup> See paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention, quoting paragraphs 3–9 of the Commentary on Article 17 of the OECD Model Convention.

<sup>170</sup> See paragraphs 8.1–9.4 of the Commentary on Article 17 of the OECD Model Convention.

Article 7 if the star company is a resident of the other State and the income is not attributable to a permanent establishment in the source State. Paragraph 2 ensures that the country in which the entertainment or sporting activities are performed may tax the income from such activities, regardless of who derives that income.<sup>171</sup>

### **13. Article 18 — Pensions and social security payments**

Article 18 allocates taxing rights over pensions paid in respect of past employment, and social security payments. There are two versions of this Article in the United Nations Model Convention. Article 18 (alternative A) gives to the recipient's country of residence the exclusive right to tax pensions, while Article 18 (alternative B) allows source taxation if the pension is paid by a resident of the source country or a permanent establishment situated there. In both versions, social security payments are taxable only in the paying country.

In practice, the treatment of pensions under tax treaties varies considerably. This reflects the fact that there are very different pension systems found in different countries. There are three stages of retirement savings at which tax may be imposed, namely, contributions to a pension fund, fund earnings and pension payments. A country's tax treaty policy with respect to pensions may be strongly influenced by its domestic law treatment of the three stages. In some countries, for example, deductions are allowed for contributions, and fund earnings are exempt, with the pension payments being fully taxed. These countries are likely to want to preserve taxing rights over the pension, since tax has been deferred at all other stages. In other countries, however, no deductions are allowed for contributions and the pension earnings are taxed, but the pension payments are exempt. These countries may have no objection to giving up source taxing rights, but may wish to preserve exemption of the pension, particularly if the amount of the pension reflects its tax exempt status in the paying country.

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<sup>171</sup> See paragraph 2 of the Commentary on Article 17 of the United Nations Model Convention, quoting paragraphs 11 to 11.2 of the Commentary on Article 17 of the OECD Model Convention.

***Paragraph 1 of alternative A, paragraphs 1 and 2 of alternative B***

Paragraph 1 of alternative A, like Article 18 of the OECD Model Convention, assigns taxing rights over pensions paid in respect of past employment, other than government service, exclusively to the country of residence of the recipient.

Although this provision is limited to pensions from past private employment, some countries prefer to provide for the same tax treatment of all pensions, including annuities, pensions paid in respect of independent personal services and government service pensions. The Commentary notes that countries are free to agree on this bilaterally.<sup>172</sup>

Allocation of sole taxing rights to the country of residence of the recipient simplifies the taxation affairs of pensioners, who are often elderly. Many countries also consider that the residence country is in a better position to determine their overall ability to pay tax, since their total income is often relatively low.<sup>173</sup>

A significant number of countries, however, consider that the source country should also have a right to tax pensions arising in its jurisdiction, particularly those countries where pensions are regarded as deferred compensation for income from employment exercised in that country, or where tax incentives have previously been provided in that country in respect of retirement savings.<sup>174</sup> The United Nations Model Convention therefore offers Article 18 (alternative B), pursuant to which pensions paid in respect of past employment may be taxed in both the residence State of the recipient (paragraph 1) and the treaty partner country if paid by a resident of, or permanent establishment in, that country (paragraph 2).

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<sup>172</sup>See paragraph 4 of the Commentary on Article 18 of the United Nations Model Convention, quoting paragraphs 3–7 of the Commentary on Article 18 of the OECD Model Convention.

<sup>173</sup>See paragraph 4 of the Commentary on Article 18 of the United Nations Model Convention, quoting paragraph 1 of the Commentary on Article 18 of the OECD Model Convention.

<sup>174</sup>See paragraph 4 of the Commentary on Article 18 of the United Nations Model Convention, quoting paragraph 9 of the Commentary on Article 18 of the OECD Model Convention, and paragraph 11 of the Commentary on Article 18 of the United Nations Model Convention.

To take into account the diverse tax treatments afforded to retirement savings and pension payments under the domestic laws of different countries, the Commentary offers a number of variations on these two basic approaches. If pensions are not taxable in the recipient's country of residence, negotiators should discuss whether to include a provision intended to avoid double non-taxation in these circumstances.<sup>175</sup> Conversely, some countries may wish to ensure that the tax-exempt status of certain pensions paid from sources in their jurisdiction is preserved where the recipient is a resident of a treaty partner country.<sup>176</sup>

Another option discussed in the Commentary is to provide for source taxation where tax relief has been granted in a country in respect of contributions to a pension scheme.<sup>177</sup> This approach would, however, give rise to administrative difficulties where individuals have worked in, and contributed to the fund from, several countries.

Where paragraph 2 of alternative B is adopted, negotiators should discuss whether the source State should grant to a resident of the other State any personal allowances, reliefs or reductions for tax purposes granted to its own residents. This may be specifically addressed in the Article in order to avoid excessive taxation.<sup>178</sup>

Other options for source taxation of pensions, and examples of possible provisions, are discussed in the Commentary on Article 18 of the OECD Model Convention.<sup>179</sup> These include exclusive source taxation of pensions, non-exclusive source taxation, limited source taxation and source taxation of pension payments only where the

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<sup>175</sup> See paragraph 5 of the Commentary on Article 18 of the United Nations Model Convention.

<sup>176</sup> See paragraph 6 of the Commentary on Article 18 of the United Nations Model Convention, quoting paragraphs 22–23 of the Commentary on Article 18 of the OECD Model Convention.

<sup>177</sup> See paragraph 16 of the Commentary on Article 18 of the United Nations Model Convention.

<sup>178</sup> See paragraph 12 of the Commentary on Article 18 of the United Nations Model Convention.

<sup>179</sup> See paragraphs 12–21 of the Commentary on Article 18 of the OECD Model Convention.



State of residence does not tax these payments. The policy arguments for and against these provisions, which are also discussed in the Commentary, should be considered by negotiators prior to commencement of negotiations.<sup>180</sup>

***Paragraph 2 of alternative A, paragraph 3 of alternative B***

Paragraph 2 of alternative A and paragraph 3 of alternative B give to the source State sole taxing rights over pensions and other payments made under that country's social security system. The rationale for this is described in the Commentary as being that "the payments involved are wholly or largely financed out of the tax revenues of the State of source".<sup>181</sup>

There is no equivalent to this paragraph in the OECD Model Convention, although the Commentary on Article 18 of that Convention proposes an alternative provision which provides for non-exclusive source taxing rights.<sup>182</sup> The Commentary on the United Nations Model Convention also recognizes non-exclusive source taxation as an alternative, particularly in the case of countries that provide double tax relief through the credit method.<sup>183</sup>

For countries where parts of the social security system have been privatized, extension of the provision to payments under a mandatory private scheme would be appropriate.<sup>184</sup>

In the absence of paragraph 2 of alternative A (paragraph 3 of alternative B), social security payments would, unless covered by Article 19 (Government service), fall within Article 21 (Other income).

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<sup>180</sup> See section II.B of the present Manual, on a policy framework and country model.

<sup>181</sup> See paragraph 7 of the Commentary on Article 18 of the United Nations Model Convention.

<sup>182</sup> See paragraphs 24–28 of the Commentary on Article 18 of the OECD Model Convention.

<sup>183</sup> See paragraph 9 of the Commentary on Article 18 of the United Nations Model Convention.

<sup>184</sup> See paragraph 10 of the Commentary on Article 18 of the United Nations Model Convention.

Under Article 21 of the United Nations Model Convention, both countries would be able to tax the payments (with the residence country providing relief from double taxation). Under the OECD Model Convention, however, Article 21 would allocate sole taxing rights to the country of residence of the recipient.

### *Other provisions*

The Commentary discusses a number of important issues concerning:

- Tax treatment of contributions to foreign pension schemes
- Tax obstacles to the portability of pension rights, and
- Tax exempt treatment of investment income derived by pension funds established in a treaty partner country<sup>185</sup>

The Commentary notes that “allowing recognition of cross-border pension contributions and facilitating cross-border transfer of pension rights from a pension scheme to another will also stimulate the movement of personnel to foreign countries”.<sup>186</sup>

## **14. Article 19 — Government service**

Article 19 generally reserves the sole right to tax remuneration from, and pensions paid in respect of, government service to the paying State, unless the recipient is an individual who is both a resident of, and a national of, the other State.

The Article applies only to State employees and persons receiving a pension in respect of past employment by a State. It does not apply to persons rendering independent services.<sup>187</sup>

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<sup>185</sup> See paragraphs 17 and 18 of the Commentary on Article 18 of the United Nations Model Convention, quoting paragraphs 31–69 of the Commentary on Article 18 of the OECD Model Convention.

<sup>186</sup> See paragraph 18 of the Commentary on Article 18 of the United Nations Model Convention.

<sup>187</sup> See paragraph 2 of the Commentary on Article 19 of the United Nations Model Convention, quoting paragraph 2.1 of the Commentary on Article 19 of the OECD Model Convention.

The provisions of this Article provide exceptions to the usual rules of Article 15 (Dependent personal services) and Article 18 (Pensions and social security payments). Articles 15 and 18 give priority to this Article.

The Article is identical to Article 19 of the OECD Model Convention.

### ***Paragraph 1***

Subparagraph (a) of paragraph 1 sets out the general rule that salary, wages and other similar remuneration paid in respect of services rendered in the course of employment by a Government of a treaty partner country will be taxable only in that country.

The Commentary notes that “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”.<sup>188</sup> It is also consistent with the provisions of the Vienna Convention on Diplomatic Relations<sup>189</sup> and the Vienna Convention on Consular Relations.<sup>190</sup>

An exception to this general rule is provided by subparagraph (b) of paragraph 1 where the recipient is a resident and national of the other country (the receiving State) and the services are rendered in the receiving State (unless the person became a resident of the receiving State solely for the purpose of providing those services). Where the conditions of the exception are met, exclusive taxing rights over the remuneration are allocated to the receiving State. This exception commonly applies to “locally engaged” staff such as secretarial staff,

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<sup>188</sup> See paragraph 2 of the Commentary on Article 19 of the United Nations Model Convention, quoting paragraph 2 of the Commentary on Article 19 of the OECD Model Convention.

<sup>189</sup> See Article 34 of the Vienna Convention on Diplomatic Relations. Available from [http://legal.un.org/ilc/texts/instruments/english/conventions/9\\_1\\_1961.pdf](http://legal.un.org/ilc/texts/instruments/english/conventions/9_1_1961.pdf).

<sup>190</sup> See Article 49 of the Vienna Convention on Consular Relations. Available from [http://legal.un.org/ilc/texts/instruments/english/conventions/9\\_2\\_1963.pdf](http://legal.un.org/ilc/texts/instruments/english/conventions/9_2_1963.pdf).

drivers or security personnel who are employed in the receiving State by an embassy, consular office or other diplomatic representation of the country to which the services are provided.

Some countries prefer to include the expression, found in the 1963 version of the OECD Model Convention, “in the discharge of functions of a governmental nature” in relation to the services rendered on the basis that this limits the activities to a narrower range of services.<sup>191</sup> Negotiators who encounter this proposal should ensure that the two teams reach a common understanding of the functions so described as the concept can differ from country to country.

### *Paragraph 2*

Paragraph 2 deals with pensions paid out of State funds to a person in respect of past employment by that State. It applies both to pensions paid directly by the State and to pensions paid out of a separate fund created by a government body.<sup>192</sup>

Subparagraph (a) provides the general rule that such pensions may be taxed only in the paying State. Subparagraph (b), however, makes an exception in the case of a recipient who is a resident and national of the other State. In these circumstances, the pension will be taxable only in that other State.

Difficulties in the application of paragraph 2 can arise where pensions are paid partly in consideration of private services and partly for government services, for example, where pension rights have been transferred from a private scheme to a public scheme. The Commentary offers an alternative provision that provides for apportionment to ensure that only that part of the pension that is paid in

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<sup>191</sup> See paragraph 2 of the Commentary on Article 19 of the United Nations Model Convention, quoting paragraph 5 of the Commentary on Article 19 of the OECD Model Convention.

<sup>192</sup> See paragraph 2 of the Commentary on Article 19 of the United Nations Model Convention, quoting paragraph 5.2 of the Commentary on Article 19 of the OECD Model Convention.

respect of government service falls within the scope of subparagraph (a) of paragraph 2.<sup>193</sup>

A further alternative favoured by a few countries is to extend the operation of Article 18 (Pensions and social security payments) to all pensions, including government service pensions. In this case, paragraph 2 of Article 19 should be deleted.<sup>194</sup>

### ***Paragraph 3***

Paragraph 3 provides that the rules specified in paragraphs 1 and 2 do not apply with respect to government service salaries and pensions if the services are performed in connection with a business carried on by the relevant Government. In these cases, the normal rules of Articles 15, 16, 17 and 18 apply to the remuneration.

The Commentary notes that countries preferring the provisions of paragraphs 1 and 2 to apply to such remuneration may delete paragraph 3. If it is intended that paragraphs 1 and 2 should apply only to certain business activities conducted by public bodies, such as public railways or postal services, this may be specified in those paragraphs.<sup>195</sup>

## **15. Article 20 — Students**

Under Article 20, payments received from abroad by visiting students, business trainees and apprentices for their maintenance, education or training are exempted from tax in the country in which they are studying or training.

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<sup>193</sup> See paragraph 2 of the Commentary on Article 19 of the United Nations Model Convention, quoting paragraphs 5.2 – 5.6 of the Commentary on Article 19 of the OECD Model Convention.

<sup>194</sup> See paragraph 3 of the Commentary on Article 19 of the United Nations Model Convention.

<sup>195</sup> See paragraph 2 of the Commentary on Article 19 of the United Nations Model Convention, quoting paragraph 6 of the Commentary on Article 19 of the OECD Model Convention.

The Article is the same as Article 20 of the OECD Model Convention except that the latter provision does not expressly cover “business trainees”.

The Article applies only to students, and so forth, who are visiting the country solely for the purpose of their education or training, and covers payments for maintenance, education or training only when the source of these payments is outside the country being visited. Clearly, in most countries such payments would not be liable to tax under domestic law. The Article does not cover payments for services (which are covered under Article 15, or Article 7 or 14 in the case of independent services). A number of countries, however, prefer to extend the exemption to remuneration for services rendered by the student or trainee, particularly where the services that are provided are connected with his studies or training.<sup>196</sup> This approach can lead to difficulties in the country being visited as it creates unequal treatment in respect of its own residents.

Some treaties include an additional paragraph which requires the country in which the student is studying or training to give, in respect of grants, scholarships and employment income of the student, the same tax exemptions, reliefs or reductions as would be given to domestic students. This paragraph was formerly included in the United Nations Model Convention, but has been deleted in view of the practical difficulties of applying the provision. Countries that wish to include this provision should be aware of the policy considerations and administrative difficulties described in the Commentary.<sup>197</sup> In the absence of this provision, Article 21 will apply to such grants and allowances to the extent that other Articles, such as Article 15, do not cover them.

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<sup>196</sup>Draft wording could be along the following lines: “2. Notwithstanding the provisions of Articles 14 and 15, remuneration for services rendered by a student or a business apprentice in a Contracting State shall not be taxed in that State, provided that such services are in connection with his studies or training.”

<sup>197</sup>See paragraphs 3–9 of the Commentary on Article 20 of the United Nations Model Convention.

*Article for teachers*

Although neither the United Nations Model Convention nor the OECD Model Convention includes a separate provision dealing with income derived by visiting teachers or professors, a limited exemption from source taxation is often found in treaties of developing countries that wish to attract the services of foreign educators.

In the absence of a special provision, the remuneration would fall within Article 14 (Independent personal services) or Article 15 (Dependent personal services). Under these Articles, teachers and professors who visit a country for an extended period on a teaching assignment are likely to be taxable in that country. If the assignment lasts more than 183 days, some may become tax residents of that country and therefore liable to tax on their worldwide income. As this may operate as a disincentive for foreign teachers, countries that wish to encourage teachers to undertake teaching assignments in their country, for example, as part of a development programme, may want to provide a specific exemption for the teacher's remuneration in a tax treaty.

Typically, these countries seek to include an additional article in the treaty which provides for an exemption from tax in the host country for remuneration of visiting teachers, professors and, sometimes, researchers derived from their teaching or research activities in that country.<sup>198</sup> These provisions are, however, often difficult to apply and administer, so negotiators should be careful in drafting the article to ensure that the scope and application of the exemption is clear.

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<sup>198</sup> Draft wording could be along the following lines: "Notwithstanding the provisions of Article 15, a professor or teacher who makes a temporary visit to one of the Contracting States for a period not exceeding two years from the date of first arrival in that State, solely for the purpose of teaching or carrying out research at a university, college, school or other educational institution in that State and who is, or immediately before such visit was, a resident of the other Contracting State shall, in respect of remuneration for such teaching or research, be exempt from tax in the first-mentioned State, provided that such remuneration is derived by the professor or teacher from outside that State."

The Commentary on Article 20 (Students) of the United Nations Model Convention includes a discussion on issues that should be considered in preparing a provision dealing with remuneration of teachers and professors, including:

- The possibility of creating double exemption (for instance, if the teacher ceases to be a resident for tax purposes in the other country or qualifies for some form of exemption in the other country)
- The inclusion of a time limit (normally two years) and the application of that limit
- The possibility of limiting the exemption to teaching services performed at “recognized” institutions or research performed in the public (versus private) interest
- Whether an individual should be entitled to benefits under the Article in respect of more than one visit<sup>199</sup>

It should be noted that the same benefit for visiting educators could be achieved with more precision through domestic law, unless the intention is to limit the exemption to teachers and professors of treaty partner countries.

## 16. Article 21 — Other income

Article 21 allocates taxing rights over all income that is not otherwise dealt with under the other distributive rules of the treaty, namely, Articles 6 to 20 of the United Nations Model Convention.

The income covered by this Article may be:

- A category of income that is not covered under any other Article, for example, lottery winnings or pensions that are not paid in respect of past employment
- Income from sources not mentioned in an article, for example, royalties derived by a resident of one State in respect of rights or property used in the other State that is paid by a resident of a third State who has no permanent establishment or fixed base in that other State, or

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<sup>199</sup> See paragraphs 10 – 12 of the Commentary on Article 20 of the United Nations Model Convention.



- Income from sources outside the two treaty partner countries, that is, from sources in a third State

### ***Paragraph 1***

Paragraph 1 gives exclusive taxing rights over such other income to the country of residence of the recipient.

In the case of a dual resident, that is to say, a person that is a resident of both treaty partner countries under their domestic laws, Article 4 determines their country of residence for purposes of the treaty.

Paragraph 1 is identical to paragraph 1 of Article 21 of the OECD Model Convention.

### ***Paragraph 2***

Paragraph 2, like its equivalent in Article 21 of the OECD Model Convention, makes an exception to the rules of paragraph 1 where the income is attributable to a permanent establishment (or fixed base, if Article 14 is included in the treaty). In that case, income (other than income from immovable property<sup>200</sup>) may be taxed in accordance with the provisions of Article 7 or Article 14, that is to say, the profits may be taxed in the country in which the permanent establishment or fixed base is situated.

The paragraph primarily addresses the case of income arising in a third State that is attributable to a permanent establishment or fixed base. It also deals, however, with the case where the payer and the recipient (or beneficial owner) of the income are both resident in the same State, but the income is attributable to a permanent establishment or fixed base of the recipient in the treaty partner country. For example, interest paid by a resident of State A may be beneficially owned by another resident of State A but attributable to a fixed base of that person situated in State B. In this case, paragraph 2, in

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<sup>200</sup>The Commentary describes the tax treatment of income from immovable property. See paragraph 4 of the Commentary on Article 21 of the United Nations Model Convention, quoting paragraph 4 of the Commentary on Article 21 of the OECD Model Convention.

combination with Article 7, will allow State B to tax the income, and Article 23 will require State A to relieve double taxation. If State A relieves by the exemption method, however, this will result in that State not being able to tax the income at all, notwithstanding that the interest arises in State A.

Some countries do not agree with this outcome, and seek to include a provision that ensures that State A may impose tax as the source country (limited, where appropriate, in accordance with treaty provisions such as Articles 10, 11 or 12). The country in which the permanent establishment or fixed base is situated must give relief from any double taxation.<sup>201</sup>

The Commentary suggests possible solutions for countries that are concerned about enterprises seeking to abuse the treaty by attaching shares, bonds or patents to a permanent establishment in order to obtain more favourable treatment.<sup>202</sup>

### ***Paragraph 3***

Paragraph 3, which has no equivalent in the OECD Model Convention, provides an exception to paragraph 1 and permits source taxation of income that comes within the scope of Article 21. Under the OECD Model, source taxation of such income is not permitted.

Paragraph 3 is frequently found in treaties of developing countries as well as in treaties of some developed countries.<sup>203</sup> Some countries which generally do not include paragraph 3 of Article 21 in their tax treaties might agree, in negotiations with countries that seek its inclusion, to limit the scope of this paragraph by listing specific items of income which may be subjected to the source-country

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<sup>201</sup> See paragraph 4 of the Commentary on Article 21 of the United Nations Model Convention, quoting paragraph 5 of the Commentary on Article 21 of the OECD Model Convention.

<sup>202</sup> See paragraph 4 of the Commentary on Article 21 of the United Nations Model Convention, quoting paragraph 6 of the Commentary on Article 21 of the OECD Model Convention.

<sup>203</sup> Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997 – 2013”, *Bulletin for International Taxation*, No. 3 (2014), section 2.20.1.

taxation under the Article. Another option, which may be suited to countries that impose withholding tax on payments to non-residents, is to provide for limited source taxation, that is, by imposing a rate limit on such taxation.

If the treaty partners agree to provide for exclusive residence country taxation, paragraph 3 should be omitted.

### **Additional paragraphs**

The Commentary includes three alternative provisions which some countries include in their treaties. The first is an anti-abuse provision along the lines of paragraph 6 of Article 11 and paragraph 6 of Article 12, dealing with excessive payments between related parties.<sup>204</sup> Another option for countering abuse is to include a “main purpose” test in the Article.<sup>205</sup>

Finally, if the domestic laws of the treaty partner countries differ as to when income may be said to “arise” in each State, a source rule, similar to that in paragraph 5 of Article 11 and paragraph 5 of Article 12, could be included.<sup>206</sup>

## **D. Chapter IV — Taxation of capital**

### **1. Article 22 — Capital**

Article 22 allocates taxing rights over capital owned by a resident of one of the treaty partner countries.

The Article deals with taxes on capital as specified in Article 2, but not estate duties, inheritance taxes, gift duties or transfer duties.

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<sup>204</sup> See paragraph 7 of the Commentary on Article 21 of the United Nations Model Convention, quoting paragraphs 7–11 of the Commentary on Article 21 of the OECD Model Convention.

<sup>205</sup> See paragraph 8 of the Commentary on Article 21 of the United Nations Model Convention and section IV.C of the present Manual.

<sup>206</sup> See paragraph 9 of the Commentary on Article 21 of the United Nations Model Convention.

As discussed in relation to Article 2 (Taxes covered), countries must make a decision whether to cover capital taxes in a treaty. If neither country imposes such taxes, or if double taxation of capital is unlikely to arise because only one country has capital taxes, negotiators may decide not to cover capital taxes in Article 2, and may omit Article 22. Consequential changes are also required in this case to paragraphs 1 and 3 of Article 23 A, paragraphs 1 and 2 of Article 23 B and paragraph 4 of Article 24.<sup>207</sup>

### *Paragraph 1*

Paragraph 1 permits the country in which immovable property (or real property) is situated to tax capital represented by that immovable property owned by a resident of the other country. “Immovable property” takes its meaning from the definition of the term in Article 6.

The allocation of taxing rights over capital in this paragraph mirrors that in respect of income from immovable property under Article 6.

### *Paragraph 2*

Paragraph 2 provides that the country in which a permanent establishment or fixed base of a non-resident is situated may tax capital represented by movable business property of the permanent establishment or fixed base.

This corresponds to the rules for taxing income attributable to a permanent establishment or fixed base. If Article 14 is not included in the treaty, the references to fixed base should be omitted.

In essence, the paragraph applies to property, other than immovable property, that is effectively connected with the permanent establishment or fixed base. To form part of the business property of the permanent establishment or fixed base, more is required than the mere recording of the property in the books of the permanent establishment or fixed base.

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<sup>207</sup> See Commentary on paragraph 4 of Article 24 of the United Nations Model Convention.

***Paragraph 3***

Paragraph 3 allocates taxing rights over capital represented by ships or aircraft used in international traffic, boats used in inland waterways transport and movable property (that is to say, property other than immovable property) that relates to those operations. Exclusive taxing rights are allocated to the country in which the place of effective management of the transport enterprise is situated.

Taxation of capital of transport enterprises under this paragraph corresponds to the treatment of income of such enterprises. Accordingly, if taxing rights over income from international transport are allocated under Article 8 to the country of residence of the enterprise (rather than the country in which the place of effective management is situated), then a corresponding change should also be made to this paragraph.<sup>208</sup>

If paragraph 2 of Article 8 is omitted, then the references to boats engaged in inland waterways transport in this paragraph should also be omitted.

The Commentary provides an alternative version of paragraph 3 that is intended to make it clear that this paragraph does not apply where the enterprise that owns the ships, aircraft or boats does not also operate them in transport activities, for example, where the ships, aircraft or boats are operated by another enterprise.<sup>209</sup>

***Paragraph 4***

Paragraph 4 of Article 22 of the United Nations Model Convention is enclosed in square brackets to indicate that it is not a recommendation, only an option that countries may adopt if they wish to do so. The

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<sup>208</sup>Draft wording could be along the following lines: “3. Capital of an enterprise of a Contracting State 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 that State.”

<sup>209</sup>See paragraphs 4.1 and 4.2 of the Commentary on Article 22 of the United Nations Model Convention.

paragraph deals with all other elements of capital, that is to say, the elements of capital that are not dealt with in paragraphs 1 to 3 of the Article. The option in the United Nations Model Convention, like the equivalent provision in the OECD Model Convention, allocates exclusive taxing rights to the country of residence of the owner of that capital.

It is noted in Article 22 of the United Nations Model Convention, however, that the question of how to tax such capital is left to bilateral negotiations.

Some treaties provide a non-exclusive taxing right to the country in which the other elements of capital are situated. Others allow both countries to apply their domestic law in respect of taxation of capital.<sup>210</sup> If double taxation arises as a result, the country of residence of the taxpayer is required to provide relief in accordance with Article 23.

A few countries prefer to provide for taxation only in the country where the other elements of capital are located. This, however, is likely to be more difficult to negotiate as few countries are prepared to give up taxing rights over their own residents.

## **E. Chapter V — Methods for the elimination of double taxation**

The distributive rules of a tax treaty (that is, the provisions that allocate taxing rights over income) frequently permit both countries to tax the same taxpayer on the same income. When this occurs, Article 23 of the United Nations Model Convention requires the country of residence of the taxpayer to provide relief from double taxation by one of two methods. Article 23 A provides for relief by the exemption method, while Article 23 B provides for relief by the credit method.

Many countries draft their own text for this article, but it is important to ensure that the basic principles are captured in that text, whichever method is used, and that the obligation on the residence State to eliminate double taxation is retained.

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<sup>210</sup>For example, “Gains from the alienation of any property or right other than those mentioned in paragraphs 1, 2 and 3 may be taxed in both Contracting States.”

Treaty practice shows that the provisions of the Article are often expressly declared to be subject to the provisions of domestic law. Such conditions should be taken to refer to the methods by which the exemptions or credits will be calculated and applied. They do not relieve the residence State from its obligation to provide relief in accordance with the treaty.<sup>211</sup>

If the treaty does not cover capital taxes, the references to capital and to capital taxes should be omitted.

### **1.1 Article 23 A — Exemption method**

Under the exemption method provided for in Article 23 A, the country of residence is required to exempt items of income derived by its residents that may be taxed in the treaty partner country in accordance with the treaty. For example, the residence State will exempt income derived by its residents from the use of immovable property situated in the other State, or will exempt business profits derived by its residents through a permanent establishment situated in the other State.

In effect, under the exemption method, only the country where the income is generated, or where the permanent establishment or fixed base is situated, will tax that income. By granting an exemption to its residents with respect to an item of foreign-source income, the residence country ensures that its residents are not subjected to higher taxation rates than residents of the source country with respect to that income. Indeed, if the source State provides tax incentives targeted at foreign investors, those investors may be treated more favourably than residents of the source State if their country of residence exempts the income from taxation. Where the residence State applies the exemption method, the benefit of tax incentives of the source State is not reduced or cancelled by taxation in the country of residence of the investor as would be the case under the credit method.

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<sup>211</sup> See, for example, paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 32.8 of the Commentary on Article 23 of the OECD Model Convention.

*Paragraph 1*

Paragraph 1 provides the central rule that the taxpayer's country of residence will exempt from tax income that may be taxed in the other State in accordance with the treaty.

The exemption applies irrespective of the amount, if any, of tax imposed in the treaty partner country. Since this can result in less-than-single taxation or effective double non-taxation where the income is not taxed in the source country, or where the treaty imposes limits on source taxation, countries may want to restrict the operation of paragraph 1 to income that is effectively taxed in the source country, or may extend the application of paragraph 2 (which provides for the credit method) to additional categories of income.<sup>212</sup> Some countries may also wish to include a provision that applies a "switchover" to the credit method in certain circumstances, for example, for income that benefits from a preferential regime that is introduced in the source country after signature of the treaty.<sup>213</sup> The Commentary also includes an alternative switchover clause that provides for relief by the credit method in cases where the source country applies the treaty provisions to exempt income, notwithstanding that the residence country would interpret the provisions as allowing the source country to tax.<sup>214</sup>

Since the amount of a taxpayer's taxable income or capital may be relevant for non-tax purposes, for example, for social benefits, the Commentary provides an alternative formulation of paragraph 1. Under this alternative provision, instead of reducing the taxpayer's income or capital by the amount of the foreign income or capital, the taxpayer's tax liability is reduced by the amount of tax applicable to that foreign income or capital.<sup>215</sup>

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<sup>212</sup> See paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 33 – 35 of the Commentary on Article 23 of the OECD Model Convention, and paragraph 15 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>213</sup> See paragraph 31.1 of the Commentary on Article 23 of the OECD Model Convention.

<sup>214</sup> See paragraph 19 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>215</sup> See paragraph 16 of the Commentary on Article 23 of the United



The Commentary discusses a number of issues that can arise in the application of the exemption method, including the amount to be exempted, the treatment of losses, and taxation of the rest of the income.<sup>216</sup>

### ***Paragraph 2***

Paragraph 2 provides for the credit method to apply in respect of dividends, interest and royalties which may be subjected to limited taxation in the source State in accordance with the treaty.

Since it is clearly intended under the treaty that taxation of such income is to be shared by the two States, the country of residence should not be required to exempt the income (though it may if it so wishes). For the same reason, this paragraph may be extended to other categories of income where source taxation is limited, for example, in some treaties, fees for technical services.

As is generally the case in respect of the credit method, the residence country is not obliged to provide a credit for the foreign tax to the extent that the foreign tax exceeds the amount of tax which is payable on that income in the residence State (ordinary credit).<sup>217</sup>

### ***Paragraph 3***

Countries using the exemption method may apply either “full exemption” or “exemption with progression”.<sup>218</sup> Under full exemption,

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Nations Model Convention, quoting paragraph 37 of the Commentary on Article 23 of the OECD Model Convention.

<sup>216</sup> See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 38 – 46 of the Commentary on Article 23 of the OECD Model Convention.

<sup>217</sup> See the different methods of credit (“ordinary credit” and “full credit”) in paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting, in particular, paragraph 16 of the Commentary on Article 23 of the OECD Model Convention.

<sup>218</sup> See paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting, in particular, paragraphs 14 and 20 – 22 of the Commentary on Article 23 of the OECD Model Convention.

income which may be taxed in the treaty partner country is not taken into account at all for purposes of taxation in the residence State.

Paragraph 3 expressly provides for exemption with progression, pursuant to which the income, while it is exempt from tax in the country of residence, may nevertheless be taken into account in determining the rate of tax applied to other income of that resident.<sup>219</sup> Worked examples of the application of full exemption and exemption with progression are found in the Commentary.<sup>220</sup>

If the alternative formulation of paragraph 1 of Article 23 A<sup>221</sup> is adopted in a treaty, paragraph 3 is not necessary and may be omitted.

## 1.2 Article 23 B — Credit method

Under the credit method for addressing double taxation provided for in Article 23 B, the country of residence is obliged to reduce its normal tax claims on its residents by the amount of tax that those residents have already paid to the source State on income or profits that may be taxed in that State in accordance with the treaty.

When the tax rate in the source State is lower than the domestic rate in the country of residence, only the excess of the domestic tax over the foreign tax is payable in the country of residence of the taxpayer. When the foreign tax is higher than the domestic tax, the country of residence does not collect any tax. The effective overall burden on the taxpayer is the higher of the domestic tax and the foreign tax.

A few countries seek to maximize their revenue (without imposing any additional tax burden on foreign investors) through

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<sup>219</sup> See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 55 and 56 of the Commentary on Article 23 of the OECD Model Convention.

<sup>220</sup> See paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 20 of the Commentary on Article 23 of the OECD Model Convention.

<sup>221</sup> See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 37 of the Commentary on Article 23 of the OECD Model Convention.

so-called soak-up taxes, which are designed to increase source taxation to the level of the residence country in the expectation that the residence country will provide credit for the source tax. Where the additional source tax results in a violation of the provisions of Article 24 (Non-discrimination), the taxation is not “in accordance with the Convention” for purposes of Article 23. In these circumstances, the country of residence is not obliged to provide double tax relief for the additional tax.

By relieving double taxation through the credit method, the country of residence generally ensures that its residents pay the same amount of tax, regardless of whether the income is derived from foreign or domestic sources.

*Paragraph 1*

Paragraph 1 allows the country of residence of a taxpayer to tax income and profits derived from (or capital owned in) the treaty partner country, but imposes an obligation on the country of residence to deduct from its residents’ tax liability an amount equal to the tax paid in the treaty partner country.

In accordance with the second sentence of paragraph 1, the credit that must be provided by the residence country is limited to the tax that would otherwise be payable on that income in the country of residence. In computing the limitation, the country of residence typically computes income according to its own laws, not according to the tax rules applicable in the source State.

Sometimes domestic law allows for aggregation of foreign tax credits, for example, by providing that the limit relates to all income from each source country (“per country limitation”), or to specific types of income regardless of source (“separate basket limitation”). Some countries apply an “overall credit” system under which the total of all foreign taxes is credited against the domestic tax applicable to the total foreign income.

A country that wishes to give full credit for the source taxation under the treaty, for example, where the source tax permitted under the treaty may exceed the tax that would be imposed in the

residence country, may omit the second sentence of paragraph 1.<sup>222</sup> Worked examples of the application of ordinary credit provided under the second sentence of paragraph 1 and of full credit are found in the Commentary.<sup>223</sup>

The Commentary also provides guidance on the computation of the credit, and on issues relating to losses, thin capitalization and partnerships.<sup>224</sup>

### ***Paragraph 2***

Paragraph 2 provides for exemption with progression where income is exempted by the provisions of the treaty from taxation in the residence State. In effect, this paragraph allows the country of residence to take the exempt income into account in determining the tax liability in respect of other income of the taxpayer.<sup>225</sup>

Exemption with progression is discussed above in relation to paragraph 3 of Article 23 A.

## **Special issues**

### ***Capital taxes***

As noted in the Commentary, credit is to be allowed for income tax only against income tax, and for capital tax only against capital tax.<sup>226</sup>

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<sup>222</sup> See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 48 of the Commentary on Article 23 of the OECD Model Convention.

<sup>223</sup> See paragraph 14 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 23–26 of the Commentary on Article 23 of the OECD Model Convention.

<sup>224</sup> See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 60–69.3 of the Commentary on Article 23 of the OECD Model Convention.

<sup>225</sup> See also paragraph 18 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 79 of the Commentary on Article 23 of the OECD Model Convention.

<sup>226</sup> See paragraph 16 of the Commentary on Article 23 of the United

If one State does not impose capital taxes, or both countries tax only domestic assets, with the result that no double taxation arises, the references to capital may be deleted.

### ***Intercorporate dividends***

Where a parent company receives dividends from a subsidiary, juridical double taxation of the dividends is relieved by the credit method under Article 23 A or Article 23 B. However, recurrent corporate taxation may still occur where corporate profits are taxed first at the level of the subsidiary and again upon distribution at the level of the parent company.

Such recurrent taxation, which may occur at several levels in a chain of companies, has been addressed by some countries through their domestic law or through treaties.

The Commentary discusses this issue<sup>227</sup> and identifies three possible solutions:

- Exemption with progression in respect of the dividends received by a parent company from its subsidiary in a treaty partner country
- Credit for underlying taxes imposed on the subsidiary in respect of the profits out of which the dividends are paid (in addition to credit for tax on the dividends themselves)
- Assimilation to a holding in a domestic subsidiary, for example, access to imputation credits or participation exemptions

### **Tax sparing**

The benefit of special tax concessions offered by the source State to foreign investors may be lost if the investor is a resident of a country

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Nations Model Convention, quoting paragraphs 70 and 71 of the Commentary on Article 23 of the OECD Model Convention.

<sup>227</sup> See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 49–54 of the Commentary on Article 23 of the OECD Model Convention.

that uses the credit method. In these cases, the reduction in source taxation merely results in an increase in the amount of tax collected by the country of residence of the taxpayer.

By contrast, the exemption method ensures that no further tax will be imposed in the country of residence on the income that has benefited from the tax incentive in the source country. However, if the treaty partner is not prepared to use the exemption method, developing countries often seek to include tax-sparing provisions in their treaties. For some developing countries, preservation of the benefit of their tax incentives through relief of double taxation by the exemption method or by the inclusion of tax-sparing provisions “is a basic and fundamental aim in the negotiation of tax treaties”.<sup>228</sup>

Tax sparing is an arrangement under which the developed country will agree to provide a credit for the source tax of the developing country, notwithstanding that the tax has not actually been imposed because of tax incentives provided by the developing country. The purpose of tax sparing is to ensure that the benefit of the incentive is not lost to the taxpayer as a result of taxation of the income by the country of residence.<sup>229</sup>

While some developed countries are prepared to agree to such provisions with their least developed treaty partners, many are resistant to a tax-sparing provision, especially after the publication of the

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<sup>228</sup> See paragraph 4 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>229</sup> For example, paragraph 3 of Article 23 of the Canada-Argentina treaty (1993) provides:

For the purposes of subparagraph (a) of paragraph 1, tax payable in Argentina by a company which is a resident of Canada in respect of profits attributable to manufacturing activities or to the exploration or exploitation of natural resources carried on by it in Argentina shall be deemed to include any amount which would have been payable thereon as Argentine tax for any year but for an exemption from, or reduction of, tax granted for that year or any part thereof under specific provisions of Argentine legislation that the competent authority of Canada agrees should be covered by this provision, and only to the extent that the said provisions have the effect of exempting or relieving a source of income for a period not in excess of ten years.

OECD report entitled *Tax Sparing: a Reconsideration* recommending caution in agreeing to tax-sparing provisions in treaties.<sup>230</sup> In particular, the report noted that tax sparing was vulnerable to taxpayer abuse, and was not necessarily an effective tool for promoting economic development.<sup>231</sup> The report did not say that tax sparing should never be granted, but suggested that it should be considered only in regard to States whose economic level was considerably below that of OECD member States. It also recommended the use of “best practices”, such as the limitations mentioned below, to minimize potential for abuse.

The Commentary suggests three different forms that tax-sparing provisions may take, namely, a deduction for the tax that the source State could have imposed, a deduction for a fixed rate of tax or an exemption of the income.<sup>232</sup>

Countries that are prepared to include tax-sparing provisions should ensure that the incentives for which tax sparing is sought are described with sufficient precision so that the other country knows exactly which measures are covered. This may involve a reference to legislation that sets out which income or projects are eligible for the incentive. Increasingly, tax-sparing provisions include certain limitations, for example:

- The eligible incentives may be limited to certain types of investment or activities, for instance, genuine investments aimed at developing the domestic infrastructure of the developing country
- Tax sparing may apply only to active business income (not passive income such as interest, royalties or leasing payments)
- Tax sparing may not apply to financial activities such as banking and insurance

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<sup>230</sup> OECD, *Tax Sparing: A Reconsideration* (1998), reproduced in the full-length version of the OECD Model Tax Convention on Income and on Capital (Paris: OECD, 2010), vol. II, p. R(14)-1.

<sup>231</sup> See paragraph 18 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 75 of the Commentary on Article 23 of the OECD Model Convention.

<sup>232</sup> See paragraph 16 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraph 74 of the Commentary on Article 23 of the OECD Model Convention.

- A “sunset” clause may apply, for instance, a provision that states that tax sparing will apply only for a limited period (such as 10 years), unless further extended by agreement between the two countries<sup>233</sup>

The Commentary discusses other approaches that may be adopted by countries seeking to preserve the benefit of their tax incentives, namely:

- Making the granting of the tax incentive under domestic law of the source country conditional upon the income being exempted (or the tax forgone credited) in the investor’s country of residence
- Providing in a treaty that income benefiting from a tax incentive will be exempt from tax in the investor’s country of residence until repatriated, or
- Allowing the residence country to tax the income but requiring it to transfer to the source country amounts of tax that are reasonably attributable to that country’s tax incentives<sup>234</sup>

Negotiators from countries that wish to include tax-sparing provisions in their treaties should read paragraphs 3 to 12, as well as paragraphs 16 to 18 of the Commentary on Article 23 of the United Nations Model Convention, quoting paragraphs 72 to 78.1 of the Commentary on Article 23 of the OECD Model Convention.

## **F. Chapter VI — Special provisions**

Both the United Nations and OECD Model Conventions contain a Chapter VI on special provisions, which are provisions dealing with non-discrimination, the mutual agreement procedure and exchange of information. An optional article on assistance in the collection of taxes is also included.

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<sup>233</sup> See paragraph 12 of the Commentary on Article 23 of the United Nations Model Convention.

<sup>234</sup> See paragraphs 3–9 of the Commentary on Article 23 of the United Nations Model Convention.



## 1. Article 24 — Non-discrimination

Tax discrimination can be a significant barrier to cross-border investment and activities where different tax treatment puts foreign investors at a competitive disadvantage to locals conducting similar activities. Article 24 seeks to address common forms of tax discrimination by imposing an obligation on both Contracting States to remove that discrimination in certain situations.

It should be noted that the Article precludes discrimination only on the basis of specific criteria (for example, nationality or foreign ownership), where the relevant circumstances are otherwise comparable between the person from the treaty partner country and a local person. The Article does not preclude all tax distinctions; only the particular forms of discrimination specified therein. Some differences in tax treatment are recognized as being legitimate, for example, different methods of taxing residents and non-residents. Other forms of tax discrimination may be less acceptable, but nevertheless are not precluded by the treaty.

It should also be noted that tax treatment that is specifically mandated by other Articles of the treaty cannot be regarded as being in violation of the non-discrimination article, for example the provisions of Article 9 (Associated enterprises). Furthermore, while the non-discrimination article is not intended to provide more favourable treatment to foreign investors than to locals, a domestic law treatment that does in fact provide such favourable treatment is not a violation of the Article.

If a domestic law treatment is found to violate the non-discrimination rules of a tax treaty, the domestic law is not itself invalidated. The domestic law will continue to apply in cases that are not covered by the treaty, for example, in relation to persons who do not come within the scope of the treaty. However the domestic law must be applied in a way that does not discriminate against a resident or national of the treaty partner country where the law would otherwise constitute a breach of Article 24. For example, if the domestic law of a country provides for more onerous tax treatment for persons that are not nationals of the country, then nationals of the treaty partner country (but not others) must be given the same treatment as nationals of the country applying the law.

The general principles for applying Article 24 are described in the Commentaries.<sup>235</sup>

Even if a particular type of tax discrimination is not addressed in Article 24, developing countries should try to avoid discriminatory tax treatment in their domestic law as far as possible, particularly if they wish to attract foreign investment. If, however, a domestic law would potentially breach the non-discrimination rules, and for good policy reasons (such as the prevention of tax avoidance or evasion) the country considers that the law must be maintained, negotiators for that country should be prepared to explain fully the operation of those laws during negotiations and, if the other country agrees, specify precisely in the Article any laws that are to be excluded from the operation of the treaty rules in this Article.

### ***Paragraph 1***

Paragraph 1 stipulates that a Contracting State may not tax nationals of the other State more harshly than its own nationals.

The term “national” is defined in Article 3,<sup>236</sup> and includes legal persons, partnerships and associations that derive their status as such in the country, as well as individuals who are nationals of that country. For legal persons, partnerships and associations, this generally means that the entity is incorporated or established in that country.

Nationals of a treaty partner country cannot be taxed at a higher rate, or subjected to more onerous administrative or compliance obligations than those applicable to a State’s own nationals who are, for tax purposes, in the same circumstances. The text of paragraph 1 makes it clear that the comparison must be made between nationals of the two countries that have the same residential status, that is to say, a national of State A who is a resident of State B is not “in the same circumstances” as a national of State A who is a resident of State A. Issues relating

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<sup>235</sup> See paragraph 1 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraphs 1 – 3 of the Commentary on Article 24 of the OECD Model Convention.

<sup>236</sup> Subparagraph (f) of Article 3 (1) of the United Nations Model Convention.

to the meaning of “in the same circumstances” should be resolved by reference to the Commentaries and the examples provided therein.<sup>237</sup>

The second sentence of paragraph 1 provides that tax discrimination against nationals of the treaty partner country who are residents of a third State must also be eliminated.

### ***Paragraph 2***

Paragraph 2 precludes tax discrimination against stateless persons who are resident in one or other of the States. In the absence of this provision, stateless persons would not be protected against discrimination on the basis of nationality.

Treaty practice with respect to this paragraph varies.

### ***Paragraph 3***

Paragraph 3 ensures that a permanent establishment in a treaty partner country is not less favourably taxed than a local enterprise, where they are both carrying on the same activities.

Difficult issues can arise with respect to the application of this provision, and negotiators are strongly advised to read the Commentaries for guidance on the implications of the equal treatment requirement for:

- Assessment of tax
- Treatment of dividends received in respect of holdings owned by permanent establishments
- Structure and rate of tax
- Withholding tax on dividends, interest and royalties received by a permanent establishment
- Credit for foreign tax

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<sup>237</sup> See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraphs 5–25 of the Commentary on Article 24 of the OECD Model Convention.

- Extension to permanent establishments of the benefit of the credit provisions of double taxation conventions with third States<sup>238</sup>

One issue of particular importance to many developing countries is that paragraph 3 would preclude the application of branch profits taxes that take the form of an additional tax (or higher tax rate) on the profits of a permanent establishment. Countries that wish to continue to impose such taxes commonly include a specific provision—generally in Article 10 (Dividends)—that allows them to impose an additional tax on the taxable profits of a permanent establishment.<sup>239</sup> As the application of the branch profits tax is then specifically mandated by the treaty, such treatment cannot be regarded as a violation of the non-discrimination rules.

#### ***Paragraph 4***

Under paragraph 4, payments made to a resident of a treaty partner country in respect of interest, royalties and other disbursements must be deductible under the same conditions as payments to a resident. Accordingly, foreign lenders or suppliers of technology or services cannot be subjected to a tax disadvantage compared to local lenders or suppliers through the imposition of limitations, or additional requirements, on deductions in respect of payments to those foreign lenders or suppliers.

The Commentary clarifies, however, that thin capitalization rules imposed under domestic law do not violate paragraph 4 insofar as they are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11.

In some countries, deductibility of disbursements to foreign residents may be conditional upon the income being taxed in that country. Negotiators for countries where this is the case should raise

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<sup>238</sup> See paragraph 2 of the Commentary on Article 24 of the United Nations Model Convention, quoting paragraphs 33–72 of the Commentary on Article 24 of the OECD Model Convention.

<sup>239</sup> See paragraphs 18–24 of the Commentary on Article 10 of the United Nations Model Convention.

the matter during negotiations and, if necessary, clarify that such treatment is not precluded under the Article.

***Paragraph 5***

Paragraph 5 provides that foreign-owned resident companies cannot be taxed more harshly than locally owned resident companies in similar circumstances. It is aimed at ensuring that resident companies are taxed equally, irrespective of who owns or controls their capital.

This paragraph is concerned only with taxation of income of the resident company itself, and not with taxation of the owners or of distributions by the company to them, or with rules that depend on the relationship between the company and other enterprises, for example, consolidation rules or loss transfers.

Countries that have special rules relating to foreign-owned companies that they consider important to maintain should raise these matters during negotiations and, if necessary, make specific provision for them.

***Paragraph 6***

In accordance with paragraph 6, the operation of Article 24 is not limited to taxes covered by the treaty as specified in Article 2. The non-discrimination rules in the United Nations and OECD Model Conventions apply to all taxes, including national- and subnational-level taxes, income tax, value added tax (VAT), property taxes, petroleum taxes, and so forth.

However, in some countries, there may be constitutional or other barriers to applying the non-discrimination rules to all taxes. While it is desirable that the rules apply as widely as possible, these countries may need to limit the application of these rules in their treaties to taxes covered by the treaty, or to those taxes and other major taxes imposed in the two countries.

**2. Article 25 — Mutual agreement procedure**

Tax treaties provide a mechanism by which taxpayers and tax administrations can resolve issues and uncertainties relating to the application

or interpretation of the tax treaty and the elimination of double taxation. Article 25 of the United Nations and OECD Model Conventions also put forward provisions for mandatory arbitration in cases that are not resolved within a specified time by the two competent authorities (as defined in Article 3).

Countries that enter into tax treaties must be in a position to meet their obligations with respect to the mutual agreement procedure, that is to say, they must establish processes within their tax administrations to enable taxpayers, or competent authorities from treaty partner countries, to present cases for consideration. Suitably trained senior personnel must also be designated as authorized representatives of the competent authority and be available to resolve such cases and, where necessary, to consult with the competent authority of the treaty partner country with a view to reaching a solution.

The term “competent authority” is defined in subparagraph (e) of Article 3 (1). While countries are free to designate their own representatives for this purpose, it is important that the persons or authorities so nominated have sufficient authority to effectively negotiate with their counterparts in the other country and to make binding decisions with respect to the cases brought before them. The competent authority will therefore generally be either the relevant minister or head of the tax administration, and they would then designate senior officials in the tax administration or Ministry of Finance as their authorized representatives who would undertake the duties mentioned above.

The Commentaries provide extensive guidance on how Article 25 should be interpreted and applied. In addition, in 2012, the United Nations published its Guide to the Mutual Agreement Procedure under Tax Treaties<sup>240</sup> which provides practical guidance to countries that have little or no experience with the mutual agreement procedure. The Guide looks, for example, at:

- Typical cases dealt with in the mutual agreement procedure
- The role of the competent authority

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<sup>240</sup> Available from [http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-Guide\\_MAP.pdf](http://www.un.org/esa/ffd/wp-content/uploads/2014/10/ta-Guide_MAP.pdf).

- How and when taxpayers can make a request for mutual agreement
- How the mutual agreement procedure works
- How competent authorities interact
- How mutual agreements are implemented
- The relationship between the mutual agreement procedure and domestic law

The Guide includes a number of recommendations, based on international practice and experience, on ways to deal with mutual agreement processes and procedural issues. The Guide has a particular focus on the specific concerns of developing countries and countries in transition.

The OECD has also published its Manual on Effective Mutual Agreement Procedures, which highlights best practices of competent authorities in OECD countries and describes recommended approaches for conducting activities under the mutual agreement procedure.<sup>241</sup>

The relationship between the mutual agreement procedure (including arbitration) and domestic law is important. The mutual agreement procedure is separate from, and additional to, domestic law remedies. Domestic law limitations, for example, with respect to time, confidentiality and procedures, should not be allowed to prevent effective mutual agreement. However, most countries will not allow a taxpayer to pursue both mutual agreement and domestic law remedies simultaneously.<sup>242</sup> In most countries, a solution reached under the mutual agreement procedure cannot override a legal decision (for example, a final court decision) made in a particular case in accordance with domestic law remedies. Conversely, an agreement reached under the mutual agreement procedure will generally not be implemented unless the taxpayer renounces domestic law remedies with respect to that issue.

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<sup>241</sup> Available from <http://www.oecd.org/tax/transfer-pricing/manual-on-effective-mutual-agreement-procedures-memmap.htm>.

<sup>242</sup> See paragraph 18 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 76 of the Commentary on Article 25 of the OECD Model Convention.

*Paragraph 1*

Paragraph 1 provides an avenue for taxpayers to seek solutions to tax issues arising out of the treaty. The requirements are:

- The person has to have reason to believe that his tax treatment is not, or will not be, in accordance with the treaty<sup>243</sup>
- The case has to be presented to the competent authority of which the taxpayer is a resident, or, in cases involving the nationality non-discrimination rule in paragraph 1 of Article 24, a national
- The case has to be presented within three years from the time the person is notified of the action which will result in taxation not in accordance with the treaty (for instance, a notice of assessment)

Countries may seek a different time limit, for example, one that would better align with time limits for challenges to tax actions under their domestic law. The agreed period should not be shorter than three years, but a longer period may be agreed upon to reflect the period allowed for objections under domestic law.<sup>244</sup>

As noted in the Commentaries, no special procedure is stipulated as to how requests for mutual agreement are to be presented.<sup>245</sup> Countries may find it convenient to apply the same procedures as are applicable for domestic law objections. Alternatively, appropriate procedures, conditions, methods and techniques may be agreed to under paragraph 4 of Article 25 of the United Nations Model Convention. Additionally, the Commentary highlights the necessary cooperation of the person who makes the request.<sup>246</sup>

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<sup>243</sup> It should be noted that the Mutual Agreement Procedure would not be available in respect of a violation of domestic law, unless that violation also gives rise to taxation that is not in accordance with the treaty.

<sup>244</sup> Paragraph 20 of the Commentary on Article 25 of the OECD Model Convention suggests that three years should be the minimum time provided.

<sup>245</sup> See paragraph 9 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 16 of the Commentary on Article 25 of the OECD Model Convention.

<sup>246</sup> See paragraphs 22 – 24 of the Commentary on Article 25 of the United Nations Model Convention.



***Paragraph 2***

Paragraph 2 sets out the obligations of the competent authority to whom the case is presented. The competent authority must, if it considers the taxpayer's objection to be justified, try to resolve the matter, either through unilateral action or through an agreement with the competent authority of the other country.

If a solution is reached, it must be implemented notwithstanding any domestic law time limits, for example, on tax adjustments. While some countries consider that the time limit for implementation of mutual agreements should be linked to domestic law time limits, it should be noted that the application of domestic law time limits may effectively remove the taxpayer's ability to obtain relief under the mutual agreement procedure, for example, if a late adjustment is made in one country and domestic law time limits prevent a corresponding adjustment in the other country. It should also be recognized that mutual agreement cases may take longer to resolve than domestic law cases, particularly where two or more competent authorities are required to consider the case and consult each other on possible solutions.

***Paragraph 3***

Paragraph 3 authorizes and requires the competent authorities to try to resolve issues relating to interpretation or application of the treaty, as well as double taxation issues that are not dealt with under the treaty, for example, where a resident of a third State has a permanent establishment in both Contracting States.

The laws of some countries do not permit the elimination of double taxation in cases not dealt with under the treaty. These countries will generally not agree to include the second sentence of paragraph 3 in their treaties.

***Paragraph 4***

Paragraph 4 authorizes the competent authorities to consult with each other directly for purposes of the mutual agreement procedure. They may consult, without the need for diplomatic formalities, through any means, for example, by letter, e-mail, telephone or face-to-face

meetings; or the competent authorities may establish a formal joint commission for dealing with the case.

Some countries prefer to address cases solely through direct, informal means, and not through a joint commission. These countries omit the words “including through a joint commission consisting of themselves or their representatives”.

The second sentence in paragraph 4 of the United Nations Model Convention<sup>247</sup> allows the competent authorities to develop, through consultation, bilateral procedures for the implementation of the mutual agreement procedure. Procedural issues, and suggestions for possible procedures that could be adopted by the competent authorities, are discussed in paragraphs 20 to 46 of the Commentary on Article 25 of the United Nations Model Convention. These paragraphs cover:

- Aspects of the mutual agreement procedure that should be dealt with
- Necessary cooperation of the person who makes the request
- Information on adjustments
- Initiation of competent authority consultation at the point of proposed or finalized adjustments
- Correlative adjustments
- Publication of competent authority procedures and determinations
- Procedures to implement adjustments
- Unilateral procedures

### *Paragraph 5*

The United Nations and OECD Model Conventions include a paragraph that provides for binding arbitration procedures to resolve issues that the competent authorities are unable to resolve under the mutual agreement procedure. There are, however, important differences between the two paragraphs, which are discussed below.

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<sup>247</sup>There is no equivalent provision in Article 25 of the OECD Model Convention.

Paragraph 5 in the United Nations Model Convention is an optional provision.<sup>248</sup> Both the United Nations and OECD Model Conventions recognize that not all countries will be willing or able to commit to mandatory arbitration.<sup>249</sup> Few tax treaties entered into by developing countries to date include such a provision. Given that the provision is a fairly recent addition to the OECD Model Convention, and was added to the United Nations Model Convention only in 2011, this is hardly surprising.

The inclusion of an arbitration provision in a treaty may have the benefit of ensuring that competent authorities act in a timely and effective manner in resolving mutual agreement issues. If a matter is not resolved within a specified time, a request can be made for unresolved issues to be submitted to arbitration. There are also arguments against an inclusion of mandatory arbitration, however. Arguments for and against the inclusion of an arbitration provision are elaborated in the Commentary.<sup>250</sup> In developing a tax treaty policy framework and a country model (see section II.B) these arguments have to be carefully evaluated.

Countries that wish to provide for arbitration may have different views on the type of arbitration provision they want to include in their treaties. There are four significant differences between the arbitration provision found in the United Nations Model Convention and that in the OECD Model Convention. These are discussed in paragraph 13 of the Commentary on Article 25 of the United Nations Model Convention. Paragraph 5 of Article 25 (alternative B) tends to give more weight to the competent authorities of the contracting States.

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<sup>248</sup> Alternative A of Article 25 of the United Nations Model Convention does not include this paragraph.

<sup>249</sup> See paragraph 13 of the Commentary on Article 25 of the United Nations Model Convention, paragraph 18 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraphs 64 and 65 of the Commentary on Article 25 of the OECD Model Convention, and the footnote to paragraph 5 of Article 25 of the OECD Model Convention.

<sup>250</sup> See paragraphs 3 – 5 of the Commentary on Article 25 of the United Nations Model Convention.

Countries for which mandatory arbitration as provided for in paragraph 5 of either Model Convention is not appropriate may wish to consider alternatives proposed in the Commentary, such as voluntary arbitration (pursuant to which both competent authorities must agree, on a case-by-case basis, to submit the matter to arbitration),<sup>251</sup> or limitation to a certain range of cases, for example, issues of fact such as those found in transfer pricing matters or whether a permanent establishment exists.<sup>252</sup>

The Annex to the Commentary on paragraph 5 of Article 25 (alternative B) addresses a number of the procedural issues by providing a sample agreement that could be used as a basis for a mutual agreement to implement the arbitration process.

### *Interaction with the General Agreement on Trade in Services*

A number of countries include in their treaties a provision that deals with a potential overlap of the mutual agreement provision in the tax treaty and the dispute resolution mechanism of the General Agreement on Trade in Services (GATS).

The dispute resolution mechanisms of the GATS do not apply to disputes relating to the application of the GATS national treatment rule if the disputed measure is a tax covered by a tax treaty. Countries that wish to ensure that any dispute as to whether a tax is covered by a tax treaty and is dealt with through the mutual agreement procedure, rather than the GATS dispute resolution procedures, should include the provision set out in paragraph 93 of the Commentary on Article 25 of the OECD Model Convention.<sup>253</sup>

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<sup>251</sup> See paragraphs 14–16 of the Commentary on Article 25 of the United Nations Model Convention.

<sup>252</sup> See paragraph 18 of the Commentary on Article 25 of the United Nations Model Convention, quoting paragraph 66 of the Commentary on Article 25 of the OECD Model Convention.

<sup>253</sup> Quoted in paragraph 47 of the Commentary on Article 25 of the United Nations Model Convention.

## **Administrative assistance (Articles 26 and 27)**

As the economy becomes increasingly globalized, cooperation between tax authorities has become a vital part of international tax systems.

All treaties provide for exchange of tax information between competent authorities, while ensuring that confidentiality with respect to taxpayer information is maintained. Some countries also seek to include an article in their treaties that provides for reciprocal assistance between the two tax administrations in collecting outstanding tax liabilities.

### **3. Article 26 — Exchange of information**

A tax treaty authorizes and requires tax administrations to obtain and exchange relevant tax information, including information held by financial institutions. This is a very powerful tool in preventing fiscal evasion by taxpayers and, as noted in the Commentary on Article 26 of the United Nations Model Convention, is, from the perspective of many developing countries, also important in curtailing the capital flight that is often accomplished through tax evasion and avoidance.<sup>254</sup>

Exchange of information has been a key focus of tax administrations over the past decade or more.<sup>255</sup> Comparable (though not identical) standards for exchange of tax information are now found in the United Nations and OECD Model Tax Conventions, the model Agreement on Exchange of Information on Tax Matters<sup>256</sup> and the Council of Europe-OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters.<sup>257</sup>

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<sup>254</sup> See paragraph 1.1 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>255</sup> For example, the OECD Global Forum on Transparency and Exchange of Information for Tax Purposes was established in the early 2000s with a view to implementing internationally agreed standards on transparency and exchange of information on request. More than 120 jurisdictions now participate in its work.

<sup>256</sup> Available from <http://www.oecd.org/ctp/harmful/2082215.pdf>.

<sup>257</sup> Available from <http://www.oecd.org/ctp/exchange-of-tax-information/conventiononmutualadministrativeassistanceintaxmatters.htm>.

Any country wishing to enter into a tax treaty must be prepared to commit to the current international standards for exchange of information as reflected in Article 26 of the United Nations Model Convention.

Countries will need to ensure that their tax administrations have the legal and administrative ability to obtain and exchange tax information. Some developing countries may have concerns about the administrative burden placed on their revenue agencies by the obligation to exchange tax information, but should always take account of the benefits of access to tax information in addressing these concerns. These countries may wish to include in their model a provision requiring extraordinary costs incurred in providing information to be borne by the party requesting the information.<sup>258</sup>

The Commentary on Article 26 of the United Nations Model Convention provides detailed guidance on the interpretation and application of the provisions, and should be carefully read by negotiators and competent authorities. In particular, it addresses:

- Differences between the versions of Article 26 found in the 2001 and 2011 United Nations Model Conventions, and in the OECD Model Convention<sup>259</sup>
- Mechanisms for exchanging tax information.<sup>260</sup> This provides practical guidance on:
  - Routine or automatic transmittal of information
  - Transmittal on specific request
  - Spontaneous (discretionary) transmittal of information
  - Use of information received
  - Consultation among several competent authorities
  - Factors affecting the implementation of exchange of information and the structure of exchange of information processes

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<sup>258</sup> See paragraphs 29.3 and 29.4 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>259</sup> See paragraphs 1.2–4.3 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>260</sup> See Section C, Inventory of exchange mechanisms, paragraph 30 of the Commentary on Article 26 of the United Nations Model Convention.

The OECD 2006 Manual on the implementation of exchange of information provisions for tax purposes<sup>261</sup> also provides practical assistance to officials dealing with exchange of information, and may be helpful in designing or revising national manuals. It covers:

- General and legal aspects of exchange of information
- Exchange of information upon request
- Spontaneous information exchange
- Automatic (or routine) exchange of information
- Industry-wide exchange of information
- Simultaneous tax examinations
- Tax examinations abroad
- Country profits regarding information exchange
- Information exchange instruments and models

A detailed discussion of administrative issues relating to exchange of information may also be found in chapter IX of the *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*.<sup>262</sup>

Information relating to tax years prior to the entry into force of a treaty may also be exchanged. Some countries, however, prefer to limit the period for which such information may be requested.<sup>263</sup>

### ***Paragraph 1***

Paragraph 1 authorizes and requires the exchange of relevant information on all taxes, whether or not they are taxes covered by the treaty. Information must be obtained and exchanged by the competent

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<sup>261</sup> Available from <http://www.oecd.org/tax/exchange-of-tax-information/36647823.pdf>.

<sup>262</sup> Diane M. Ring, “Exchange of information”, *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (United Nations publication, Sales No. 13.XVI.2).

<sup>263</sup> See paragraph 5.5 of the Commentary on Article 26 of the United Nations Model Convention.

authorities if it is “foreseeably relevant”<sup>264</sup> to the administration of either the treaty provisions or domestic law provisions (provided that the tax treatment under the domestic law is not contrary to the treaty).

Paragraph 1 of Article 26 of the United Nations Model Convention differs from the equivalent paragraph in the OECD Model Convention in that it specifies that “[i]n particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes”. This statement of purpose is intended to provide explicit guidance to Contracting States on the interpretation of the Article.<sup>265</sup> Even in the absence of this statement, it is clear that this is the main purpose of the exchange of information provisions.

The paragraph is intended to have broad application. Provided the information sought is relevant to the application of the treaty or domestic taxes, exchange is not limited to information about residents of the two Contracting States, or indeed, to taxpayer-specific information at all. General information, for example, about tax avoidance schemes, may also be exchanged.

Information about all taxes, whether or not they are taxes covered by the treaty, may be exchanged. Countries for which this is problematic, for example, where the competent authority cannot obtain information about subnational taxes, may seek to limit the obligation to treaty taxes and other important taxes, such as the value added tax (VAT).<sup>266</sup>

Examples of common types of requests for exchange of information are set out in paragraphs 10 to 10.2 of the Commentary on Article 26 of the United Nations Model Convention.

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<sup>264</sup>The meaning of “foreseeably relevant” is discussed in paragraphs 7.1 and 7.2 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>265</sup>See paragraph 4.2 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>266</sup>For possible wording, see paragraph 8.1 of the Commentary on Article 26 of the United Nations Model Convention.



### ***Paragraph 2***

Paragraph 2 ensures that tax information that is provided by one country to the other remains confidential and is used only for tax purposes. It may be disclosed to and used by officials in the tax administration of the country receiving the information for purposes of assessment, collection or enforcement of taxes in that country.

Paragraph 2 also allows disclosure of the information in public court proceedings and judicial decisions. As this can result in the information being made public, countries for which this is problematic should raise the matter during negotiations and may, for example, expressly provide that such disclosure be permitted only if the country supplying the information raises no objection.

If the two countries wish to allow the information to be used for a broader range of purposes (for example, in money-laundering cases), they should specifically provide for this.<sup>267</sup>

The Commentary states that exchanged information may also be disclosed to oversight bodies (for example, authorities that supervise tax administration) to the extent it is necessary to do so, provided the persons involved in the oversight activities are also subject to confidentiality requirements.<sup>268</sup>

### ***Paragraph 3***

Paragraph 3 sets out the limits to the obligation to exchange information (subject to the provisions of paragraphs 4 and 5).

A country generally has to provide information to the other country only if that type of information would be obtainable under the law and normal practices of both countries. This should not, however, be interpreted in a way that would prevent effective exchange of

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<sup>267</sup> See paragraphs 13–13.3 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>268</sup> See paragraphs 14 and 14.1 of the Commentary on Article 26 of the United Nations Model Convention.

information.<sup>269</sup> If there are certain types of information that cannot be obtained, this should be raised before or during negotiations.<sup>270</sup> Significant changes, after entry into force of a treaty, to domestic laws or administrative practices relating to obtaining or supplying information must be disclosed to the other country.<sup>271</sup>

A country is not obliged to provide to the other country certain confidential information specified in subparagraph (c), for example, information that would disclose trade secrets or disclosure of which would be contrary to public policy.

The scope of these limitations, and drafting options to clarify some of the more controversial aspects, are discussed in paragraphs 15 to 25 of the Commentary on Article 26 of the United Nations Model Convention.

#### ***Paragraph 4***

Paragraph 4, a recent addition to Article 26, clarifies that a State that is requested to provide information under this Article must use its information-gathering powers to obtain that information, even though it may not be required for purposes of taxation in that country.

For countries that lack the ability under domestic law to obtain information in these circumstances, paragraph 26.3 of the Commentary on Article 26 of the United Nations Model Convention suggests possible drafting of a provision requiring each country to ensure that its competent authority has sufficient powers to obtain necessary information.

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<sup>269</sup> See paragraph 15 of the Commentary on Article 26 of the United Nations Model Convention.

<sup>270</sup> Note that, in accordance with paragraph 5 of Article 26, domestic law bank secrecy requirements do not relieve a country's obligation to provide relevant tax information held by financial institutions.

<sup>271</sup> See the second sentence of paragraph 4 of Article 2 of the United Nations Model Convention.

***Paragraph 5***

Paragraph 5 ensures that the limitations in paragraph 3 cannot be used to prevent the exchange of information held by banks, financial institutions, nominees, agents, fiduciaries, and so forth, or that related to ownership interests in a person. Thus, for example, bank secrecy rules in a country do not relieve the obligation on that country to supply information requested by the other country under Article 26. It is important, therefore, that prior to negotiations, countries ensure that their competent authorities have the necessary powers to obtain such information, at least in response to requests from treaty partners.<sup>272</sup>

Paragraphs 27.2 to 27.7 of the Commentary on Article 26 of the United Nations Model Convention discuss the application of this paragraph as well as alternative provisions for dealing with issues concerning confidential communications between legal representatives and their clients.

***Paragraph 6***

Paragraph 6 of Article 26 of the United Nations Model Convention, which has no equivalent in Article 26 of the OECD Model Convention,<sup>273</sup> provides that the competent authorities shall develop, through consultation, “appropriate methods and techniques” concerning exchange of information. Countries should consider what procedures are appropriate for the competent authority of their country to provide effective exchange of information, including exchanges made upon request, or automatically, or spontaneously.

Section C of the Commentary on Article 26 provides useful guidance on some of the procedural aspects that countries may wish to agree upon.

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<sup>272</sup> Obviously, it is desirable that relevant tax information be obtainable for domestic law purposes as well as to satisfy requests from treaty partner countries.

<sup>273</sup> Paragraph 10 of the Commentary on Article 26 of the OECD Model Convention states that the manner in which the exchange of information will be effected may nevertheless be decided upon by the competent authorities of the two Contracting States.

#### 4. Article 27 — Assistance in collection

Article 27 requires the tax administration of each country to provide assistance to the other in collecting taxes owed in that other country as if the debt were its own tax claim. These provisions are a useful adjunct to exchange of information in that they ensure that taxpayers cannot evade taxes in one country by moving their residence or assets to a treaty partner country.

Nevertheless, it is recognized that not all countries will be in a position to accept such a provision.<sup>274</sup> At this time, only a relatively small percentage of treaties entered into by countries outside the OECD include provision for assistance in collection.<sup>275</sup> Having regard, in particular, to the administrative burden these provisions could place on the tax administration of developing countries, such countries need to consider whether they are in a position to include such provisions in their treaties.

The provisions of Article 27 of both the United Nations and the OECD Model Conventions are identical. They provide for comprehensive assistance in respect of all taxes owed to a Contracting State, provided that the conditions of the Article are met. The Commentary on Article 27 of the United Nations Model Convention, however, provides drafting suggestions for more limited assistance for countries for which comprehensive assistance is not possible or is not appropriate.<sup>276</sup>

Paragraph 1 of the Article allows the competent authorities to settle how the Article is to be applied in practice. Before including an article providing for assistance in collection in a treaty, countries should have a clear view on the issues raised in paragraphs 6 to 9 of the Commentary on Article 27 of the United Nations Model Convention, for example, what documentation is required, how costs will be dealt

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<sup>274</sup> See footnote to Article 27 of the United Nations Model Convention and paragraph 1 of the Commentary on Article 27 of the United Nations Model Convention.

<sup>275</sup> See Wim Wijnen and Jan de Goede, “The UN Model in Practice 1997-2013”, *Bulletin for International Taxation*, No. 3 (2014), section 2.23.2.

<sup>276</sup> See paragraphs 2, 11, 12, 23, 24 and 37 of the Commentaries on Article 27 of the United Nations and OECD Model Conventions.

with, time limits on requests, minimum thresholds for requests, how amounts collected are to be remitted, and so forth.

Negotiators and competent authorities may also find it useful to read the provisions relating to assistance in recovery of the Council of Europe/OECD Multilateral Convention on Mutual Administrative Assistance in Tax Matters and the accompanying Explanatory Report.<sup>277</sup>

## G. Chapter VII — Final provisions

As is common in international agreements, the United Nations Model Convention, like the OECD Model Convention, provides a procedure for the entry into force, ratification and termination of a treaty. A treaty enters into force when both countries have completed the specified procedures necessary to give the treaty the force of law in their jurisdiction (generally either ratification or enactment as a statute) followed by an exchange of instruments of ratification or an exchange of notes stating that these procedures have been completed. Once the treaty has entered into force, the provisions of the treaty will have effect from the date or dates set out in the treaty. These dates are usually in the future (for example, the beginning of the next fiscal year commencing after the date of entry into force), but some provisions may have retroactive effect where this is to the benefit of taxpayers.

Entry into force and termination provisions need to be adapted to the particular requirements of each country. The drafting of these provisions should be part of the development of a country model mentioned in section II.B. It is recommended that negotiators read the section on post-negotiation activities in *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*,<sup>278</sup> which includes

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<sup>277</sup> A new revised explanatory report has been published and is available from <http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf>.

<sup>278</sup> Odd Hengsle, “Post-negotiation activities”, *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014), p. 121.

examples of possible drafting of provisions, including alternative provisions, on entry into force and termination.

## **1. Article 29 — Entry into force**

Article 29 specifies the procedure for entry into force and the dates on which the provisions of the treaty will have effect.

### ***Paragraph 1***

Paragraph 1 provides that the treaty is to be ratified as soon as possible. The two countries will also agree on the place at which the instruments of ratification are to be exchanged. That place will generally be in either country, but may be in a third country if this is convenient to both sides.

Ratification is in essence the agreement of a State to be legally bound by the terms of a treaty. The requirements within a country for ratifying, or giving the force of law to a treaty, differ. For some countries it may involve endorsement of the signed treaty by parliament or by a person or committee authorized to accept on behalf of the State the rights and responsibilities arising from the treaty; for others it may involve incorporating the treaty into domestic law. Negotiators should liaise with their Ministry of Foreign Affairs as to the procedures applicable in their country.

Once all the necessary procedures for ratification have been completed in a country, that country is required under paragraph 1 to produce a formal instrument of ratification. When both countries have completed their instruments of ratification, their representatives will meet in the place agreed in the treaty for a formal ceremony to exchange those instruments.

Some countries prefer not to require a formal exchange of instruments of ratification as suggested in paragraph 1 of Article 29 of the United Nations Model Convention. The Commentary notes that it is open to these countries to provide instead that each country will notify the other (generally through diplomatic channels) when the legal requirements for giving the treaty the force of law in their

country have been completed.<sup>279</sup> When negotiators draft their country model, they should ask for guidance on this provision from their Ministry of Foreign Affairs.

***Paragraph 2***

Paragraph 2 specifies when the treaty will enter into force, and when the provisions of the treaty will have effect.

The treaty enters into force (that is to say, is binding on the Contracting States) at the time when the exchange of instruments of ratification takes place. For treaties that use the alternative formulation providing for notification, the treaty enters into force when the later of the two notifications is made.

Some countries prefer to delay the entry into force of the treaty for a short time to allow taxpayers and tax administrations to put in place any procedural or other changes to take account of the treaty. This can be achieved by providing that the treaty will enter into force upon the expiration of a specified period, for example, one month after either the exchange of instruments of ratification or the later of the notifications.

Even after the treaty enters into force, however, the provisions will have effect in each country only from the dates specified in paragraph 2. Each country will need to select dates that work effectively with their domestic law. For example, if income taxes are assessed on a fiscal year basis, the paragraph may provide that, in that country, the provisions of the treaty will have effect with respect to income derived from the beginning of the next fiscal year. Some countries will have a different date of effect for withholding taxes, as these taxes are collected upon payment without regard to the fiscal year. Countries should provide for at least a short delay before entry into force to enable withholding agents to adjust their withholding arrangements to reflect the new treaty rates.

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<sup>279</sup> See the Commentary on Articles 29 and 30 of the United Nations Model Convention, quoting paragraph 2 of the Commentary on Articles 30 and 31 of the OECD Model Convention.

Articles dealing with non-discrimination, exchange of information and assistance in collection of taxes are not limited in their application to taxes covered by the treaty or to residents of either country. The date from which these articles will have effect with respect to such taxes and persons, as well as the extent to which administrative assistance can be requested for information or liabilities relating to periods prior to entry into force of the treaty, should be discussed during negotiations. Some countries prefer to specify the date from which these provisions apply, in particular with respect to taxes other than treaty taxes, or liabilities arising or income derived in earlier years.

If the treaty is replacing an existing treaty, the existing treaty should be terminated by a provision to this effect in the new treaty. The paragraph should also specify that the provisions of the existing treaty will cease to have effect from the date or dates that the provisions of the new treaty have effect. In some cases, for example, where the provisions of the earlier treaty are more beneficial to the taxpayer, the new treaty may provide for an extension of that treatment for a specified period.

Rarely, countries may wish to delay giving effect to certain provisions, such as an article dealing with assistance in collection of taxes. This must be provided for specifically in the treaty.

## **2. Article 30 — Termination**

Article 30 provides that the treaty will continue to operate until terminated. Countries commonly agree on a minimum period of five years before a tax treaty may be terminated. This provides a measure of certainty and stability for taxpayers, revenue and tax administrations.

Although tax treaties are rarely terminated in practice (other than by replacement with a new, updated tax treaty), the Article sets out the procedure by which a treaty may be terminated after the expiration of the initial period. This procedure involves one country giving the other country formal notice of termination through diplomatic channels. Normally, the Article will specify that the notice of termination must be given by 30 June of the calendar year at the latest. As the treaty will then normally cease to have effect from the beginning of the next calendar year, this allows taxpayers sufficient time to



put their affairs in order before the end of the year in which notice of termination is given.

Countries will generally initiate termination procedures only after careful deliberation, when efforts to renegotiate an unsatisfactory treaty have failed, for example, where a treaty partner country is unwilling to renegotiate an outdated treaty or in cases where a change of domestic law has a significant and highly detrimental effect on the operation of the tax treaty.

The Article also sets out the dates from which the provisions will cease to have effect once the treaty has been terminated. These will usually mirror the dates specified in paragraph 2 of Article 29 (Entry into force).

### **3. Terminal clause (Note)**

Tax treaties often include a terminal clause concerning the signing of the treaty and the official language or languages in which it is made. While the United Nations Model Convention states merely that this clause will be drafted in accordance with the constitutional procedure of both Contracting States, in practice such clauses commonly are formulated along the following lines if two official languages are used:

Done at [place] on [date], in duplicate in [language] and [language], both texts being equally authoritative.

In the case of three official languages, the clause may be formulated as follows:

Done at [place] on [date] in duplicate, in the [one country's] language, the [other country's] language and [a third] language, each text being authentic. In case of divergent interpretations of the [own country's] language and the [other country's] language texts, the [third] language text shall prevail.

## Section IV — Improper use of treaties

### A. Introduction

Taxpayers may, from time to time, seek to obtain benefits from treaties in ways that were not intended by the two countries. For example, a resident of State A may seek to take advantage of lower withholding rates on royalties provided by State B under its treaty with State C, by structuring contracts through an intermediary in State C.

The Commentary on Article 1 of the United Nations Model Convention discusses a number of approaches that can be applied to prevent improper use of tax treaties,<sup>280</sup> including specific or general legislative anti-abuse rules or judicial doctrines found in domestic law, specific and general anti-abuse rules found in tax treaties, and interpretation of tax treaty provisions. The OECD/G20 Base Erosion and Profit Shifting (BEPS) Project also identifies treaty abuse as a major source of concern. Action 6 of that project examines how to prevent the granting of treaty benefits in inappropriate circumstances and makes some recommendations on possible actions to limit this form of treaty abuse.<sup>281</sup>

To minimize the risk of treaty abuse, developing countries should consider the extent to which they can or should adopt any of these approaches. As a guiding principle, “the benefits of a double tax convention should not be available where the main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of

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<sup>280</sup> See paragraphs 8 – 103 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>281</sup> OECD, *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 — 2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project (Paris: OECD, 2015). Available from <http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm>.

the relevant provisions”.<sup>282</sup> As noted in the Commentary, however, “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”.<sup>283</sup>

Practical guidance on this issue for negotiators and competent authorities of developing countries is also to be found in chapter X of the *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*.<sup>284</sup> The chapter deals with:

- How to prevent tax treaties from being used improperly as a basis for tax avoidance
- How to ensure that tax treaties do not prevent the effective operation of domestic anti-avoidance rules, and
- How to use the administrative assistance provisions in tax treaties as an effective mechanism to support the operation of domestic anti-avoidance rules

The chapter includes a discussion of six common examples of transactions involving potential abuse of tax treaties, namely:

- Treaty shopping and the use of conduit companies
- Income shifting
- International hiring-out of labour
- Circumventing treaty threshold requirements
- Changing the character of income
- Tax-sparing abuses

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<sup>282</sup> See paragraph 23 of the Commentary on Article 1 of the United Nations Model Convention, quoting paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention.

<sup>283</sup> See paragraph 9 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>284</sup> Philip Baker, “Improper use of tax treaties, tax avoidance and tax evasion”, *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (United Nations publication, Sales No. 13.XVI.2).

## B. Preventing improper use of tax treaties

### 1. Domestic law anti-abuse rules and judicial doctrines

Many countries have anti-abuse rules in their domestic law, such as general anti-abuse rules, or rules to deal with controlled foreign corporations, thin capitalization or transfer pricing, or judicial doctrines such as “substance-over-form” or “business purpose”.

Countries are free to apply such rules and judicial doctrines, provided that those rules do not conflict with the provisions of tax treaties. In many cases, a proper interpretation will lead to the conclusion that there is no conflict.<sup>285</sup> Where a conflict does arise, however, the treaty provisions must prevail.

If there is doubt as to whether the application of the domestic rules gives rise to a conflict, the rules should be discussed during negotiations or, if necessary, through the mutual agreement procedure. In determining whether or not a conflict exists, the guidance in paragraphs 16 to 19 of the Commentary on Article 1 of the United Nations Model Convention should be considered. The guidance in paragraphs 22 to 26 of the Commentary on Article 1 of the OECD Model Convention will also provide assistance.

It should be noted that some countries are more inclined to find a conflict between certain domestic anti-abuse rules and tax treaties.<sup>286</sup> Clarification in the treaty that nominated domestic law rules do not conflict with the treaty provisions, or inclusion of provisions allowing the application of the domestic rules, would be particularly useful in these cases.<sup>287</sup>

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<sup>285</sup> See paragraphs 12 – 30 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>286</sup> See, for example, paragraphs 27.4 – 27.9 of the Commentary on Article 1 of the OECD Model Convention.

<sup>287</sup> Such provisions could, for example, provide that “nothing in this Convention shall affect the application of [description of domestic law provision or reference to statutory provision]”.

## **2. Specific anti-abuse rules found in tax treaties**

The United Nations Model Convention includes a number of specific anti-avoidance provisions, such as the concept of “beneficial owner”, the special relationship provision in Articles 11 (Interest) and 12 (Royalties),<sup>288</sup> and the provision in Article 13 dealing with immovable property held through interposed entities.<sup>289</sup>

Countries may wish to include other specific provisions to deal with abusive situations that they have encountered. For the reasons set out in paragraph 33 of the Commentary on Article 1 of the United Nations Model Convention, however, such provisions should be used with caution.

## **3. General anti-abuse rules found in tax treaties**

Some treaties include provisions that either authorize the competent authority to deny treaty benefits in abusive cases, or confirm that the treaty does not prevent the denial of benefits in such cases. Examples of such provisions are included in paragraphs 34 and 35 of the Commentary on Article 1 of the United Nations Model Convention.

Other countries may wish to include a general “main purpose” rule in their treaties, to allow the denial of treaty benefits where abuse of the treaty was a main purpose for entering into the arrangement.<sup>290</sup>

Before including general anti-avoidance provisions in their treaties, countries should consider possible implications for their other treaties that do not include a similar provision.<sup>291</sup> In some countries, the fact that a general anti-avoidance provision is included in some treaties but not in others may be interpreted as meaning that, in the

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<sup>288</sup> See paragraph 6 of Article 11 and paragraph 6 of Article 12 of the United Nations Model Convention.

<sup>289</sup> See paragraph 4 of Article 13 of the United Nations Model Convention.

<sup>290</sup> See paragraph 36 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>291</sup> See paragraph 37 of the Commentary on Article 1 of the United Nations Model Convention.

absence of such a provision, domestic law rules and doctrines cannot be employed to counter improper use of treaties.

### C. Examples of improper uses of tax treaties

The Commentary includes examples of cases involving improper uses of tax treaties and possible approaches (including draft provisions) to deal with these cases.<sup>292</sup> The examples deal with:

- Dual residence and transfer of residence<sup>293</sup>
- Treaty shopping, including denying benefits to: conduit companies; entities benefiting from preferential tax regimes; income subject to low or no tax under preferential tax regimes; and transactions that have been entered into for the main purpose of obtaining treaty benefits involving reductions in source taxation<sup>294</sup>
- Triangular cases where the abusive arrangements involve three States<sup>295</sup>
- Income shifting, including non-arm's length transfer prices, thin capitalization, use of base companies, directors' fees and remuneration of top-level managers, and attribution of interest to a tax-exempt or government entity<sup>296</sup>
- Hiring-out-of-labour arrangements designed to obtain exemption of employment income in the country where employment activities are exercised<sup>297</sup>

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<sup>292</sup> See paragraphs 40 – 99 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>293</sup> See paragraphs 41 – 46 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>294</sup> See paragraphs 47 – 57 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>295</sup> See paragraphs 58 – 61 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>296</sup> See paragraphs 62 – 80 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>297</sup> See paragraph 81 of the Commentary on Article 1 of the United Nations Model Convention. See also paragraph 1 of the Commentary on Article 15

- Use of so-called star companies by artistes or sportspersons to avoid taxation in the country where their activities are performed<sup>298</sup>
- Arrangements that seek to change the classification of income for treaty purposes in order to obtain unintended treaty benefits;<sup>299</sup> such arrangements include conversion of dividends into interest, allocation of price under a mixed contract, conversion of royalties into capital gains and use of derivative transactions
- Arrangements that are intended to circumvent thresholds found in treaties, such as time limits for certain permanent establishments (for example, furnishing of services) or holdings of immovable property through companies or other entities<sup>300</sup>

In deciding which anti-abuse rules, if any, should be included in tax treaties, negotiators should take into account:

- The risk of abuse in the context of their economy and tax system, and in their interaction with the tax system of the other country
- The ability of the tax administration of their country to effectively administer the provisions
- The effectiveness of the proposed provision in dealing with a broad range of cases
- Whether the provision is part of their country's (or the treaty partner country's) usual treaty practice

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of the United Nations Model Convention, quoting, in particular, paragraphs 7 – 8.28 of the Commentary on Article 15 of the OECD Model Convention.

<sup>298</sup> See paragraphs 82 – 85 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>299</sup> See paragraphs 86 – 93 of the Commentary on Article 1 of the United Nations Model Convention.

<sup>300</sup> See paragraphs 94 – 99 of the Commentary on Article 1 of the United Nations Model Convention.



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