The 2011 Update of the UN Model Double Taxation Convention

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http://www.un.org/esa/ffd/tax/

Introduction

- It does not go into the same historical depth on the origins of the UN Model as the 2001 Model did. Nevertheless, it is in the context of the “Financing for Development” process

- The Introduction notes*, recognize the special importance of international tax cooperation in encouraging investment for development and maximizing domestic resource mobilization, including the countering of tax evasion*

Introduction

- The Articles of the Convention are based on a recognition by the source country that:

a) taxation of income from foreign capital should take into account expenses allocable to the earnings of the income so that such income is taxed on a net basis
b) taxation should not be so high as to discourage investment
c) it should take into account the appropriateness of the sharing of revenue with the country providing the capital

- In addition, the Model embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either a foreign tax credit or an exemption

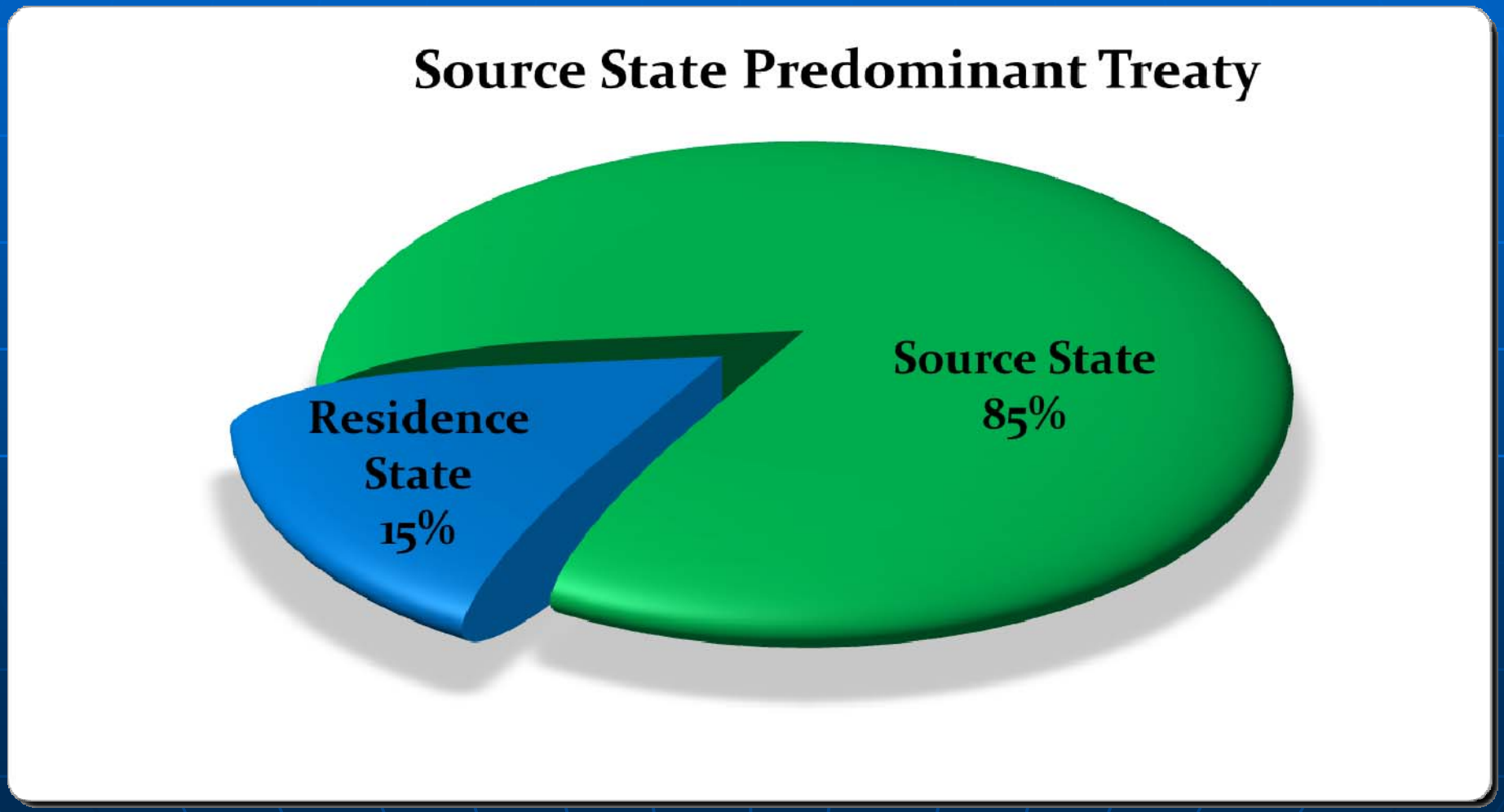
Introduction

- The Introduction clarifies that its provisions:
  - Are not binding and should not be construed as formal recommendations of the United Nations
  - Are intended to facilitate the negotiation, interpretation and practical application of bilateral tax treaties based upon its provisions

General issues on the Commentaries

- While there have been some important changes to the text of the articles of the Model themselves, the vast majority of changes have been to the Commentaries on the Articles of the Model, which are formally regarded as also being part of the 2011 UN Model
- Often a UN Commentary quotes parts of the corresponding Commentary on the OECD Model and, where this happens, it is now clear that it does so approvingly, unless it makes its disagreement clear, something that was not so obvious under previous versions of the UN Model
- References are generally to the 2010 OECD Model, unless otherwise indicated
- Sometimes wording from an older version of a OECD Commentaries is quoted as being more relevant than the Commentaries on the 2010 OECD Model in interpreting the 2011 UN Model, such as in relation to articles 7 and 8

A Key Aspect of the UN Model



Specific aspects of the 2011 UN Model

The primary differences between the articles of the 2011 UN Model and the 2001 UN Model are as follows:

- a modified version of article 13(5) to address possible abuses
- an optional version of article 25 that provides for mandatory binding arbitration when a dispute cannot be resolved under the usual MAP
- a new version of article 26 that confirms and clarifies the importance of exchange of information under the UN Model, along the lines of the 2010 OECD Model
- a new article 27 on assistance in the collection of taxes, again along the lines of the 2010 OECD Model

Commentaries on the Articles

Article 1 (Persons covered)

- The Commentary on Article 1 of the 2011 UN Model was amended to provide further guidance in relation to the issue of addressing treaty abuse
- In this regard, the Committee recognizes that for tax treaties to achieve their role, it is important to maintain a balance between the need for tax administrations to protect their tax revenues from the misuse of tax treaty provisions and the need to provide legal certainty and to protect the legitimate expectations of taxpayers
- This Commentary also expresses agreement with the OECD Commentary that countries do not have to grant the benefits of a tax treaty where arrangements that constitute an abuse of the provisions of the tax treaty have been entered into

Commentaries on the Articles

Article 1 (Persons covered)

- Under the guiding principle aforementioned, two elements must therefore be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:
  - a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position; and
  - obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions
- These two elements will also often be found, explicitly or implicitly, in general anti-avoidance rules and doctrines developed in various countries

Commentaries on the Articles

Article 1 (Persons covered)

- In order to minimize the uncertainty that may result from the application of the approach aforementioned, it is important that this guiding principle be applied on the basis of objective findings of facts, not solely the alleged intention of the parties

- The determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements

Commentaries on the Articles

Article 5 (Permanent establishment)

- The 2011 UN Model does not change a central difference between the two Models, i.e. the degree of economic activity required to form a PE in a country is, in many respects, lower under the 2011 UN Model than under the 2010 OECD Model
- These threshold differences between the two Models result in the 2011 UN Model preserving more taxing rights to source countries compared to the 2010 OECD Model

Commentaries on the Articles

Article 5 (Permanent establishment)

- A distinct difference in the treatment of taxation of services under the two Models remains. The 2011 UN Model retains a “services permanent establishment” provision in article 5(3)(b), while the 2010 OECD Model has no similar rule

- Under the 2011 UN Model, a PE exists if a non-resident enterprise “furnishes” services in the source country for more than 183 days in any 12-month period in respect of “the same or a connected project

Commentaries on the Articles

Article 5 (Permanent establishment)

- The Commentary on Article 5 of the 2011 UN Model has been substantially updated in many ways, including by addressing issues where negotiating parties wish to delete article 14 and to rely on articles 5 and 7 instead

- As a minor change, article 5(3)(b) has been amended to refer to a 183-day period, rather than “six months”, thereby avoiding any argument as to whether part of a month should regarded as constituting a “month”, but without assuming the correctness of that argument, and the period to test whether this threshold is met is now one “commencing or ending in the fiscal year concerned”

Attribution of Profit

- Once you have a PE, you have to attribute profit to it, to determine the amount of profit that the source country can tax (Article 7; Business Profits)
- OECD approach – hypothesizing of the PE as if it was a separate legal entity from the rest of the "enterprise", though actually it clearly isn't. In effect it means you are treated as though you can lend to yourself or pay royalties for yourself
- UN Model differs – not hypothetically treated as a separate entity – generally can't lend to yourself etc.

Attribution of Profit

- Avoids the difficulty of assuming hypothetical flows within a single legal body and having to give deductions for notional flows, without having the right to tax those flows

- Avoids the complexity of the OECD Article – a broader concern that developing countries tend to disproportionately suffer from complex "solutions" to perceived problems

Islamic Financing

Article 11 (Interest)

- Certain Islamic financing issues addressed
- Q. How can an interest Article apply when there is no interest?
- A. It isn't interest, but should be treated in the same way for the purposes of avoiding double taxation

Capital Gains

- **Article 13 (Capital Gains)**
- As a result of work done by the UN Tax Committee in past years on the "improper use of treaties", paragraph 5 of Article 13 was amended as follows:
  - "Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, may be taxed in that other State if the alienator, at any time during the 12 month period preceding such alienation, held directly or indirectly at least __ per cent (the percentage is to be established through bilateral negotiations) of the capital of that company."

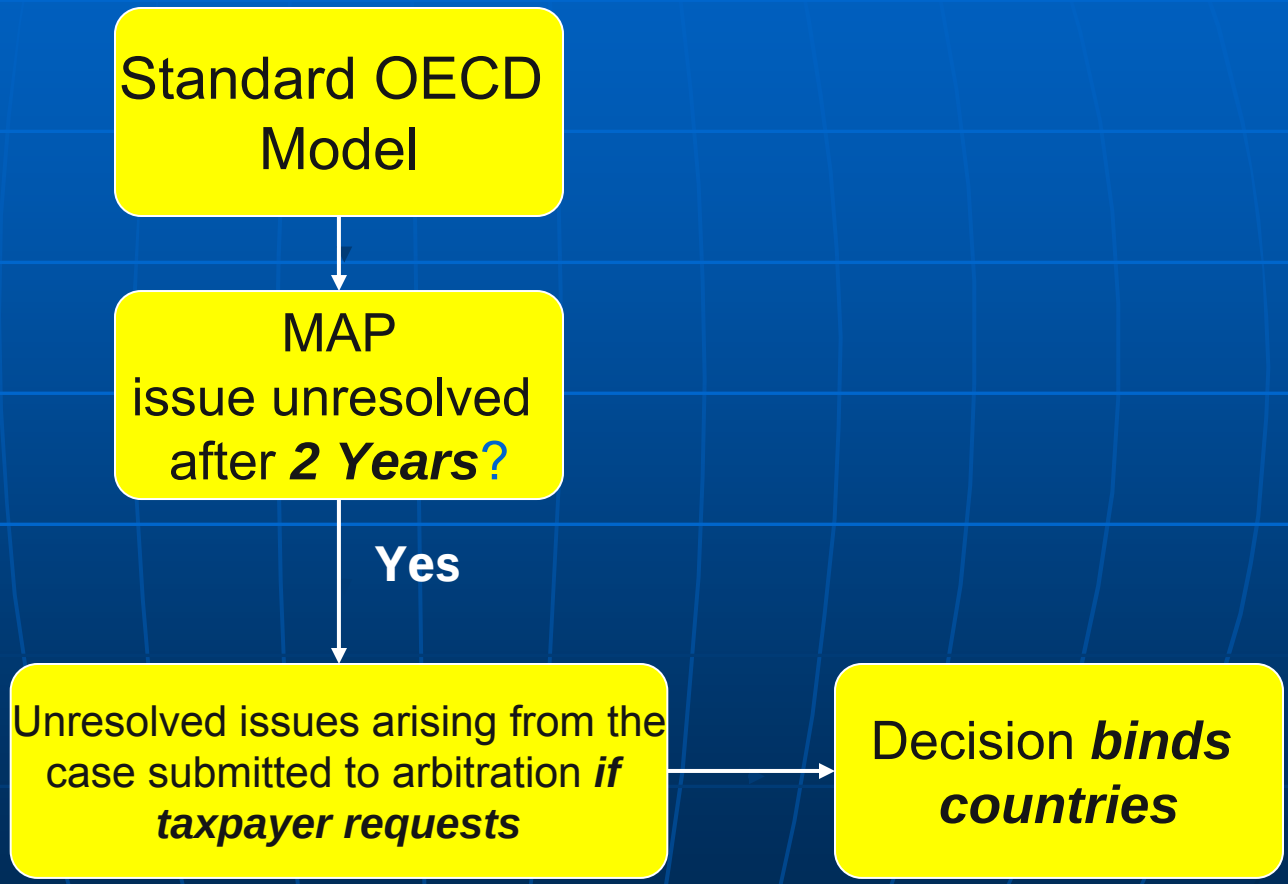
Dispute Settlement

Article 25 – the Mutual Agreement Procedure choices where there is no resolution:

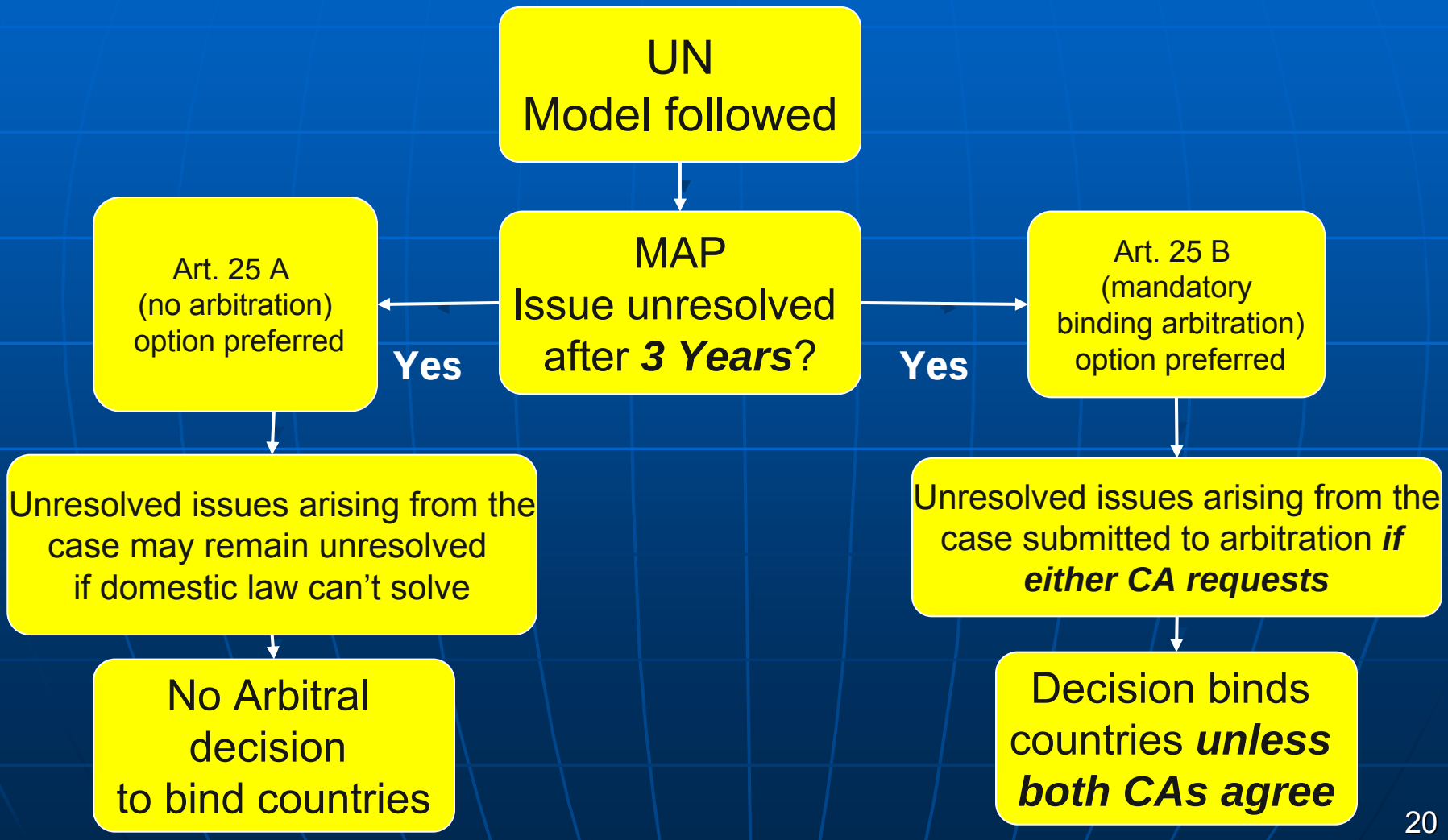
- Leave unresolved under treaty (e.g. leave to domestic law) or
- Force a decision

- Mutual Agreement Procedure Arbitration – New *Alternative* Art 25 B will include a mandatory arbitration option where put in a bilateral treaty – still within Competent Authority (CA) process
- Pros and cons of mandatory arbitration for countries – requires close consideration in the light of your own circumstances

Arbitration Under the OECD Model



Arbitration Under the UN Model



Differences to OECD Model

- While the OECD Model Convention provides that arbitration must be requested by the person who initiated the case, UN Art. 25B provides that arbitration must be requested by the competent authority of one of the Contracting States

Differences to OECD Model

- UN Art. 25B, unlike the OECD Model Convention provision, allows the competent authorities to depart from the arbitration decision if they agree to do so within six months after the decision has been communicated to them. But *both* would need to agree
- Inherently optional, so no need for OECD footnote

The Choice?

Why you might prefer *no* arbitration clause

- satisfied with the combination of MAP and domestic law
- feel lack of experience in MAP may make it harder to succeed in arbitration
- consider it hard to find arbitrators who fully understand developing country issues

The Choice?

- costs of arbitrator, facilities translation etc must be borne by the countries (and foreign exchange may be required) – concern that might unduly pressure less well-off countries to "cave-in"
- possible concerns that arbitrators may instinctively identify with more regular "clients" (big countries)
- possible criticisms of undue abrogation of sovereignty?

The Choice?

Why you might prefer mandatory binding arbitration

- more certainty to taxpayers – better investment climate
- domestic remedies may not solve (in fact they may be "timed-out“)
- encourages solving within 2 (or 3 for the UN Model) years
- you may think third party aspect actually reduces pressure on you from larger countries/ multinationals

The Choice?

Why you might prefer arbitration

- use of arbitrators can adjust for gaps in domestic experience and can be a learning process;
- limiting sovereignty in this way has benefits to a country.

- Different countries – different conclusions.

Exchange of Information (EOI)

Expanded Article 26

- Basically the same as the OECD Model now, because a strong EOI provision was seen as particularly important for developing countries in combating tax avoidance and evasion.
- Main difference makes clear a purpose of exchanging information to assist in combating both "tax avoidance" and "tax evasion" - useful as there doesn't seem to be a consistent use of these terms – best to clarify.
- Part of a package of measures to help address abuse (e.g. Improper Use of Treaties discussion in Commentary to Article 1, Change to Art. 13(5))

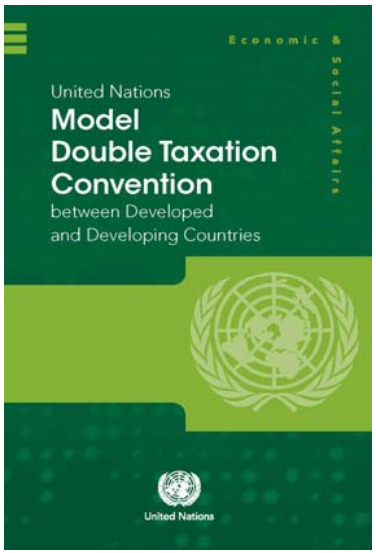
Mutual Assistance in Enforcing Tax Debts

New Article 27

- Traditional "Revenue Rule" - one country does not enforce a revenue judgment of another nation
- Sometimes seen as an exertion of that country's sovereign power
- Widely recognized that this is taken advantage of to avoid tax obligations

Mutual Assistance in Enforcing Tax Debts

- New optional Article allows enforcement as if it was the country's own debt. There are protections against abuse
- Picks up provision from OECD Model because seen as potentially useful for developing countries in combating avoidance and evasion, but with greater recognition of the burdens this can place on smaller developing countries - obligations regarding contribution to costs perhaps clearer under the UN Model



Thank you

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