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Overview of Major Issues in the Application of Tax Treaties

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1. Introduction

Over the last few decades, the number of bilateral tax treaties has increased dramatically. The United Nations Model Double Taxation Convention Between Developed and Developing Countries1 ("UN Model Convention") and the Organisation for Economic Co-operation and Development's Model Tax Convention on Income and on Capital[2] ("OECD Model Convention") provide models for countries to use in negotiating the terms of their treaties and are regularly updated. The UN Model Convention was most recently revised in 2011 and the OECD Model Convention in 2010.[3] Developing countries are increasingly entering into tax treaties with developed and other developing countries in order to facilitate cross-border trade and investment. Although there is a vast and growing body of literature dealing with the substantive provisions of tax treaties and the relationship between those provisions and the provisions of a country's domestic law, relatively little information is available about the practical application of tax treaties.

This paper is intended to provide an overview of the issues involved in applying the provisions of bilateral tax treaties. In this regard, the paper provides an introduction to the other papers in this collection, which deal in more detail with the most important aspects of the application of tax treaties. In general terms, the application of the provisions of tax treaties involves questions that are ancillary to the substantive rules in the treaty: how does a taxpayer obtain the benefits of the treaty? Often these ancillary questions involve procedural issues such as filing and information requirements and the burden of proof.

There is no generally accepted definition of what is involved in the application of the provisions of tax treaties. In general, the term "application" is used to indicate that the focus is not on what the provisions of the treaty say, but how they are applied in a procedural sense. Therefore, one way to view issues

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1 United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention Between Developed and Developing Countries* (New York: United Nations, 2011).

2 Organisation for Economic Co-operation and Development, Model Tax Convention on Income and on Capital, (Paris: OECD, 2010) (looseleaf).

3 Any references to the UN Model Convention and Commentary are to the 2011 version unless otherwise noted. Similarly, any references to the OECD Model Convention and Commentary are to the 2010 version unless otherwise noted.

involved in the application of tax treaties is to differentiate between the substantive rules of the treaty and the procedural aspects of applying those rules. This distinction is not completely clear, however, because substantive and procedural issues sometimes blend together. For example, the substantive provisions of a treaty require interpretation before they can be applied. This interpretative aspect of tax treaties can be considered to relate to the substance of the provisions or to their application or to both. Nevertheless, for the purposes of this overview a discussion of treaty interpretation has been excluded.

The paper begins with a discussion of the different ways in which countries implement tax treaties into their domestic legal systems because the method of implementation may affect the requirements that countries impose on taxpayers seeking to obtain the benefits of a tax treaty. It then examines the rules provided in tax treaties that govern the way in which the provisions of the treaties are applied. In general, few rules of application are provided in the treaties themselves; for the most part, tax treaties leave the method for the application of the provisions of the treaties up to the domestic law of the contracting states. Therefore, the next section of the paper deals with the provisions of domestic law dealing with the application of tax treaties. This section includes a discussion of how tax authorities determine whether taxpayers qualify for treaty benefits, how the treaty benefits are provided, and how the tax authorities of countries deal with the application of tax treaties from an organizational viewpoint. The paper then discusses in general terms how the provisions of tax treaties are applied by a country to its residents and to residents of the other country. The application of the provisions of tax treaties in light of a country's anti-avoidance rules presents special difficulties that are discussed briefly in the final section of the paper.

Although the paper deals with practical issues in the application of tax treaties generally, it focuses in particular on the needs of developing countries. Developing countries often have less experience with tax treaties than developed countries. Although the UN Model Convention and Commentary provide guidance for developing countries concerning the substantive provisions included in their treaties, they do not provide much guidance with respect to the problems faced by developing countries in applying their treaties. The papers in this collection are intended to provide such guidance.

The terms used in this paper conform to standard international usage. The term "source country" is used to denote the country in which income is earned or from which a payment is made, while the term "residence country" is used to describe the country in which the person who earns the income or receives the payment is resident and usually taxable on the income or payment. Developing countries are typically source countries. Moreover, the provisions of bilateral tax treaties based on the UN and OECD Model Conventions often require the source country to reduce its taxes on amounts earned in the source country by residents of the resident country.

2. Background: The General Relationship between Tax Treaties and Domestic Law

The status of tax treaties in a country's legal system may affect how the country applies the provisions of its bilateral tax treaties. The legal status of tax treaties is essentially a question of the relationship between tax treaties, or treaties in general, and domestic law.[4] This topic is well beyond the scope of this paper; however, it has important consequences for the application of tax treaties in many, if not all, countries. For example, if a country considers treaties (and international law generally) to be the highest source of law in its legal system, prevailing over domestic law, it may be unable or reluctant to impose procedural requirements on accessing treaty benefits to the extent that those requirements might be viewed as limiting the treaty benefits. For this reason, a brief discussion of the status of tax treaties in relation to domestic law is provided here as background for the subsequent examination of the issues involved in the practical application of tax treaties.

The first point to emphasize about the status of tax treaties in domestic legal systems is the enormous variation in country practices.[5] In some countries, such as Argentina, Belgium, Italy and the Netherlands, international law and tax treaties are considered to be the highest source of law in the hierarchy of legal rules. This principle may be part of a country's constitution or a creation of the courts. In other countries, such as Australia, Canada, Germany, Norway, Russia, Sri Lanka and the United Kingdom, tax treaties have the same status as domestic law. In other countries, such as Brazil,[6] the relationship between tax treaties and domestic law is unclear.

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[4] See generally Guglielmo Maisto, ed., *The Relationship between Tax Treaties and Domestic Law* (Amsterdam: IBFD, 2006).

[5] See generally David W. Williams, *Practical issues in the application of double taxation conventions,* General Report, in International Fiscal Association, vol. LXXXIIIb Cahiers de droit fiscal international (Deventer, The Netherlands: Kluwer, 1998) 19-57 at 27-29.

[6] See José Roberto Pisani, "Brazil," in IFA, Cahiers de droit fiscal international, supra note 5, at 270.

Traditionally, under public international law a distinction was made between so-called monist and dualist approaches to the status of treaties and international law.[7] Under a monist approach, international law and domestic law are part of one system in which international law always prevails over domestic law. Under a dualist approach, international law and domestic law are separate legal systems and the former does not necessary prevail over the latter in the event of a conflict. Public international law scholars have recognized more recently that this distinction between monist and dualist approaches is too simplistic to accommodate the enormous variation in national practices.[8]

The scholarly debate about monism, dualism and moderate dualism is not important for this paper. What is important, however, for the application of tax treaties is the extent to which a country considers the provisions of tax treaties to prevail over domestic law in the event of a conflict. For countries that consider international law and treaties always to prevail over domestic law, the adoption of domestic rules to implement a treaty will not be allowed to diminish the benefits of the treaty. For some countries, the priority accorded to treaties may be a constitutional requirement, in which case rules for the application of a treaty raise issues of constitutional validity. However, for countries that consider the relationship between treaties and domestic law to be more nuanced, it may be possible to adopt domestic rules that may restrict or qualify access to the benefits of a treaty and, in extreme cases, may deny treaty benefits entirely (so-called treaty overrides). For federal states, the issue may be even more complex because tax treaties may not be legally binding on the subnational governments.

Another significant factor concerning the status of tax treaties is that in some countries tax treaties must be incorporated into domestic law in order to have legal effect. Tax treaties are special in this regard. They apply to the contracting states on a state-to-state basis once each state has ratified the treaty. However, in many countries tax treaties do not confer any rights on taxpayers unless they become part of domestic law, which may require additional steps. For example, in several countries tax treaties are incorporated into domestic law by means of legislation that formally declares the treaty to be part of domestic law and gives priority to the provisions of the treaty to the extent that they conflict with domestic law. In some cases the implementing legislation may prescribe

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7 See Frank Engelen, *Interpretation of Treaties under International Law* (Amsterdam: IBFD, 2004) at 518-19.

8 Professor Vogel suggests that the current scholarly term is "moderate dualism." See Klaus Vogel, *Klaus Vogel on Double Taxation Conventions*, 3rd ed. (Deventer, The Netherlands: Kluwer, 1997).

procedures or conditions for the application of the treaty. This raises the potential for conflicts between the implementing legislation and the treaty.

In summary, most countries appear to have considerable freedom and flexibility from the perspectives of both international law and domestic law with respect to the method for the application of bilateral tax treaties. Such freedom and flexibility exist despite the widely varying differences with respect to the status of tax treaties vis-à-vis domestic law. Nevertheless, these general considerations concerning the status of tax treaties may impose limitations on the way in which a country applies the provisions of its tax treaties. One especially important aspect of this issue is the relationship between a country's tax treaties and its domestic anti-avoidance rules. This issue is discussed in the final section of the paper.

3. Rules of Application in Bilateral Tax Treaties

3.1 The United Nations and OECD Model Conventions

For purposes of both the UN and OECD Model Conventions, it is assumed that any rules for the application of the provisions of those Model Conventions are a matter for the domestic law of the contracting states. Consequently, there are no general rules in the Model Conventions or in the Commentaries with respect to how the provisions of the treaty should be applied. There are, however, a few specific rules with respect to application issues that are discussed briefly in this section.

Articles 10(2) and 11(2) of both Conventions and Article 12(2) of the UN Model Convention, which provide limitations on the rate of source country tax on dividends, interest and royalties respectively, include the following sentence:

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

This wording, "shall settle," seems to require the competent authorities to agree on the method for the application of the limitations on source country tax in the Articles. However, the Commentary indicates that the source country is free to apply its domestic law.[9] In particular, the Commentary provides that the source country is entitled to impose its tax by requiring the payer of the dividends, interest or royalties to withhold tax from the payment or by assessing the nonresident recipient of the payment for the tax directly. Not surprisingly, most countries have chosen to collect the taxes on dividends, interest and royalties by way of withholding taxes because withholding taxes have proven to be an effective mechanism for collecting the tax on these types of payments to nonresidents.

The Commentary also clarifies that, since procedural issues are not dealt with in the Model Conventions, each country is entitled to adopt its own procedural requirements. Therefore, a country can either limit the rate of tax imposed on the relevant payment to the maximum rate provided in the treaty or it can impose tax on the relevant payment at the rate provided in its domestic law and require the nonresident recipient to apply for a refund of the tax to the extent that it exceeds the rate provided in the treaty.[10] For example, if a country imposes a withholding tax at a rate of 25 percent on payments of dividends by a resident company to a shareholder resident in the other contracting state and Article 10(2) of the treaty between the two countries limits the rate of tax on dividends to 15 percent, the country can either reduce the obligation on the resident company to withhold tax to 15 percent of the dividend paid to the nonresident shareholder or require the resident company to withhold tax at the full domestic rate of 25 percent and require the nonresident shareholder to apply for a refund of the tax withheld in excess of the treaty rate.

The Commentary on Article 1 of the OECD Model Convention reiterates the principle that the contracting states are free to adopt procedures to implement the provisions of the treaty.[11] However, that Commentary expresses a preference for the automatic reduction in the rate of withholding as the

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9 Paragraph 18 of the Commentary on Article 10 of the OECD Model Convention and paragraph 13 of the Commentary on Article 10 of the UN Model Convention, quoting paragraph 18 of the Commentary on Article 10 of the OECD Model Convention; paragraph 12 of the Commentary on Article 11 of the OECD Model Convention and paragraph 18 of the Commentary on Article 11 of the UN Model Convention, quoting paragraph 12 of the Commentary on Article 11 of the OECD Model Convention. Although there is no comparable provision in the Commentary on Article 12(2) of the UN Model Convention, it seems likely that a similar result would apply.

10 Paragraph 19 of the Commentary on Article 10 of the OECD Model Convention and paragraph 13 of the Commentary on Article 10 of the UN Model Convention quoting paragraph 19 of the Commentary on Article 10 of the OECD Model Convention; paragraph 12 of the Commentary on Article 11 of the OECD Model Convention and paragraph 18 of the Commentary on Article 11 of the UN Model Convention quoting paragraph 12 of the Commentary on Article 11 of the OECD Model Convention. Although there is no comparable provision in the Commentary on Article 12(2) of the UN Model Convention, it seems likely that a similar result would apply.

11 Paragraph 26.2 of the Commentary on Article 1 of the OECD Model Convention. There is no comparable statement in the Commentary on the UN Model Convention.

more appropriate method for providing the benefits of the treaty – the reduced rate of source country tax – in an expeditious fashion. That Commentary also emphasizes that, if a country uses a refund mechanism, the refund should be provided expeditiously unless interest is paid on the amount of the refund.

The provisions of Articles 10(2) and 11(2) of both Model Conventions and Article 12(2) of the UN Model Convention, requiring the competent authorities of the contracting states to agree on the method by which the reductions in source country tax are to be applied, are not widely used. The competent authorities are not obligated to agree and most countries have not in fact entered into competent authority agreements as to the mode of application of these provisions.

Aspects of Article 24 (Nondiscrimination) of both the UN and OECD Model Conventions may affect the method of application of other provisions of the Model Conventions. Article 24(1) provides that nationals of one country shall not be subject to taxation or "any requirement connected therewith" by the other country that is different or more burdensome than the taxation and connected requirements to which nationals of the other country are subject. A similar requirement applies to stateless persons under Article 24(2) and to enterprises of one contracting state owned or controlled by residents of the other state under Article 24(5). The Commentary indicates clearly that the reference to "any requirement connected" to taxation in Article 24(1), (2) and (5) is intended to cover procedural aspects related to the application of the provisions of the treaty such as the filing of tax returns, terms of payment of tax, time and other related requirements.[12] However, the Commentary on Article 24(5) of both Models indicates that most countries do not consider that the imposition of additional information requirements or a reversal of the burden of proof with respect to transfer pricing for enterprises owned or controlled by nonresidents would be discriminatory, in violation of Article 24(5).[13]

The other aspects of Article 24 – the prohibition of discrimination against a permanent establishment in the source country of a resident of the other country under Article 24(3) and against resident enterprises with respect to the deduction of payments to residents of the other country compared to

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[12] Paragraph 15 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the UN Model Convention quoting paragraph 15 of the Commentary on Article 24 of the OECD Model Convention.

[13] Paragraph 80 of the Commentary on Article 24 of the OECD Model Convention and paragraph 4 of the Commentary on Article 24 of the UN Model Convention quoting paragraph 80 of the Commentary on Article 24 of the OECD Model Convention.

the deduction of such payments to residents of the source country under Article 24(4) – do not extend to requirements connected with taxation. Accordingly, a country is not precluded from imposing different requirements concerning the application of the provisions of the treaty to a permanent establishment, as long as the taxation on the permanent establishment is not "less favourable" than the taxation imposed on resident enterprises in similar circumstances. As the Commentary indicates, under Article 24(3) "it is the result alone that counts."[14] Thus, it is permissible for countries to apply a different mode of taxation and related procedural requirements to nonresidents with permanent establishments. Similarly, although the deduction of payments by a resident of the source country to a resident of the other country must be allowed "under the same conditions" as payments to residents of the source country, Article 24(4) does not prevent the application to payments to nonresidents of different procedural and other related rules such as additional information requirements.[15]

Article 25 of both the UN and OECD Model Conventions provides a mutual agreement procedure whereby the competent authorities of the contracting states can "settle questions relating to the interpretation and application of the Convention"[16] and resolve "difficulties arising out of the application of the Convention in the broadest sense of the term."[17] These questions and difficulties include procedural aspects of the application of the provisions of the treaty. Article 25(1) allows a taxpayer to invoke the mutual agreement procedure if "the actions" of a contracting state result in taxation that is not in accordance with the provisions of the treaty. According to the Commentary, the term "actions" has a broad meaning, including "all acts or decisions" relating to the charging of tax.[18] As a result, it appears unlikely that the mutual agreement procedure can be invoked with respect to procedural and other application rules that do not result directly in the charging of tax.

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14 Paragraph 34 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the UN Model Convention quoting paragraph 34 of the Commentary on Article 24 of the OECD Model Convention.

15 Paragraph 75 of the Commentary on Article 24 of the OECD Model Convention and paragraph 2 of the Commentary on Article 24 of the UN Model Convention quoting paragraph 75 of the Commentary on Article 24 of the OECD Model Convention.

16 Paragraph 2 of the Commentary on Article 25 of the UN Model Convention.

17 Paragraph 1 of the Commentary on Article 25 of the OECD Model Convention.

18 Paragraph 14 of the Commentary on Article 25 of the OECD Model Convention and paragraph 9 of the Commentary on Article 25 of the UN Model Convention quoting paragraph 14 of the Commentary on Article 25 of the OECD Model Convention.

Article 25(3) of both the UN and OECD Model Conventions provides a more general rule that requires the competent authorities to "endeavour to resolve by mutual agreement any difficulties or doubts arising as to the . . . application of the Convention." The Commentary indicates that the power of the competent authorities under Article 25(3) can be used to resolve any problems resulting from the implementation of procedures for the limitation of source country tax on dividends, interest and royalties.[19]

Articles 26 and 27 of both the UN and OECD Model Conventions, dealing with exchanges of information and assistance in the collection of tax, clearly have an impact on the application of the other provisions of the treaty and on the enforcement of domestic tax generally. Most of the distributive articles of the Model Conventions rely on the need for accurate information about the taxpayer and the income derived by the taxpayer. Article 26 is an important mechanism to supplement the information-gathering powers of the tax authorities under domestic law. The exchange of information under tax treaties has recently been enhanced through the elimination of bank secrecy, the broadening of Article 26 and the work of the Global Forum on Transparency and Exchange of Information.[20] Article 27 is a relatively recent addition to the UN and OECD Model Conventions, and thus it has been included in only a few treaties and there is little experience with its practical application.

3.2 Rules of Application In Actual Bilateral Tax Treaties

Given that the Model Conventions do not contain rules for the application of their provisions, it is not surprising that few individual bilateral tax treaties contain such rules. Italy is an exception in this regard, as it includes a provision in its treaties that requires nonresidents to apply for a refund of amounts withheld in excess of the reduced rate provided in the treaty.[21] This provision also makes

[19] Paragraph 51 of the Commentary on Article 25 of the OECD Model Convention and paragraph 10 of the Commentary on Article 25 of the UN Model Convention quoting paragraph 51 of the Commentary on Article 25 of the OECD Model Convention.

[20] See OECD, *Global Forum for Transparency and Exchange of Information for Tax Purposes*, at www.oecd.org/tax/transparency. The Global Forum was established in 2002 under the auspices of the OECD. As of early 2013 it comprised 120 member countries. The Global Forum has established standards for exchange of information on request and a peer review process to ensure effective exchanges of information.

[21] Andrea Manganelli, "Italy," in IFA, Cahiers de droit fiscal international, supra note 5, 435-54, note 3, at 441-42. However, by Italian ministerial resolution, under certain conditions Italian-resident payers are entitled to apply the reductions in tax directly.

the time limits of domestic law applicable and requires a certificate from the tax authorities of the residence country that the requirements of the treaty have been satisfied.

4. Rules for the Application of Tax Treaties in Domestic Law

4.1 Introduction

Given the freedom provided by tax treaties to the contracting states to deal with the methods by which the provisions of tax treaties are applied, it is not surprising that country practices in this regard vary widely. Consequently, it is important for countries, especially developing countries, to be aware of the different methods that are available and to adopt methods that best serve their needs in light of their resources. The development of best practices for the application of tax treaties would be a useful tool for both developing and developed countries.

This section of the paper raises several issues with respect to the application of tax treaties that countries should deal with in their domestic law. Although it attempts to identify these issues comprehensively, it does not discuss them in detail. Most of the issues are discussed in more detail in other papers in this collection. The purpose of this part of the paper is to provide a comprehensive framework for thinking about how countries might provide for the application of their tax treaties in their domestic law.

Some countries have no rules in their domestic law with respect to the application of tax treaties. The absence of any application rules is understandable because, when a country first decides to enter into tax treaties with other countries, it is usually preoccupied with developing its negotiating positions on the provisions of either the UN or the OECD Model. Countries accept as a general principle that the provisions of any tax treaties that they enter into will take priority over any conflicting provisions of domestic law. As noted above, countries that require some legislative action to incorporate the provisions of tax treaties into domestic law must consider how that will be accomplished. But otherwise, it often appears to be assumed that tax treaty provisions apply more or less automatically or that any issues concerning their application will be dealt with on a case-by-case basis as they arise.

If a country has rules for the application of tax treaties in its domestic law, several general issues must be considered. First, do those rules apply to all tax treaties or are different rules adopted for different treaties? A second issue is whether any domestic application rules are administrative or legislative in nature. Third, the rules for the application of tax treaties may be dependent on the basic method or methods of taxation – self-assessment, assessment by the tax authorities or withholding tax – adopted by a country. Closely related to, or part of, the method of taxation are the issues of the burden of proof and time limits with respect to claims for treaty benefits. Fourth, several general considerations arise with respect to the role of the country's tax authorities in applying its treaties. For example, the effectiveness and efficiency of domestic rules may be impacted by the location of responsibility for applying tax treaties within the organizational structure of a country's tax authority. Moreover, do the tax authorities have the necessary powers, such the power to gather information and collect tax, to enable them to apply the provisions of tax treaties effectively? Finally, to what extent do the tax authorities provide administrative guidance to taxpayers concerning the application of tax treaties, and what form does that guidance take?

Each of these general considerations is discussed briefly below.

4.2 General or Specific Application Rules

It may seem obvious, especially for countries with sizeable tax treaty networks, that a country should have general rules to govern the application of all of its tax treaties. Such general rules would apply uniformly to all treaties and would provide certainty for taxpayers and tax officials. Although the desirability of general rules for the application of tax treaties seems obvious, very few countries have comprehensive general rules.[22] Some countries may consider that rules for the application of tax treaties are unnecessary because the ordinary procedural aspects of their domestic tax law are adequate to deal with any issues.[23]

For many countries, the rules for the application of tax treaties have developed over time on a piecemeal basis in response to specific problems arising with respect to a specific treaty or a specific article. In some cases, application of the rules may have emerged from case law rather than legislation. Such a system of specific rules may lack coherence and consistency. More importantly, the complexity of such a system may result in the denial of treaty benefits if those benefits are conditional on a taxpayer's faithful adherence to the application rules. Because of these problems, it

[22] Williams, supra note 5, at 32-35.

[23] This is apparently the situation in Belgium. See Thierry Denayer, "Belgium," in IFA, Cahiers de droit fiscal international, supra note 5, 245-64 at 245-46.

would be worthwhile for countries entering into tax treaties to seriously consider promulgating general rules (legislative or administrative – see section 4.3 below) for the application of tax treaties. Such general rules should deal with issues such as the requirements for claiming treaty benefits (filing tax returns or other forms, information disclosure requirements, burden of proof, time limits, etc.).

Moreover, the promulgation of general rules for the application of tax treaties could require a country to apply all of its tax treaties uniformly. Such uniformity would ensure that taxpayers are treated fairly in terms of access to treaty benefits irrespective of the particular tax treaty that applies. However, this type of equal treatment might be viewed as inappropriate in some circumstances. Tax treaties are bilateral rather than multilateral agreements and therefore differences between a country's tax treaties are to be expected. In some cases, the particular treaty negotiated between two countries may involve not only the substantive provisions of the treaties but also the method of application for those provisions. Therefore, the only firm conclusion concerning the equal application of a country's tax treaties is that, in principle, such equal application is a desirable objective, although it may be subject to exceptions based on particular treaties.

4.3 Legislative or Administrative Rules

Country practices vary concerning the use of legislative or administrative rules, or a combination of both, to deal with the application of tax treaties. What type of law is used to deal with the application of tax treaties is a question of domestic law. In some countries, issues concerning the application of tax treaties are treated as matters of general administrative law; in other countries they are matters for tax law.[24] Further, there is the additional question of whether application rules should be the subject of binding rules of law or non-binding administrative pronouncements from the tax authorities. There are advantages and disadvantages associated with each approach. For example, the use of binding rules provides more certainty for taxpayers and tax officials but the use of administrative guidance provides more flexibility, since such guidance can usually be more easily revised to reflect changing circumstances.

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24 The character of the rules for the application of tax treaties may have implications for the resolution of tax disputes concerning those rules. Such disputes may be subject to the jurisdiction of the administrative courts or specialized tax courts.

4.4 Relationship between the Rules for the Application of Tax Treaties and the Method of Taxation

In general, there are three primary methods used by countries to establish the amount of tax payable by a person: assessment by the tax authorities, self-assessment and withholding. Under a system that requires the tax authorities to assess the amount of tax payable, the taxpayer is typically obligated to provide certain specified information and the tax authority is obligated to assess the tax payable based on that information. In contrast, under a self-assessment system, the taxpayer is obligated to file a return containing specified information and to determine the amount of tax payable. Under a withholding tax (which must be distinguished from a system of interim withholding on account of tax payable), the payer of certain amounts is obligated to withhold the amount of tax imposed usually at a flat rate on the gross amount paid and remit such tax to the tax authorities. As a general matter, countries appear to use a combination of withholding taxes on certain payments to nonresidents in combination with either self-assessment or assessment by the tax authorities for other amounts.

The method of taxation can have an important effect on how the provisions of tax treaties are applied. Under a system of assessment by the tax authorities, the responsibility for applying the provisions of a tax treaty rests with the tax authorities in the same way that they must apply other aspects of the tax law. Nevertheless, some countries require taxpayers to make a specific request for treaty benefits and provide the information necessary to support the claim. This type of requirement makes good sense for practical reasons. Taxpayers are in a much better position than the tax authorities to know which treaty and which provision of the treaty are relevant.

If taxpayers are not required to make specific requests for treaty benefits, the tax authorities will be required to analyze the information provided by the taxpayer and on the basis of that information determine whether the provisions of a tax treaty are applicable. The administrative burden imposed on the tax authorities in this regard may be onerous depending on the size of the country's tax treaty network, the quality of the information provided by the taxpayer and the sophistication and experience of the tax authorities with respect to tax treaties. Apart from the administrative issues, requiring taxpayers to make specific requests for treaty benefits raises the question of the consequences if a request for treaty benefits is not made in the proper manner or within the time limit established for filing the request. It is arguably inappropriate and perhaps a violation of the treaty to deny the benefits of the treaty because of a failure to comply with procedural requirements of domestic law.

Under a self-assessment system, the onus is on the taxpayer to claim any treaty benefits that may be applicable. The taxpayer applies the relevant provisions of a treaty in the first instance – usually when filing a tax return – and the tax authorities then have the responsibility to verify the taxpayer's claim. Even under a self-assessment system, some countries require taxpayers to disclose specifically any claims for exemptions, credits or reduced rates of tax based on tax treaties.[25] The same effect may be accomplished in countries (for example, Australia)[26] that impose penalties for failure to disclose questionable positions that turn out to be incorrect. Some countries may deny self-assessment to nonresidents making claims for treaty benefits because of concerns about protecting the domestic tax base. However, this concern is limited to business profits because most countries enforce taxes on payments to nonresidents by withholding, as discussed below.

Claiming treaty benefits under a self-assessment system raises a serious concern where a taxpayer claims exemption from source country tax as a result of the treaty. For example, a resident enterprise of one country doing business in the other country claims that it is not taxable in the other country because it is not carrying on business through a permanent establishment in the other country. The issue raised by this situation is whether the resident is required to file a tax return in the other country even though it claims to be exempt from tax by that country. If the taxpayer is not required to file a return, the tax authorities of the source country may never be put on notice about the taxpayer's situation and never get an opportunity to verify the taxpayer's claim for exemption. Therefore, in such circumstances it is appropriate to require taxpayers to file a return or otherwise disclose the claim for exemption.[27]

The importance of disclosing exemptions claimed under tax treaties also applies to residents of a country claiming an exemption or reduction in residence country tax as a result of the application of a tax treaty. For example, a taxpayer may claim exemption from residence country tax under Article 23 for income that is taxable in the source country under the provisions of the tax treaty. The taxpayer should be required to disclose the claim for exemption so that the tax authorities can verify

[25] For example, section 6114 of the U.S. Internal Revenue Code requires taxpayers to disclose if they are claiming treaty benefits.

[26] See Roger Hamilton, "Australia," in IFA, Cahiers de droit fiscal international, supra note 5, 217-23 at 217. Under this type of penalty regime, taxpayers are induced to disclose any tax positions, including tax treaty positions, that are risky.

[27] Such a requirement would not be discriminatory under Article 24(3), even if it is imposed only on nonresidents claiming exemption, because Article 24(3) does not extend to requirements connected with taxation, as discussed above in section 2.

that claim. Moreover, although the residence country exempts the foreign source income from residence country tax, it may take that income into account in determining the rate of tax on the taxpayer's other income (exemption with progression) or for other purposes. In this case, the residence country requires information concerning the amount of the income earned in the source country.

Many countries use withholding at source as an effective means of collecting tax. In some cases (for example, salaries of the employees) the withholding may be imposed on an interim basis. After the end of the year, taxpayers are required to pay any tax deficiency or claim a refund for any excessive tax withheld for the year. In other cases, often involving payments of dividends, interest, rent and royalties to nonresidents, the amount withheld is imposed as a final tax without the possibility of any further payment or refund. In either case, the obligation to withhold is imposed on the payer of the amount. In most cases the payer will be a resident of the country or a nonresident with a permanent establishment in the country. The provisions of tax treaties do not deal with withholding per se. Consequently, the application of withholding as an interim measure or as a withholding tax is a matter for domestic law. Thus, even if a treaty provides for a maximum tax rate of 15 percent on the amount of a dividend paid by a resident company to a shareholder resident in the other country, the domestic law may require the company to withhold at a higher rate or a lower rate, or it may exempt the payment from residence country tax completely. If the country requires withholding at a rate higher than the rate of tax specified in the treaty, it must provide a refund of the excess tax withheld. In this case, the nonresident is usually required to file a claim for a refund, which the tax authorities have an opportunity to verify.

Many countries align the obligation to withhold imposed on a resident payer and the rate of taxation specified in the treaty. In this situation, the obligation to apply the provisions of the treaty is imposed in the first instance on the withholding agent. If the withholding agent fails to withhold the required amount, it is often made liable to pay that amount as tax on behalf of the nonresident. Again, the issue is: how do the tax authorities get notice that the amount of withholding has been reduced pursuant to the provisions of a tax treaty so that they have an opportunity to verify that the claim for reduced tax is legitimate? As mentioned above, this concern must be balanced against the interests of taxpayers receiving the benefits of reduced withholding taxes under tax treaties in a timely manner.

4.5 The Role of the Tax Authorities in Applying Tax Treaties

4.5.1 Introduction

Since the provisions of tax treaties require interpretation and application, the role of tax authorities of a country in performing these functions is important. In this section of the paper, three aspects of the role of the tax authorities with respect to applying tax treaties are discussed: the location of responsibility for applying tax treaties, the powers of the tax authorities with respect to the application of tax treaties, and administrative guidance for taxpayers.

As a general matter, the development of expertise by the tax authorities with respect to tax treaties is a critical prerequisite for the proper application of tax treaties. Expertise concerning tax treaties is relatively scarce even in the tax administrations of developed countries with extensive and longstanding treaty networks. The development of such expertise in the tax administrations of developing countries is a serious challenge.

4.5.2 Location of Responsibility

One important aspect of how the tax authorities of a country apply the provisions of tax treaties is where the responsibility for that function is located in the organizational structure of the tax administration. There are many possibilities in this regard and although no single option is right for all countries, it is a matter that all countries should consider seriously. Some of the considerations that should be taken into account include:

- Whether issues involving the application of tax treaties are dealt with by a centralized unit of tax treaty specialists or by decentralized tax auditors as part of their general assessment and audit functions.
- How the tax administration is organized to deal with international issues in general. The provisions of tax treaties affect both residents of a country earning foreign source income and nonresidents earning domestic source income. Therefore, if a country allocates responsibility for dealing with residents earning foreign source income and nonresidents earning domestic source income to different units, responsibility for applying tax treaties could be allocated on the same basis. However, for many developing countries, the taxation of nonresidents earning domestic source income is likely to be more important than the taxation of residents on their foreign source income.

- If responsibility for applying tax treaties is allocated to different groups or units within the tax administration, their work should be coordinated to avoid duplication and inconsistency.
- The relationship between the competent-authority function and the application of tax treaties to taxpayers.

4.5.3 The Powers of the Tax Authorities Relating to the Application of Tax Treaties

The tax authorities must have the powers to properly investigate claims for treaty benefits. These powers include the ability to gather information and to collect tax. These powers are not peculiar to tax treaties and a detailed discussion is beyond the scope of this overview.

The power to obtain information from a country's treaty partners is particularly important for the verification of claims for treaty benefits. Article 26 of both the UN and OECD Model Convention provides for the exchange of information necessary to carry out the terms of the treaty. In addition, as noted above, Article 27 of both the UN and OECD Model Convention allows the treaty partners to provide assistance in the collection of each others' taxes.

4.5.4 Administrative Guidance Concerning the Application of Tax Treaties

It is obviously important for the tax authorities to provide as much information as possible to taxpayers about how the provisions of the country's tax treaties will be applied. At the very least, the tax authorities should provide the text of the tax treaties that it has entered into with other countries, preferably in electronic format freely accessible by taxpayers and their advisers. Other information that could be provided includes treaties signed but not yet ratified and countries with which negotiations for a tax treaty have commenced. The provision of this type of basic information is especially important for developing countries in which such information may not be readily available from commercial publishers.

In addition, the tax authorities should provide information about any procedures that must be followed or forms that must be filed to obtain treaty benefits, including any related time requirements. It is desirable that such information be provided in a readily accessible manner on the tax authorities' website. Treaty benefits should not be denied because taxpayers cannot easily discover and comply with any procedural requirements. Similarly, any forms should be readily available on the public website of the tax authorities.

The use of forms is a common and effective way used by several countries to allow taxpayers to claim treaty benefits. To the extent that such forms may impose procedural requirements, they may make treaty benefits more difficult to obtain, contrary to the purpose of the treaty. For example, if a nonresident is expected to file a form claiming reduced treaty rates of withholding tax for every such payment, the compliance burden on the taxpayer and the administrative burden on the tax authorities dealing with the forms could be substantial. In some circumstances, the taxpayer may be required to file the forms with the withholding agent rather than with the tax authorities. The withholding agent is then required to file a return with the tax authorities. If forms are used, a decision must be made as to whether their use is mandatory or optional and, if optional, whether a letter providing the necessary information is sufficient. Obviously, it is desirable if the forms are available in the languages of the country's treaty partners.

Many tax authorities provide binding rulings to taxpayers with respect to proposed transactions. These advance rulings should also be available with respect to the application of tax treaties. In addition, taxpayers should be able to contact the tax authorities to discuss potential claims for treaty benefits on an informal and impartial basis. Such informal contact assumes that the tax authorities responsible for the application of tax treaties are identifiable and they have the necessary expertise to provide meaningful guidance to taxpayers. It goes without saying that the tax authorities should provide equal access to all taxpayers and their professional advisers.

5. Persons Entitled to the Benefits of Tax Treaties

5.1 Introduction

This section of the paper deals with the necessity for the tax authorities to determine whether a person is entitled to the benefits of a particular tax treaty. According to Article 1 of both the UN and OECD Model Conventions, those Conventions apply to persons who are residents of one or both of the contracting states. Therefore, before applying the provisions of a treaty, it is necessary for the tax authorities to determine if the person claiming the benefits of the treaty is entitled to them as a resident of one of the contracting states. The determination of residence for purposes of the treaty must be made by a country with respect to its own residents and the residents of the other contracting state. Further, for Articles 10, 11 and 12 of both Model Conventions, it is necessary for the recipient of dividends, interest or royalties to be the beneficial owner of the payment in order to obtain the benefit of the reduced rates of source-country tax provided by the treaty. The determination of residence and beneficial ownership and connected requirements are discussed in this section. The application of the substantive provisions of a tax treaty to residents of a country and to residents of the other country is then discussed in the next two sections of the paper.

Time limits for claiming the benefits of a treaty cause many difficulties, especially where the domestic rules of the contracting states differ significantly. One persistent problem is the need for a taxpayer to provide information to one country before the information is available because, for example, it depends on the tax situation in the other country. Time limits are also relevant with respect to the period during which the tax authorities may reopen a matter.

5.2 Identification of Persons

As noted above, only persons who are residents of one or both contracting states qualify for the benefits of the treaty. Accordingly, the first requirement is that there must be a person. Article 3(1)(a) of both Model Conventions defines a person to include "an individual, a company and any other body of persons." A company is defined in Article 3(1)(b) to mean "any body corporate or any entity that is treated as a body corporate for tax purposes." The terms "individual," "body of persons," "body corporate" and "entity" are not defined. The Commentary on Article 3 of the UN Model Convention indicates that the term person "should be interpreted very broadly."[28] Similarly, the Commentary on Article 3 of the OECD Model Convention indicates that the term "person" is used in a very wide sense. Both Commentaries indicate that partnerships are considered to be persons, either as companies or as bodies of persons.

Because of the broad definition of "person," in most cases it will be clear that the claimant is a person. In any cases where there is doubt, the country applying the treaty should apply the provisions of its own law in accordance with Article 3(2) of the treaty to determine if there is a person and the nature of the person (i.e., individual, company, etc.). A question whether a person exists for purposes of a treaty could arise with respect to the special entities discussed below.

5.3 The Determination of Residence

Only a resident of a contracting state is entitled to treaty benefits. Under Article 4 of both Model Conventions, a resident of a contracting state is defined to be a person who is liable to tax in that

[28] Commentary on Article 3, paragraph 4.

state by reason of certain criteria. Therefore, as a preliminary matter, it must be determined whether a person is a resident of a country so that that person can claim the benefits of that country's treaties.

Where a country must determine whether a person is a resident of that country for purposes of its tax treaties,[29] the determination of residence is straightforward. In the first instance it must be determined whether the person is a resident under the country's domestic law. This issue should not be difficult for either the taxpayer or the tax authorities, since they both can be expected to be familiar with their own domestic law. Similarly, in most cases it should be straightforward to determine whether the person is a resident under the definition in Article 4, since again the issue is whether the person is liable to tax under domestic law by reason of certain criteria. In effect, the country applies its own domestic law to determine whether a person is resident in the country under Article 4.

In some countries, there may be a direct link between an individual's immigration status and their tax status as a resident. The United States green card is the best-known example. Anyone holding a U.S. green card, which allows the person to enter the United States to work, is considered to be a resident for U.S. tax purposes. Such a direct link between immigration status and residence may induce taxpayers to comply with their tax obligations as residents in order to maintain their immigration status.

Where, however, a country must determine whether a person is a resident of the other contracting state[30] the issue is much more difficult. In this situation, the tax authorities must determine if the person is a resident of the other contracting state for purposes of the treaty by applying the other state's domestic law. Not surprisingly, many countries require a certificate from the tax authorities of the other country to the effect that the person is a resident of that country as a condition for granting the benefits of the treaty. The use of residence certificates is widespread and can be formalized by an agreement between the competent authorities, as provided for in Articles 10(2), 11(2) and 12(2) (UN Model Convention only). The efficiency of the use of residence certificates can be improved if special forms for the purpose are created in the relevant languages of the two countries. The taxpayer can obtain a certificate from its country of residence and provide it to the country from which treaty benefits are claimed. Alternatively, the tax authorities of the country of residence can send the form directly to the tax authorities of the source country.

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[29] This is necessary primarily for the relief from double taxation under Article 23. See section 6 below.

[30] This is necessary to apply the benefits under the distributive articles (Articles 6-21) of the treaty.

A country may require the tax authorities of the other country to certify things in addition to residence. For example, a country may require the foreign tax authorities to certify that the taxpayer is the beneficial owner of dividends, interest or royalties in order to get the benefit of the reduced rates of source-country tax under Articles 10(2), 11(2) and 12(2) (UN Model Convention only).

There are potential problems with the requirement of residence and other certifications from the tax authorities of the other countries. Although the requirement of a certificate of residence imposes some additional compliance burden on the taxpayer and administrative burden on the tax authorities, this additional burden does not seem overly onerous if it is simply an annual requirement. If, however, a separate certificate is required for each payment, the burden could be significant. Another problem is the potential delay in obtaining the benefits of the treaty caused by the necessity to obtain residence or other certifications from the foreign tax authorities. The delay is dependent on how frequently such certificates are required and how much information about the tax affairs of the taxpayer must be certified by the foreign tax authorities. Another potential problem is the possible use of the certificate as leverage against the taxpayer in its other unrelated dealings with the tax authorities. Such misuse of the certification process should be discouraged. Residence and other certificates should be issued by the tax authorities based exclusively on the merits of each certificate requested.

Some countries allow withholding agents to reduce the amount withheld pursuant to a treaty based on the address of the recipient. Relying on addresses in this way makes the delivery of treaty benefits much more efficient, but is susceptible to abuse. Therefore, the withholding agent may not be able to rely on the recipient's address if the agent has reason to suspect that the recipient is not a resident of the other contracting state. In this case, a residence certificate must be obtained.

Situations in which a taxpayer is considered to be resident in both contracting states for purposes of a tax treaty are frequently encountered because countries' residence rules tend to be overly broad. In these dual-resident cases, the UN and OECD Model Conventions provide tie-breaker rules to allocate residence exclusively to one contracting state for purposes of the treaty. Under Article 4(2) of both Models, a hierarchy of four tie-breaker rules is provided for individuals, whereas under Article 4(3) the tie-breaker rule for other persons is the person's place of effective management. The Commentary on both Models allows countries to resolve the dual residence of entities other than individuals on a case-by-case basis pursuant to the mutual agreement procedure instead of by reference to the entity's place of effective management.

The application of the tie-breaker rules has important implications for the contracting states because it determines which country must give up its taxing rights. Consequently, the application of the tie-breaker rules should be carefully considered. For individuals, the tie-breaker rules are intensely factual and should be applied on a balanced basis to give residence to the country to which the individual is more closely connected. In addition, dual-resident entities are sometimes used for tax avoidance purposes.[31]

5.4 Hybrid and Special Entities

The application of the definition of resident of a contracting state to persons other than individuals and companies creates special problems. For example, although a partnership is a person for purposes of a tax treaty,[32] it is not a resident of a country under Article 4(1) if it is not liable to tax under the laws of that country. In many countries, partnerships are treated as flow-through or transparent entities for income tax purposes; they are not taxable but the partners are taxable on their shares of the partnership's income. In other countries, at least some partnerships may be taxable on their income in the same way as corporations. Similar issues may arise with respect to trusts, foundations and other entities.

A partnership that is treated by one contracting state as a flow-through or transparent entity but by the other contracting state as a separate taxable entity and a resident is an example of a co-called hybrid entity. These hybrid entities cause serious problems for the application of tax treaties. For example, in some cases the use of hybrid entities may result in unrelieved double taxation. For example, assume that X, a resident of Country A, earns business profits sourced in Country B through a limited liability company (LLC) established under the laws of Country B. Country B treats the LLC as a separate entity for tax purposes; therefore, Country B imposes tax on the LLC as a resident of Country B. In contrast, Country A treats the LLC as a flow-through or transparent entity for tax purposes and imposes tax on X in respect of the income earned through the LLC; however, Country A may not allow any credit under Article 23 for the tax paid to Country B on the income because the tax is paid by the LLC, not by X. This type of double taxation is contrary to the spirit of the treaty.

[31] See section 8 below.

[32] Because it is a body corporate or a body of persons under Article 3(1).

In other cases, the use of a hybrid entity can result in double non-taxation. For example, assume that an LLC established under the laws of Country B realizes a capital gain in respect of shares of a corporation resident in Country B. Country B does not tax the LLC on the gain because it treats the LLC as a flow-through or transparent entity for income tax purposes. Instead, Country B considers the capital gain to have been realized by the members of the LLC, who are all individuals resident in Country A. Therefore, under Article 13 of the treaty between Countries A and B, Country B does not have authority to tax the capital gain (assuming that the assets of the LLC do not consist primarily of immovable property located in Country B). On the other hand, Country A considers the LLC to be a separate taxable entity and therefore, it does not tax the capital gain because it belongs to a resident of Country B. The use of hybrid entities to obtain tax treaty benefits raises the possible application of anti-avoidance rules. The prevention of tax avoidance through the use of tax treaties is discussed below in the final section of the paper.

The Commentary on both the UN and OECD Model Conventions provides useful guidance concerning the application of the provisions of a treaty to partnerships and their partners[33] and to real estate investment trusts and collective investment vehicles.[34] However, the Commentary does not provide any similar guidance with respect to trusts and other entities or with respect to the treatment of hybrid entities generally.

5.5 Beneficial Owner

The benefit of the reduced rate of source-country tax on dividends, interest and royalties under Articles 10, 11 and 12 is available only if the recipient of the payment is a resident of the other contracting state and the beneficial owner of the payment. Therefore, the application of Articles 10, 11 and 12 requires a source country to determine not only the residence of the recipient but also the beneficial owner of the payment. According to the Commentary, the use of the term "beneficial

[33] The primary references to partnerships and their partners are found in paragraphs 2-6.7 of the Commentary on Article 1 of the OECD Model Convention and paragraphs 1-7 of the Commentary on Article 1 of the UN Model Convention; paragraph 8.8 of the Commentary on Article 4 of the OECD Model Convention and paragraph 6 of the Commentary on Article 4 of the UN Model Convention, quoting paragraph 8.8 of the Commentary on Article 4 of the OECD Model Convention; and paragraphs 6.1 and 6.2 of the Commentary on Article 15 of the OECD Model Convention and paragraph 1 of the Commentary on Article 15 of the OECD Model Convention, quoting paragraphs 6.1 and 6.2 of the Commentary on Article 4 of the OECD Model Convention.

[34] Paragraphs 6.8-6.34 of the Commentary on Article 1 of the OECD Model Convention and paragraphs 67.1-67.7 Commentary on Article 10 of the OECD Model Convention.

owner" in Articles 10, 11 and 12 is intended to deny the reduced rates of source-country tax where the payments are received by an agent, nominee or conduit and the real owner of the payment is not a resident. The precise meaning of "beneficial owner," especially as it applies to conduits, is unclear.

The OECD has recently proposed to clarify the meaning of the term.[35] In October 2012 the OECD issued revised proposals to amend the Commentary on Articles 10, 11 and 12 to provide that beneficial owner has a treaty meaning independent of domestic law[36] and that it means "the right to use and enjoy" the amount "unconstrained by a contractual or legal obligation to pass on the payment received to another person."[37] However, the Commentary will retain comments that the concept of beneficial owner is an anti-avoidance rule and must be determined "in substance."

The application of the beneficial-owner concept by the tax authorities presents some problems. The purpose of the concept is to ensure that treaty benefits are provided only to the real owners of the relevant payments. The concept is closely related to the requirement that the recipient of the payment must be a resident of the other country, as discussed above, and to anti-avoidance rules to prevent abuse of tax treaties (the so-called anti-treaty-shopping rules). Thus, the beneficial-owner concept should be applied taking this context into account.

In addition, it is not completely clear where the tax authorities should look for the source of the meaning of the term "beneficial owner." Presumably, the Commentary on the OECD Model Convention will be revised in 2014 to indicate that the term has a treaty meaning independent of the domestic law of the contracting states. However, the proposed OECD Commentary does not provide a meaning that is completely clear. Currently, some countries determine the meaning of beneficial owner under their domestic law, in accordance with Article 3(2). Other countries may consider it appropriate to determine the meaning under the domestic law of the residence country because it is so closely related to the concept of residence as determined under the law of the residence country in accordance with Article 4. If so, it would be appropriate for these countries to require taxpayers to

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[35] *OECD Model Tax Convention: Revised Proposals concerning the Meaning of "Beneficial Owner" in Articles 10, 11, and 12, October 19, 2012*, available at www.oecd.org/ctp/treaties/Beneficialownership.pdf.

[36] Ibid. Proposed paragraph 12.1 of the Commentary on Article 10; paragraph 9.1 of the Commentary on Article 11, and paragraph 4 of the Commentary on Article 12.

[37] Ibid. Proposed paragraph 12.4 of the Commentary on Article 10, paragraph 10.2 of the Commentary on Article 11, and paragraph 4.3 of the Commentary on Article 12.

obtain a certificate from the foreign tax authorities that they are both residents and beneficial owners for purposes of the foreign law.

6. The Application of Tax Treaties by a Country to its Own Residents

6.1 Introduction

In general, the provisions of tax treaties do not restrict a country's authority to tax its own residents. The provisions of tax treaties, however, do affect the taxation of a country's residents, most importantly with respect to relief from double taxation and the prohibition of discrimination. The application of Article 24(4) and (5) dealing with discrimination against resident enterprises that are owned or controlled by nonresidents or that pay amounts to residents of the other contracting state is dealt with above in section 2. Typically, claims for relief from discrimination would be made by a resident in filing its tax return or making a specific request to the tax authorities. Therefore, this section of the paper focuses on relief from double taxation.

Before determining whether a taxpayer is entitled to relief from international double taxation under an applicable tax treaty, the tax authorities of a country must determine that the taxpayer is a resident of the country. The determination of residence is dealt with in section 5.3 above.

6.2 Relief from Double Taxation

6.2.1 Introduction

The provisions of the UN and OECD Model Conventions eliminate double taxation in a variety of ways depending on the type of income. With respect to some items of income, exclusive taxing rights are given to the residence country. For example, this is the case for royalties under Article 12 of the OECD Model, for business profits where the taxpayer does not have a PE in the source country, and for certain capital gains. For certain other limited types of income, for example, income from government service under Article 19, the source country is given exclusive taxing rights. In these situations, double taxation cannot arise because only one country is entitled to tax. However, for many items of income dealt with under the distributive articles of the treaty, both the source and residence countries are entitled to tax. In these circumstances, under Article 23 of both the UN and

OECD Model Conventions, the residence country is obligated to provide relief from double taxation with respect to any income that is properly subject to tax in the source country in accordance with the treaty. Article 23 requires relief to be provided by means of either an exemption of the relevant income from residence-country tax or a credit against residence-country tax for the tax paid to the source country on the relevant income. The general issues involved in applying the provisions of Article 23 under both the exemption and foreign tax credit methods are discussed below.

Before dealing with the exemption and credit methods for relieving double taxation, it is important to understand the relationship between a country's domestic law with respect to double tax relief and the provisions of an applicable tax treaty. If a country's domestic law provides more generous relief than is provided in the tax treaty, in general the taxpayer will be entitled to the more generous relief under domestic law because tax treaties are considered to be relieving in nature. If, however, more generous relief is provided in the tax treaty, the taxpayer will be entitled to that relief because tax treaties prevail over domestic law. These points seem reasonably clear. The more difficult issue is that the rules of Article 23 are broad and general. In contrast, often the rules of domestic law dealing with double taxation relief, especially the foreign tax credit, are quite detailed. Consequently, the provision of relief under the treaty may necessitate the application of aspects of domestic law. The issue is whether the application of domestic rules in this regard is legitimate if it limits the relief under the treaty.

The Commentary on Article 23 of both the UN and OECD Model Conventions indicates that the provisions of both Article 23A and 23B "do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic law and practice applicable."[38] Because of the intimate relationship between Article 23 and the provisions of domestic law providing relief from double taxation, some countries limit the relief provided under Article 23 of the treaty to the relief provided in domestic law.[39]

Most countries use both the exemption method and the credit method for relieving double taxation. Often the exemption method is restricted to business profits earned in the other country, while the

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[38] Paragraph 32 of the Commentary on Article 23 of the OECD Model Convention and paragraph 14 of the Commentary on Article 23 of the UN Model Convention, quoting paragraph 32 of the Commentary on Article 23 of the OECD Model Convention.

[39] See paragraph 32.8 of the Commentary on Article 23 of the OECD Model Convention and paragraph 14 of the Commentary on Article 23 of the UN Model Convention, quoting paragraph 32.8 of the Commentary on Article 23 of the OECD Model Convention.

credit method is used for other types of income. This type of mixed approach is expressly recognized by Article 23B(2) of both Model Conventions.

It should also be noted that the competent authorities are authorized by Article 25(3) to use the mutual agreement procedure to consult about the elimination of double taxation that is not eliminated under Article 23 or the other provisions of the treaty.

6.2.2 Exemption Method

Although the exemption method appears to be simple, it raises several issues. The major difference between the exemption method and the credit method in terms of the application of the treaty provisions is that the amount of tax paid to the source country is irrelevant under the exemption method. The tax authorities of the residence country do not require any information from the taxpayer or the tax authorities of the source country about the amount of tax paid in the source country. However, the residence country often needs information about the amount of income earned in or received from the source country in order to determine the amount to be exempted, the tax rate on other income (exemption with progression, which is expressly authorized by Article 23A(3)), and the determination of thresholds based on income. The Commentary on both the UN and OECD Model Conventions indicates that many problems can potentially arise concerning the application of the exemption method under Article 23A.[40] Because Article 23A is silent about these problems, the provisions of domestic law apply. However, recourse to domestic law is not helpful if the exemption method is not used under domestic law. In such situations, the Commentary suggests that the contracting states should adopt rules for the application of the exemption method pursuant to the mutual agreement procedure.

Countries should be especially sensitive to the possibility of double non-taxation where the exemption method is used. The Commentary recognizes that countries may agree to amend Article 23 to prevent such double taxation.[41] Moreover, Article 23 itself permits countries that ordinarily use

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[40] Paragraphs 38-46 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the UN Model Convention, quoting paragraphs 38-46 of the Commentary on Article 23 of the OECD Model Convention.

[41] For example, by agreeing to limit the exemption method to income that is effectively taxed in the source country. Paragraph 35 of the Commentary on Article 23 of the OECD Model Convention and paragraph 14 of the Commentary on Article 23 of the UN Model Convention, quoting paragraph 35 of the Commentary on Article 23 of the OECD Model Convention and paragraph 15 of the Commentary on Article 23 of the UN Model Convention (see also paragraph 19).

the exemption method to use the credit method for dividends, interest and other income items.[42] More generally, the problem of double non-taxation involves the larger issue of the abuse of tax treaties and the relationship between tax treaties and domestic anti-abuse rules, which are discussed in section 8 below.

A final point about the application of the exemption method under Article 23 relates to the treatment of losses incurred in the source country by a resident of the other contracting state. Some residence countries may deny any deduction of such a loss because any income from the source country is exempt. In such a case, relief for the loss must be provided by the source country in the form of a loss carryover. If, however, the residence country allows a deduction for a loss occurring in the source country, the residence country is free to reduce the exemption for income subsequently derived from the source country by the amount of the earlier loss.[43] This point about losses is important because it emphasizes the more general point that the proper application of the provisions of the treaty often involves the interaction between the treaty and the country's domestic law.

6.2.3 Credit Method

As with the exemption method under Article 23A, the provisions of Article 23B with respect to the credit method do not contain detailed rules for the application of the credit method. Therefore, similar problems of application arise under the credit method as under the exemption method. These problems are sometimes resolved by recourse to the domestic law of the residence country relating to the foreign tax credit. However, if that country does not provide a foreign tax credit under its domestic law, according to the Commentary, it should establish rules of application for the credit under Article 23B and it should, if necessary, consult with the competent authority of the source country.[44]

Many issues arise in connection with the computation of a foreign tax credit: differences in the timing of the recognition of the income in the source and residence countries, foreign exchange

[42] Paragraph 31 of the Commentary on Article 23 of the OECD Model Convention and paragraph 15 of the Commentary on Article 23 of the UN Model Convention.

[43] Paragraph 44 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the UN Model Convention, quoting paragraph 44 of the Commentary on Article 23 of the OECD Model Convention.

[44] Paragraph 60 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the UN Model Convention, quoting paragraph 60 of the Commentary on Article 23 of the OECD Model Convention.

issues, the determination of the limitation of the credit to the portion of the domestic tax attributable to the income earned in the source country, the treatment of losses, and hybrid entities.[45] The Commentary on both the UN and OECD Models indicates that these "problems depend very much on domestic law and practice, and the solution must, therefore, be left to each State."[46]

Where a country uses the credit method under Article 23B, the deduction allowed against its tax is based on the tax paid to the other contracting state. Most countries require taxpayers to provide proof concerning the amount of foreign tax paid by providing a copy of the foreign tax return and evidence that the foreign tax has been paid. A certificate from the foreign tax authorities could be required for this purpose.

Although the UN and OECD Model Conventions do not contain such provisions, many tax treaties between developed and developing countries have "tax sparing" provisions. The purpose of these provisions is to ensure that tax incentives provided by developing countries for nonresident investors go to those investors rather than to the government of the country in which the investors are resident. If the residence country uses the credit method, then any tax incentives provided by the source country for investors resident in the residence country will be effectively cancelled by the tax imposed by the residence country.

For example, assume that a corporation resident in Country A makes a large investment in developing a new mine in Country B. To attract these types of new investments, Country B provides a 3-year tax holiday for the profits from the mine once it commences production. As a result, the profits are exempt from Country B's ordinary corporate income tax, which is imposed at a rate of 30 percent. Assuming that the corporation earns profits of 1 million in the first year of the mine, the corporation will pay no tax in Country B. However, assuming Country A taxes its residents on their worldwide income at a rate of 35 percent, the corporation will pay tax to Country A on its profits from Country B of 350,000. If Country B did not provide any tax holiday, it would have imposed a tax of 300,000 and the corporation would have been entitled to claim a credit for the Country B tax against the tax payable to Country A. Therefore, the tax incentive of 300,000 in foregone tax

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45 Paragraphs 61-65 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the UN Model Convention.

46 Paragraph 66 of the Commentary on Article 23 of the OECD Model Convention and paragraph 16 of the Commentary on Article 23 of the UN Model Convention, quoting paragraph 66 of the Commentary on Article 23 of the OECD Model Convention.

provided by Country B is effectively transferred to Country A, whose tax increases from 50,000 (if Country B does not provide any tax holiday) to 350,000 (if Country B provides the tax holiday).

Tax sparing provisions can take various forms, and there are serious application issues with all of them.[47] In particular, tax sparing provisions are potentially subject to abuse.

7. The Application of Tax Treaties to Residents of the Other Contracting State (Nonresidents)

7.1 Introduction

In most situations under the provisions of bilateral tax treaties, it is the source country that is required to give up or reduce its tax on income earned in the source country by residents of the other contracting state. Therefore, it is appropriate and necessary for the source country to take the necessary steps to ensure that the provisions of the tax treaty are applied properly. In general, these steps include:

- Identifying nonresidents subject to source-country tax under the source country's domestic law;
- Gathering information about the income-earning activities of nonresident;
- Determining whether nonresidents qualify for treaty benefits; and
- Determining the amount of the reduction in source-country tax required by the treaty and the method by which the reduction should be provided.

Some of these steps have been discussed in earlier sections of the paper and are cross-referenced here. This section focuses primarily on the identification of the relevant nonresident taxpayer and the application of tax treaties to the most important types of income earned by nonresidents.

[47] See paragraphs 71-72 of the Commentary on Article 23 of the OECD Model Convention and paragraphs 16, 17 and 18 of the Commentary on Article 23 of the UN Model Convention, quoting paragraphs 72-74 of the Commentary on Article 23 of the OECD Model Convention, paragraphs 76-78 of the 2000 OECD Commentary on Article 23, and paragraph 75 of the Commentary on Article 23 of the OECD Model Convention, respectively. See also the 1998 Report by the OECD, Committee on Fiscal Affairs, *Tax Sparing: A Reconsideration* (Paris: OECD, 1998).

7.2 Identification of the Relevant Nonresident Taxpayers

Dealing with issues concerning the application of tax treaties by a source country assumes that this country has identified the nonresidents that are deriving income from the source country that is subject to source-country taxation. Obviously, if a source country is not imposing tax on a nonresident because it is not aware that the nonresident is carrying on business in the source country or deriving income from the source country, there is no need to apply the provisions of an applicable tax treaty. The identification of nonresidents deriving income from the source country is critical, both for source country tax purposes generally and for the application of tax treaties.

Many countries use taxpayer identification numbers to identify taxpayers and keep track of their income-earning activities. Such numbers can be readily used for residents but some countries also require nonresidents to obtain such numbers in order to claim treaty benefits. Although the conditions for issuing a taxpayer identification number are matters of domestic law, they may have an impact on the availability of treaty benefits. For example, some countries require proof of a nonresident's country of residence as a condition of issuing a taxpayer identification number. It is necessary for countries to balance the administrative convenience afforded by taxpayer identification numbers and the burden imposed on taxpayers. The conditions for obtaining a taxpayer identification number should not be used as a disguised method for disallowing treaty benefits.

In addition to taxpayer identification numbers, several countries require nonresident individuals and companies to register with the appropriate authorities in the source country. These registration requirements often apply to nonresidents living in the country or doing business in the country. This information may be available to the country's tax authorities.

In some cases, the nonresident may be required to register directly with the tax authorities. The effectiveness of registration requirements appears to vary widely. Requiring nonresidents to be registered as a precondition for claiming treaty benefits may have a small positive impact on registration. As noted above, however, if nonresidents can derive income from the source country without detection by the tax authorities, claiming treaty benefits is irrelevant.

For countries with exchange controls, there may be a link between getting permission to transfer funds out of the country and the payer's tax obligations. Some countries (for example, Argentina) require nonresidents to appoint a local agent as a condition for claiming treaty benefits. Most countries impose withholding obligations on residents who pay amounts to nonresidents which effectively makes the resident payer the nonresident's agent for the payment of tax. This is also the case with respect to interim withholding at source on salaries and wages paid to employees and certain other amounts, including amounts paid to nonresidents.

Treaty relief in the form of reduced withholding requires authorization for the resident payer to withhold in accordance with the treaty rate rather than the domestic rate. How this reduction is implemented will determine how efficiently the treaty benefits are delivered. If, as is common practice, the withholding agent is liable for the tax payable by the nonresident if the agent fails to withhold properly, the agent may be unwilling to accept the risk of withholding less than the full amount required by domestic law. Similarly, if the conditions imposed for reduced withholding are too onerous, the withholding agent may withhold at the domestic rate, thus forcing the nonresident to apply for a refund. For example, is the withholding agent entitled to reduce the amount of tax withheld based on the residence of a recipient, as indicated by the address provided by the recipient, or is more rigorous proof of residence (certification by the foreign tax authorities) required? The former procedure is capable of providing treaty benefits faster and more efficiently but is susceptible to abuse. The latter procedure has more integrity but takes longer and imposes considerably larger compliance burdens.

As noted above, the alternative to delivering treaty benefits through reduced withholding is to require nonresidents to apply for refunds of amounts withheld in excess of the treaty rate. Such a refund process requires a large commitment of resources by the tax authorities to operate such a process efficiently. It is not surprising that many countries have decided for practical reasons to implement procedures for delivering treaty benefits that eliminate or reduce the need to make refunds.

The determination of the persons who are entitled to treaty benefits and, in particular, the issues of residence and beneficial ownership, are dealt with above in section 5.

7.3 Nonresidents Earning Particular Types of Income from the Source Country

7.3.1 Introduction

In this section, the application of the provisions of tax treaties to different types of income is discussed. The discussion is intended to show how the practical issues concerning the application of tax treaties differ depending on the type of income involved. A detailed discussion of the application of tax treaties to business profits, income from services, and investment income is provided in the separate papers in this collection dealing with those specific topics.

7.3.2 Business profits

Once it has been determined that there is an applicable treaty, in applying the provisions of that treaty to business profits, the first issue is to determine which of the several provisions of the treaty is relevant. At least 6 of the distributive articles of the UN Model Convention are potentially applicable to business profits: Articles 6, 7, 8, 14, 17, and 21. Moreover, if dividends, interest and royalties that are otherwise dealt with in Articles 10-12 are effectively connected with a permanent establishment in the source country, they are taxable by the source country in accordance with Article 7. A complete discussion of the various types of business profits is beyond the scope of this overview. It is sufficient to note that the treatment of various types of business profits differs enormously both in terms of the allocation of the right to tax and the practical issues in applying the relevant treaty provisions. A few brief comments with respect to Article 7, the general provision dealing with business profits, and Article 17 dealing with artistes and sportspersons, should serve to illustrate the range of application issues involved.

Under Article 7, the profits derived from a business carried on in the source country by a resident of the other contracting state are taxable in the source country only if the business is carried on through a permanent establishment in the source country and the income is attributable to the permanent establishment (subject to a limited force-of-attraction rule in Article 7 of the UN Model). The issues that the source country must deal with to apply Article 7 are formidable. They can be summarized as follows:

- First, as dealt with above in this section, the nonresidents carrying on business in the source country must be identified.
- Second, as also dealt with above in section 5, the country in which any particular nonresident is resident must be determined.
- Third, it must be determined that the nonresident is carrying on business in the source country through a permanent establishment in the source country; this permanent-establishment determination is intensely factual and requires the tax authorities to have good information about the nonresident’s activities in the source country.

- Fourth, it must be determined that none of the other provisions of the treaty applies to the profits because those provisions prevail over Article 7.[48]
- Finally, the profits attributable to the PE must be determined, which involves the application of the provisions of both Article 7 and the related Commentary and the provisions of domestic law.

In sharp contrast to Article 7, Article 17 of both the UN and OECD Model Conventions gives the source country the right to tax income derived from the personal activities of a resident of the other contracting state as an artiste (entertainer) or sportsperson if the activities are exercised in the source country. No permanent establishment is required and the activities do not have to continue for any specified period. Consequently, the application of Article 17 requires a source country to determine that a nonresident has performed activities of an entertainment or sports nature in the source country and to determine the amount of the income. It is unnecessary to determine the country in which the nonresident is resident because a nonresident artiste or sportsperson will ordinarily be taxable under the domestic law of the source country irrespective of whether a treaty applies.

The primary difficulties involved in applying Article 17 are gathering accurate information about the activities of nonresident artistes and sportspersons in the source country and collecting tax. Information gathering is less difficult with respect to prominent artistes and sportspersons since their performances are likely to be well publicized in the public media. Collecting tax in these circumstances is critical because artistes and sportspersons are often in the source country for a very short time. Article 17 does not impose any limits on how the source country taxes income derived by artistes and sportspersons. As a result, most countries impose tax on such income by way of a withholding tax on the gross revenues. Collection of the tax may be facilitated by arrangements between the tax authorities of the source country and the local promoters of the event or the owners of the venue. If the tax authorities have difficulty collecting the tax at the time of the event, they may have recourse to Article 27 to seek assistance from the country of residence to collect the tax, assuming, of course, that the treaty contains a provision dealing with assistance in the collection of tax.

[48] See Article 7(6) of the UN Model Convention and Article 7(4) of the OECD Model Convention.

7.3.3 Income from Services

Several provisions of the UN and OECD Model Conventions are potentially applicable to income from services.[49] The purpose of this brief discussion here is to show generally the issues that the tax authorities of the source country must confront in applying the provisions of a relevant tax treaty. These application issues can be summarized as follows:

- First, the nonresidents performing services in the source country must be identified.[50]
- Second, the country in which the nonresident service provider is resident must be established in order to determine if the benefits of a treaty are available.
- Third, it must be determined which provision of the relevant treaty is applicable. This determination is based primarily on the nature of the services (for example, employment (Article 15)), government service (Article 19), or professional or other independent services (Article 14 or Article 7).
- Fourth, it must be determined if the threshold for source-country taxation is met under the applicable article. The threshold requirement varies, from no threshold under Article 17 for entertainment and sports activities and for certain employees of resident enterprises and nonresident enterprises with a permanent establishment in the source country, to a time threshold (183 days) for certain other employees and independent contractors, to the necessity for a permanent establishment or a fixed place of business in the source country.
- Fifth, the amount of the income subject to source-country tax, in accordance with the treaty, must be determined. Some provisions allow the source country to impose tax on the gross revenue derived by the nonresident service provider, while Articles 7 and 14 require tax to be levied on the net income.
- Sixth, the method for imposing and collecting the tax must be established.

As noted above in connection with business profits, the application of the provisions of a tax treaty with respect to income from services presents serious administrative challenges for the tax

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[49] Brian J. Arnold, “The Taxation of Income from Services under Tax Treaties: Cleaning up the Mess – Expanded Version,” (online expanded version of article published in (February 2011) Vol. 65, No. 2 *Bulletin for International Taxation*).

[50] As a general rule, the provisions of the UN and OECD Model Conventions restrict the right of the source country to tax income from services to services performed in the source country. Article 16 is an exception to this general rule.

authorities of source countries, especially developing countries. For practical reasons, some countries have decided to use withholding to collect tax from nonresident service providers.[51] In general, residents paying independent nonresident service providers are required to withhold a specified percentage of the gross amount paid. The nonresident service provider is then required to file a return on a net basis and claim a refund for any excess tax withheld. Since nonresident service providers are taxable only if they have a permanent establishment or fixed base in the source country, some countries provide a system of waivers to allow nonresidents to apply to the tax authorities in advance of any payments for an exemption from withholding. Such a system requires the tax authorities to have sufficient information to decide whether a nonresident service provider has a permanent establishment or fixed base in the source country.

7.3.4 Investment Income

The treatment of investment income derived from the source country by a resident of the other contracting state under the provisions of the UN and OECD Model Conventions depends on the nature of the income. Dividends, interest, royalties, rental income from immovable property, and capital gains are all dealt with in different articles and in different ways. As with business profits and income from services, a detailed discussion of the application of the provisions of the treaty to investments is well beyond the scope of this overview. The purpose of the brief discussion here is to show the range of application issues concerning investment income that a source country must deal with. A detailed discussion of these issues is found in the paper in this collection dealing with investment income.

With respect to dividends and interest under both Model Conventions, and royalties under the UN Model Convention, the rate of source-country tax on amounts paid by a resident of the source country to a resident of the other country is limited. The other provisions dealing with investment income do not impose any limits on source-country tax with respect to either the tax base or the rate. Most source countries use withholding taxes imposed on the gross amount paid at a flat rate to collect the tax on dividends, interest, royalties, and rent from immovable property. Some countries also use a withholding mechanism for capital gains realized by nonresidents, as discussed below.

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51 Such a withholding regime may not be effective if the nonresident service provider is paid by another nonresident. In this situation, the payer is not subject to the jurisdiction of the source country unless perhaps it has a permanent establishment or a fixed place of business in the source country.

None of the provisions of the UN and OECD Model Conventions restricts the manner in which source-country tax is levied on investment income.

In general, the following steps are necessary to apply the treaty to investment income derived in the source country by a resident of the other contracting state:

- The nonresident recipient of the payment must be identified.
- The residence of the recipient of the payment must be determined in order to establish which treaty is relevant and whether the recipient is entitled to the benefits of the treaty.
- The character of the payment must be determined so that the relevant article of the treaty can be applied.
- In the case of dividends, interest, and royalties, it must be determined whether the recipient is the beneficial owner of the payment.
- The method for collecting the tax must be adopted.

As noted, in most cases source countries use withholding taxes to collect tax on nonresidents deriving investment income. Further in most cases the withholding tax is imposed as a final tax, with the result that the responsibility for the four steps outlined above to apply the treaty is placed on the person making the payment to the nonresident. The issues involved in balancing the compliance burden on the withholding agent and the delivery of treaty benefits in an efficient manner with integrity are discussed in section 4.4 above.

The provisions of Article 13 of both the UN and OECD Model Conventions dealing with capital gains present several difficult application issues. In general terms, the source country is entitled to tax capital gains from the alienation of immovable property located in the source country, the movable property of a permanent establishment or fixed base in the source country, shares of a company and interests in a partnership, trust, or estate if the assets consist principally of immovable property located in the source country.[52] Other capital gains are taxable exclusively in the residence country.[53]

The application of the provisions of Article 13 involves many of the same issues involved in applying the treaty provisions dealing with business profits, income from services, and investment (for example, the necessity to establish the residence of the taxpayer). These issues are not repeated here. The source country must obtain information necessary to calculate the amount of the gain: the cost of the property, the proceeds of the sale, and the costs incurred in connection with the sale. These amounts may require conversion from a foreign currency into the domestic currency of the source country. Finally, the collection of the tax on a capital gain realized by a resident of the other contracting state poses special problems. An obligation to withhold an amount from the purchase price on account of the estimated tax on the capital gain can be imposed on the purchaser. However, such an obligation may be difficult to enforce if the purchaser is not resident in the source country.

The enforcement problem is limited with respect to capital gains because under Article 13 the source country is given the right to tax capital gains in respect of property that, with the exception of substantial interests under the UN Model Convention, is physically located in the source country. Consequently, the tax authorities of the source country should be able to take effective enforcement action with respect to any tax payable by a nonresident against the property located in the source country.

8. Abuse of Tax Treaties and the Relationship between Tax Treaties and Domestic Law

The provisions of tax treaties can be used in a wide variety of ways to avoid tax.[54] It is important for countries to protect their domestic tax bases from abuse through the improper use of tax treaties. This is a challenging task, especially in light of the general principle that the provisions of a tax treaty generally prevail over the provisions of domestic law in the event of a conflict.

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[52] Capital gains from the alienation of ships or aircraft operated in international traffic and boats engaged in inland waterways transport and associated movable property are taxable exclusively by the country in which the alienator has its place of effective management: Article 13(3). Under Article 13(5) of the UN Model Convention, the source country is also entitled to tax gains from the alienation of substantial interests in a company resident in the source country.

[53] Article 13(5) of the OECD Model Convention and Article 13(6) of the UN Model Convention.

[54] See the Commentary on Article 1 of the UN Model Convention, paragraphs 40-99, for a description of several of the common treaty abuses.

According to the Commentary on Article 1 of both the UN and OECD Model Conventions, several techniques are available to prevent tax avoidance through the misuse of tax treaties. These techniques include specific and general anti-avoidance rules in domestic law, specific and general anti-avoidance rules in tax treaties, and the interpretation of tax treaties.[55] The provisions of the UN and OECD Models contain a few provisions that might be considered to be specific anti-avoidance rules: for example, the beneficial-owner concept in Articles 10, 11 and 12, the special-relationship rules in Articles 11(6) and 12(6), the taxation of capital gains on shares of land-rich companies, and Article 17(2) dealing with the diversion of income to so-called star companies. Countries may consider the inclusion of additional specific anti-avoidance rules in their bilateral tax treaties. However, the Commentary on the UN Model Convention cautions countries about relying exclusively on specific rules to deal with the problem of treaty abuse.[56]

With respect to the use of domestic anti-avoidance rules to prevent the abuse of tax treaties, countries need to ensure first, that such domestic rules are effective and second, that their application to tax treaty abuses is not prevented by the general principle that tax treaties prevail over domestic law. The second issue can be dealt with in a variety of ways, depending on the circumstances of each case. As the Commentary indicates, sometimes treaties contain provisions expressly allowing the application of domestic anti-avoidance rules such as controlled foreign corporation and thin capitalization rules. In other situations, the treaty uses undefined terms, which require the application of domestic law, including domestic anti-avoidance rules. Finally, the provisions of the treaty can be interpreted so as not to prevent the application of domestic anti-avoidance rules. Thus, for domestic general anti-avoidance rules, whether judicial or legislative in nature, there should be no conflict with the provisions of a tax treaty as long as the domestic rule is restricted to cases of abuse. The critical issue in this regard is, what is an abuse of a tax treaty? The Commentary on Article 1 of both the UN and OECD Model Conventions provides a general test or guiding principle of treaty abuse:

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

[55] Paragraphs 10-39 of the Commentary on Article 1 of the UN Model Convention and paragraphs 7-26 of the Commentary on Article 1 of the OECD Model Convention.

[56] Paragraph 33 of the Commentary on Article 1 of the UN Model Convention.

> favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.[57]

Although this principle is broad and general, it provides useful guidance for taxpayers and tax authorities. As the Commentary on Article 1 of the UN Model indicates:

> The members of the Committee endorse that principle. They considered that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers. Clearly, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.[58]

The Commentary on Article 1 of the UN Model provides a discussion of the advantages and disadvantages of including a general anti-abuse rule in the treaty.[59] Any such rule should be applied in accordance with the general principle outlined above as to what constitutes an abuse of a tax treaty.

Some treaty abuses can be prevented by interpreting the provisions of the treaty in accordance with their purpose and the good-faith requirement as set out in Article 31(1) of the Vienna Convention on the Law of Treaties.[60] This interpretive approach to controlling treaty abuse should also conform to the guiding principle in the Commentary on Article 1 as to what constitutes treaty abuse.[61]

The guidance in the Commentary concerning treaty abuse was extensively revised in 2011 for the UN Model Convention and in 2003 for the OECD Model Convention. Consequently, there is a serious issue as to the relevance and weight of the revised Commentary for the interpretation of tax treaties entered into before the respective Commentaries on Article 1 of the UN and OECD Models

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57 Paragraph 9.5 of the Commentary on Article 1 of the OECD Model Convention and paragraph 23 of the Commentary on Article 1 of the UN Model Convention, quoting paragraph 9.5 of the Commentary on Article 1 of the UN Model Convention.

58 Paragraph 24 of the Commentary on Article 1 of the UN Model Convention.

59 Paragraphs 34-37 of the Commentary on Article 1 of the UN Model Convention.

60 Paragraph 38 of the Commentary on Article 1 of the UN Model Convention.

61 Paragraph 39 of the Commentary on Article 1 of the UN Model Convention.

were revised. The Introduction to the OECD Model indicates expressly that subsequent versions of the Commentary should be taken into account for purposes of interpreting tax treaties previously entered into.[62] Some commentators have expressed a contrary view. Ultimately, this issue may be resolved by a country's courts. Nevertheless, the tax authorities should be aware of this issue, especially in connection with the issue of abuse of tax treaties.

In general, the tax authorities of a country should apply the provisions of its tax treaties to prevent tax avoidance and evasion. This requires a careful consideration of the inclusion of anti-abuse rules in tax treaties and the adoption of domestic anti-avoidance rules that can be applied to treaty abuses. However, in addition to ensuring that the appropriate anti-avoidance rules are in place, the tax authorities must have the capacity to interpret, apply and enforce those rules with respect to treaty abuses. In this regard, developing countries face the challenge of balancing the need to provide foreign investors with certainty in order to attract investment with the need to protect the tax base.[63] To execute this difficult balancing act properly, the tax authorities must have the necessary expertise to apply complex anti-avoidance rules, such as transfer pricing rules, to sophisticated tax avoidance transactions. The development of such expertise within the tax departments of developing countries through experience and training should be a priority.

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[62] Paragraphs 33-34 of the Introduction to the OECD Model Convention.

[63] Paragraphs 100-103 of the Commentary on Article 1 of the UN Model Convention. As noted above, one method of providing a measure of certainty to taxpayers with respect to the possible application of anti-abuse rules is through an advance rulings process.