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Article 23

Article 23 A and 23 B of the UN Model – Conflicts of qualification and interpretation

As agreed at the Ninth Annual Session of the Committee of Experts on International Cooperation in Tax Matters, this paper was prepared by Claudine Devillet for consideration and discussion at the Tenth Annual Session.

I. Introduction

1. During the seventh session of the Committee, the central issue was the 2011 update of the United Nations Model Convention (UN Model). In this respect, it was agreed that issues that could not be addressed in the course of that session would be excluded from the 2011 update and included in a catalogue of items for future discussion and possible inclusion in later updates. This was the case for the issue of conflicts of qualification. Conflicts of qualification are dealt with under paragraphs 32.1 to 32.7 of the Commentary on Articles 23A and 23B of the OECD Model Convention (OECD Model). Due to diverging views and lack of time, in quoting the Commentary on Articles 23A and 23B of the OECD Model, these paragraphs have been omitted as not being applicable to the interpretation of the UN Model.

2. During the seventh session of the Committee, a note (E/C.18/2011/CRP.2/Add.3) had been prepared by Claudine Devillet on the possible inclusion of paragraph 4 of Article 23A of the OECD Model on conflicts of interpretation in Article 23A of the UN Model. Due to diverging views, it was decided to address the matter in the Commentary and not to include paragraph 4 in the Article itself. The issue is addressed in paragraph 19 which reads as follows:

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19. A State that generally adopts the exemption method may consider that such method should not apply where the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income or of capital falls under a provision of the Convention that does not allow that State to tax such income or capital while the State of residence adopts a different interpretation under which such income or capital falls under a provision of the Convention that allows the State of source to tax. This may not be of concern to some States. But if it is, and in order to avoid unintended double non-taxation resulting from the diverging interpretations of the State of residence and the State of source, the following provision may be included in Article 23 A:

> *4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11, or 12 to such income; in the latter case, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2.*

Members of the Committee recognized that in a bilateral Convention between a "credit" country and "exemption" country, the decision whether to include such a provision would essentially lie with the exemption country; it would not be appropriate for the State of source to insist on double non-taxation arising in an arbitrary and unpredictable manner. If necessary the provision could be made unilateral and not reciprocal.

3. The issues of conflicts of qualification (paragraphs 32.1 to 32.7 of the Commentary on Articles 23A and 23B of the OECD Model) and conflicts of interpretation (paragraph 4 of Article 23A of the OECD Model) are closely linked. They have arisen again during the eight session of the Committee as part of the climate change discussion, but they have a potentially wider significance, especially in relation to actions 6 and 14 of the BEPS Action Plan which aims at eliminating opportunities for non-taxation or reduced taxation through tax evasion and avoidance and at eliminating double taxation that may result from the actions to counter BEPS.

II. Conflicts of qualifications

4. Under paragraph 2 of Article 3 any term no defined therein has the meaning it has under the domestic law of the State applying the treaty (the source State where Articles 6 to 21 are applied to a particular item of income and the residence State where Article 23 is applied to the same item of income) unless the context otherwise requires. Taking into consideration the diverging law systems of the source State and the residence State, those States may classify a same item of income differently. One country may classify it in a category which is taxable in the source State according to the treaty and the other in a category which is not taxable in the source State according to the treaty. For this reason, paragraphs 32.1 to 32.7 of the Commentary clarify the interpretation of the provisions of Articles 23A (Exemption Method) and 23B (Credit Method) and provide solutions for these conflicts of qualification. Taking into consideration the phrase *"in accordance with the provisions of this Convention, may be taxed in the other Contracting State"*, the OECD

Commentary gives precedence to the qualification under the domestic law of the State of source.

5. Where the source State has taxed an item of income in accordance with paragraph 2 of Article 3, Articles 6 to 21 and its domestic law, the residence State must eliminate double taxation by exempting the item of income or by crediting the tax levied by the source State. The residence State must eliminate double taxation even if, in accordance with its own domestic law qualification, the item of income would not be taxable in the source State and the residence State would have an exclusive right to tax in accordance with paragraph 2 of Article 3 and Articles 6 to 21 (see paragraphs 32.1 to 32.5 of the OECD Commentary). Conversely, where the source State has no right to tax such income in accordance with paragraph 2 of Article 3, Articles 6 to 21 and its domestic law, the residence State has no obligation to grant exemption for an item of income that is not taxable in the source State. The residence State has no such obligation even if, in accordance with its domestic law qualification, such income would be taxable in the source State in accordance with paragraph 2 of Article 3 and Articles 6 to 21 (see paragraphs 32.6 and 32.7 of the OECD Commentary). Paragraph 32.6 is only applicable to the extent that the State of source "applies the provisions of this Convention" to exempt an item of income or of capital. It is not applicable to cases where, absent any conflict of qualification, the Convention gives a right to tax to the State of source but that State, pursuant to its domestic law, does not exercise this right.

6. The solutions provided by paragraphs 32.1 to 32.7 of the OECD Commentary ensures that any double taxation or non-taxation resulting from the diverging law systems of the source State and the residence State is eliminated. They do not apply where the context of the treaty requires that another meaning is given to a term used in treaty than the meaning under the domestic laws of the Contracting States.

7. The OECD Report on the Application of the OECD Model Tax Convention to partnerships contains the following analysis of the application of tax conventions in cases of conflicts of qualification:

> *102. The Committee agreed that, in addressing conflicts of qualification problems faced by the State of residence, a useful starting point is the recognition of the principle that the domestic law of the State applying its tax governs all matters regarding how and in the hands of whom an item of income is taxed. The effect of tax conventions can only be to limit or eliminate the taxing rights of the Contracting States. In the case of the source State, the right to tax items of income is limited by provisions based on Articles 6 through 21 of the Model Tax Convention. In the case of the residence State, while provisions based on Articles such as 8 and 19 might be relevant, the primary restriction would arise from the provisions of the Article on Elimination of Double Taxation (Article 23 in the Model Tax Convention), by which the residence State agrees to either exempt income that the source State may tax under the Convention or to give a credit for the tax levied by the source State on that item of income.*
>
> *103. When taxing an item of income, the source State therefore applies its domestic law, subject to the restrictions and limitations imposed on it by the provisions of its tax conventions. The way that the State of residence qualifies an item of income for*

treaty purposes has no relevance on how and in the hands of whom the State of source taxes that item of income. The reverse, however, is not true. The way the State of residence eliminates double taxation will depend, to some extent, on how the Convention has been applied by the State of source.

104. The wording of Article 23 of the OECD Model Tax Convention is crucial in that respect. That article requires that relief be granted, either through the exemption or credit system, where an item of income may be taxed "in accordance with the provisions of the Convention". Thus, the State of residence has a treaty obligation to apply the exemption or credit method vis-à-vis any item of income where the tax convention authorizes taxation of that item of income by the State of source.

105. The meaning of the phrase "in accordance with the provisions of this Convention, may be taxed" needs to be clarified in that respect. Where, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income, provisions of the Convention that are different from those that the State of residence would have applied to the same item of income, the income is still being taxed in accordance with the provisions of the Convention, in this case as interpreted by the State of source. In such a case, therefore, Article 23 requires that relief from double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.

[…]

109. In other situations, however, the phrase "in accordance with the provisions of this Convention, may be taxed" needs to be interpreted in relation to possible cases of double non-taxation involving residence States that follow the exemption method. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income which it would otherwise have taxed, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to tax that income if it had been the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.

[…]

111. Such cases should not be confused with cases where the provisions of a Convention grant to the source State the right to tax an item of income but that item of income is not taxed under the domestic law of the State of source. In such cases, the State of residence must still exempt that item of income under the provisions of paragraph 1 of Article 23 A (cf. paragraph 34 of the Commentary on Article 23).

III. Conflicts of interpretation

8. Paragraph 4 of Article 23A (Exemption method) was added to the OECD Model in 2000 and gives the residence State the right to switch from the exemption method to the credit method where different interpretations of the Convention lead to double non-taxation or to the imposition of low taxes on dividends and interest because of Articles 10(2) or 11(2) of the OECD Model. Paragraph 4 applies where the source State interprets the facts of a case or the provisions of the Convention in such a way that an item of income or capital falls under a provision of the Convention that does not allow the source State to tax such income or capital while the residence State adopts a different interpretation under which such income or capital falls under a provision of the Convention that allows the source State to tax.

9. The following examples illustrate the issue:

Example 1

An employer terminates the employment of several of its employees who are residents of State A and have been working in State B for three years. He gives those employees an advance notice of termination of three months. He prefers that the employees stop working immediately rather than work during the period of three months covered by the notice. The remuneration for that period is paid in the form of a payment "in lieu" of notice.

Under the domestic law of State B, a payment "in lieu" of notice of termination is a taxable remuneration. A final court decision in State B considers, however, that such payments should be taxable only in State A (the State of residence of the employees) because they cannot relate to activities exercised within State B (application of the first sentence of Article 15(1)). The constant jurisprudence of State A considers, on the other hand, that a payment "in lieu" of notice of termination is made in consideration of the employment exercised when the notice of termination is given to the employee (application of the second sentence of Article 15(1)). According to that jurisprudence, the payment is therefore taxable in State B and State A must exempt the payment under Article 23A(1).

In the absence of Article 23A(4), a payment "in lieu" of notice of termination, which is taxable under the domestic law of both Contracting States, is not taxed in any of the Contracting States. Article 23A(4) avoids such double non taxation by allowing the residence State not to apply paragraph 1.

If State A applies Article 23B, no double non taxation will occur as there will be no foreign tax to credit.

Example 2

An enterprise of State A, Subcontractor SA, works consecutively on 7 different building sites within State B. Those building sites do not constitute connected

projects. The activities of Subcontractor SA on each site last less than 6 months but its overall activities on all 7 sites in State B last 14 months. Under Article 5 of the treaty between State A and State B, a building site constitutes a PE only if it lasts more than 6 months.

State A considers that a series of consecutive short-term sites operated by a single contractor would give rise to the existence of a PE in State B and, therefore, that the profits attributable to those sites are taxable in State B. Following Article 23A(1) State A has the obligation to exempt the said profits.

On the other hand, State B follows paragraph [18] of the OECD Commentary on Article 5, which is quoted under paragraph 11 of the UN Model, and considers that the profits relating to the activities exercised by Subcontractor SA on its territory are not attributable to a PE situated on its territory and are therefore not taxable therein.

In the absence of Article 23A(4), business profits, even though taxable under the domestic law of both Contracting States, are not taxed in any Contracting State. Article 23A(4) avoids such double non taxation by allowing the residence State not to apply paragraph 1.

If State A applies Article 23B, there will be no double non taxation as there will be no foreign tax to credit.

10. The rules provided for by paragraph 4 are only applicable to the extent that the source State applies the provisions of the Convention either to exempt an item of income or to restrict its right to tax under paragraph 2 of Article 10, paragraph 2 of Article 11 or paragraph 2 of 12 of the UN Model. Paragraph 4 does not apply in cases where the Convention gives an unlimited right of taxation to the source State but that State does not exercise this right pursuant to its domestic law.

11. Paragraph 56.3 of the OECD Commentary clarifies that paragraph 1 of Article 23A does not impose an obligation on the residence State to give exemption in cases of conflicts of qualification and that, therefore, paragraph 4 is not necessary to eliminate double exemption in those cases. The residence State could, however, have an obligation to give exemption under paragraph 1 in cases of conflict of qualification if that State does not agree with the OECD Commentary on conflicts of qualification (e.g. because its tax courts do not follow the OECD Commentary in this respect). In such situations, paragraph 4 also ensures that the residence State is not obliged to exempt the relevant income in cases of conflicts of qualification.

12. Paragraph 4 allows the residence State not to apply paragraph 1 of Article 23A in cases where the difference of views is not solved through the mutual agreement procedure (which the taxpayer is unlikely to initiate under Article 25(1) as he benefits from the non-taxation). However, would the residence State apply paragraph 4 unduly in a case where the source State does not tax an item of income because it is not taxable under its domestic law, the taxpayer may trigger the mutual agreement procedure.

13. IFA 2004 General Report on double non-taxation notes that, under different provisions agreed in treaties, exemption depends on whether the source State actually levies

taxes. In several treaties, the provisions apply to certain types of income while in other treaties they apply in a general manner. Most countries continue, generally, to use those provisions, which can have a more extended scope than paragraph 4, instead of including paragraph 4 in their tax treaties. Moreover, paragraph 4 will not be included in a treaty when both Contracting States apply the credit method.

IV. Action Plan on Base Erosion and Profit Shifting (BEPS Action Plan)

14. As a result of work undertaken as part of Action 6 (Prevent treaty abuse) of the BEPS Action Plan, the Committee of Fiscal Affairs of the OECD decided in particular in June 2014 that countries should include in their tax treaties an express statement that their common intention is to eliminate double taxation without creating opportunities for non-taxation or reduced taxation through tax evasion and avoidance. Consequently, changes to the title and the preamble of the OECD Model were decided to recognize that the purposes of a tax treaty are not limited to the elimination of double taxation and that the Contracting States do not intend the provisions of a tax treaty to create opportunities for non-taxation or reduced taxation through tax evasion and avoidance. Consequently, the avoidance of unintended non-taxation due to the differences in the domestic law or in the interpretation of tax treaty provisions between the Contracting States is clearly part of the objectives of tax treaties and the elimination of opportunities creating such unintended non-taxation should be favoured by the UN Model.

15. Double non-taxation may be perfectly in line with the object and purpose of tax treaties when the source State, which has the right to tax an item of income according to the treaty provisions, does not exercise this right for domestic reasons (e. i. because the income is non-taxable or expressly exempted from tax under its domestic law) and the residence State is obliged under paragraph 1 of Article 23A to exempt such income. One of the objectives of the exemption method is indeed to ensure neutral competition between local and foreign enterprises in the source State. If the source State does not tax a certain item of income under its domestic law, then the residents of the other Contracting State who work or invest in the source State will enjoy the same benefit as their competitors that are residents of that State and operate therein. This is a policy issue which is to be decided by each country and is not dealt with under paragraphs 32.6 and 32.7 of the OECD Commentary or under paragraph 4 of Article 23A of the OECD Model. The UN Commentary should clearly distinguish this policy issue from the cases of conflicts of qualification or interpretation resulting in non-taxation.

16. Action 14 (Make Dispute Resolution mechanisms more effective) of the BEPS Action Plan recognizes that the interpretation and application of new rules resulting from the actions to counter BEPS (including new domestic law provisions) could introduce elements of uncertainty that should be minimized as much as possible through the improvement of dispute resolution mechanisms, in particular, to avoid double taxation. Where double taxation result from a conflict of qualification and the interpretative rule provided for under paragraphs 32.1 to 32.5 is not followed, such double taxation cannot be solved under paragraphs 1 and 2 of Article 25 (Mutual Agreement Procedure) as the action of the source State would result in taxation in accordance with the with Articles 6 to 21and the action of the residence State would result in exclusive taxation in accordance with in accordance with Articles 6 to 21 and Article 23A or 23B. In this situation, the interpretative rule of Article

23A and 23B provided for under paragraphs 32.1 to 32.5 allows the resolution of mismatches and disputes resulting from conflicts of qualification.

V. Proposals

17. In case of divergences of qualification under the domestic laws of the Contracting States, the tax treaty may fail to eliminate double taxation or may create non-taxation. In these situations, each Contracting State is applying the treaty provisions properly in accordance with its domestic law characterizations. In order to eliminate double taxation or non-taxation in these situations, the Committee is recommended to agree to incorporate paragraphs 32.1 to 32.7 of the Commentary on Articles 23A and 23B of the OECD Model in the Commentary on Article 23 of the UN Model.

18. In case of divergences of interpretation of the treaty provisions between the Contracting states, the tax treaty may fail to eliminate double taxation or may create non-taxation. The mutual agreement procedure organised under Article 25 may eliminate double taxation by redressing actions resulting in taxation not in accordance with the tax treaty. Where a tax treaty does not contain a provision similar to paragraph 4 of Article 23A of the OECD Model, a Contracting State that applies the exemption method must exempt an item of income that it considers taxable in the other State in accordance with the treaty even if that item of income is not taxed in the source State for whatever reason (e.g. because the other State considers that it may not tax the item of income under the tax treaty). Article 23A of the UN Model should provide a rule under which the residence state shall not exempt an item of income or of capital where a divergence of interpretation would result in non-taxation. The Committee is therefore recommended to include in Article 23A of the UN Model the alternative provision proposed under paragraph 19 of the UN Commentary on Article 23:

> *"4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11 or 12 to such income; in the latter case, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2."*

19. Paragraph 4 would also apply where the source State interprets the facts of a case or the provisions of the Convention in such a way that an item of income falls under the provisions of paragraph 2 of Article 10, 11 or 12, which provides for limited taxation in the source State while the residence State adopts a different interpretation and considers that such income falls under a provision of the Convention that provides for unlimited taxation in the source State. The last sentence of paragraph 4, which is not found in the OECD Model, has been added for the sake of certainty in order to make explicit that in such case the residence State will apply paragraph 2 of Article 23A and give a credit for the tax levied in the source State.

20. Where the source State applies the provisions of paragraph 2 of Article 10, 11 or 12 to an item of income, some countries may prefer not to deny the application of the provisions of paragraph 1 despite the fact that the source State must limit its tax on such income. The Commentary on paragraph 4 would allow those countries to limit the scope of paragraph 4 to cases where the source State applies the provisions of the Convention to exempt an item of

income or capital from tax and to delete the part of paragraph 4 dealing with Articles 10, 11 and 12.

Proposed Changes to the UN Model

Paragraph 4 of Article 23 A

"4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11 or 12 to such income; in the latter case, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2."

Commentary on paragraph 1 (E. Conflicts of qualification) and paragraph 4 of Article 23 A

14. The following extracts from the Commentary on Article 23A and 23B of the OECD Mode Convention are applicable to Articles 23A and 23B (the additional comments that appear between square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the provisions of the OECD Model Convention and those of this Model and also to specify the applicable paragraph/subparagraph of this Model):

[…]

E. Conflicts of qualification

32.1 Both Articles 23 A and 23 B require that relief be granted, through the exemption or credit method, as the case may be, where an item of income or capital may be taxed by the State of source in accordance with the provisions of the Convention. Thus, the State of residence has the obligation to apply the exemption or credit method in relation to an item of income or capital where the Convention authorises taxation of that item by the State of source.

32.2 The interpretation of the phrase "in accordance with the provisions of this Convention, may be taxed", which is used in both Articles, is particularly important when dealing with cases where the State of residence and the State of source classify the same item of income or capital differently for purposes of the provisions of the Convention.

32.3 Different situations need to be considered in that respect. Where, due to differences in the domestic law between the State of source and the State of residence, the former applies, with respect to a particular item of income or capital, provisions of the Convention that are different from those that the State of residence would have applied to the same item of income or capital, the income is still being taxed in accordance with the provisions of the Convention, as interpreted and applied by the State of source. In such a case, therefore, the two Articles require that relief from

double taxation be granted by the State of residence notwithstanding the conflict of qualification resulting from these differences in domestic law.

32.4 This point may be illustrated by the following example. A business is carried on through a permanent establishment in State E by a partnership established in that State. A partner, resident in State R, alienates his interest in that partnership. State E treats the partnership as fiscally transparent whereas State R treats it as taxable entity. State E therefore considers that the alienation of the interest in the partnership is, for the purposes of its Convention with State R, an alienation by the partner of the underlying assets of the business carried on by the partnership, which may be taxed by that State in accordance with paragraph 1 or 2 of Article 13. State R, as it treats the partnership as a taxable entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which could not be taxed by State E by reason of paragraph 5 of Article 13. In such a case, the conflict of qualification results exclusively from the different treatment of partnerships in the domestic laws of the two States and State E must be considered by State R to have taxed the gain from the alienation "in accordance with the provisions of the Convention" for purposes of the application of Article 23 A or Article 23 B. State R must therefore grant an exemption pursuant to Article 23 A or give a credit pursuant to Article 23 B irrespective of the fact that, under its own domestic law, it treats the alienation gain as income from the disposition of shares in a corporate entity and that, if State E's qualification of the income were consistent with that of State R, State R would not have to give relief under Article 23 A or Article 23 B. No double taxation will therefore arise in such a case.

32.5 Article 23 A and Article 23 B, however, do not require that the State of residence eliminate double taxation in all cases where the State of source has imposed its tax by applying to an item of income a provision of the Convention that is different from that which the State of residence considers to be applicable. For instance, in the example above, if, for purposes of applying paragraph 2 of Article 13, State E considers that the partnership carried on business through a fixed place of business but State R considers that paragraph 5 applies because the partnership did not have a fixed place of business in State E, there is actually a dispute as to whether State E has taxed the income in accordance with the provisions of the Convention. The same may be said if State E, when applying paragraph 2 of Article 13, interprets the phrase "forming part of the business property" so as to include certain assets which would not fall within the meaning of that phrase according to the interpretation given to it by State R. Such conflicts resulting from different interpretation of facts or different interpretation of the provisions of the Convention must be distinguished from the conflicts of qualification described in the above paragraph where the divergence is based not on different interpretations of the provisions of the Convention but on different provisions of domestic law. In the former case, State R can argue that State E has not imposed its tax in accordance with the provisions of the Convention if it has applied its tax based on what State R considers to be a wrong interpretation of the facts or a wrong interpretation of the Convention. States should use the provisions of Article 25 (Mutual Agreement Procedure), and in particular paragraph 3 thereof, in order to resolve this type of conflict in cases that would otherwise result in unrelieved double taxation.

> 32.6 The phrase "in accordance with the provisions of this Convention, may be taxed" must also be interpreted in relation to possible cases of double non-taxation that can arise under Article 23 A. Where the State of source considers that the provisions of the Convention preclude it from taxing an item of income or capital which it would otherwise have had the right to tax, the State of residence should, for purposes of applying paragraph 1 of Article 23 A, consider that the item of income may not be taxed by the State of source in accordance with the provisions of the Convention, even though the State of residence would have applied the Convention differently so as to have the right to tax that income if it had been in the position of the State of source. Thus the State of residence is not required by paragraph 1 to exempt the item of income, a result which is consistent with the basic function of Article 23 which is to eliminate double taxation.

Paragraph 32.6 is only applicable to the extent that the State of source "applies the provisions of this Convention" to exempt an item of income or of capital. Clearly, therefore, paragraph 32.6 is not applicable to cases where, absent any conflict of qualification, the Convention gives a right to tax to the State of source but that State, pursuant to its domestic law, does not exercise this right. For example, where a Developing country grants special tax incentives designed to promote economic development for specific items of income. In such cases, the State of residence must still exempt the items of income under the provisions of paragraph 1 of Article 23 A (cf. quoted paragraph 34 of the OECD Commentary on Article 23).

> 32.7 This situation may be illustrated by reference to a variation of the example described above. A business is carried on through a fixed place of business in State E by a partnership established in that State and a partner, resident in State R, alienates his interest in that partnership. Changing the facts of the example, however, it is now assumed that State E treats the partnership as a taxable entity whereas State R treats it as fiscally transparent; it is further assumed that State R is a State that applies the exemption method. State E, as it treats the partnership as a corporate entity, considers that the alienation of the interest in the partnership is akin to the alienation of a share in a company, which it cannot tax by reason of paragraph 5 of Article 13. State R, on the other hand, considers that the alienation of the interest in the partnership should have been taxable by State E as an alienation by the partner of the underlying assets of the business carried on by the partnership to which paragraphs 1 or 2 of Article 13 would have been applicable. In determining whether it has the obligation to exempt the income under paragraph 1 of Article 23 A, State R should nonetheless consider that, given the way that the provisions of the Convention apply in conjunction with the domestic law of State E, that State may not tax the income in accordance with the provisions of the Convention. State R is thus under no obligation to exempt the income.

[…]

Paragraph 4

16.1 The Committee considers that the following Commentary on paragraph 4 of Article 23 A of the OECD Model Convention (as it read on 22 October 2010) is applicable to paragraph 4 (the additional comments that appear in italics between square brackets, which are not part of

the Commentary on the OECD Model, have been inserted in order to reflect the fact that paragraph 4 also applies where the State of source applies the provisions of paragraph 2 of Article 12 to an item of income):

> 56.1 The purpose of this paragraph is to avoid double non taxation as a result of disagreements between the State of residence and the State of source on the facts of a case or on the interpretation of the provisions of the Convention. The paragraph applies where, on the one hand, the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income or capital falls under a provision of the Convention that eliminates its right to tax that item or limits the tax that it can impose while, on the other hand, the State of residence adopts a different interpretation of the facts or of the provisions of the Convention and thus considers that the item may be taxed in the State of source in accordance with the Convention, which, absent this paragraph, would lead to an obligation for the State of residence to give exemption under the provisions of paragraph 1.
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> 56.2 The paragraph only applies to the extent that the State of source has applied the provisions of the Convention to exempt an item of income or capital or has applied the provisions of paragraph 2 of Article 10, *[…]* 11 *[or 12]* to an item of income. The paragraph would therefore not apply where the State of source considers that it may tax an item of income or capital in accordance with the provisions of the Convention but where no tax is actually payable on such income or capital under the provisions of the domestic laws of the State of source. In such a case, the State of residence must exempt that item of income under the provisions of paragraph 1 because the exemption in the State of source does not result from the application of the provisions of the Convention but, rather, from the domestic law of the State of source (see paragraph 34 above). Similarly, where the source and residence States disagree not only with respect to the qualification of the income but also with respect to the amount of such income, paragraph 4 applies only to that part of the income that the State of source exempts from tax through the application of the Convention or to which that State applies paragraph 2 of Article 10, *[…]* 11 *[or 12]*.
>
> 56.3 Cases where the paragraph applies must be distinguished from cases where the qualification of an item of income under the domestic law of the State of source interacts with the provisions of the Convention to preclude that State from taxing an item of income or capital in circumstances where the qualification of that item under the domestic law of the State of residence would not have had the same result. In such a case, which is discussed in paragraphs 32.6 and 32.7 above, paragraph 1 does not impose an obligation on the State of residence to give exemption because the item of income may not be taxed in the State of source in accordance with the Convention. Since paragraph 1 does not apply, the provisions of paragraph 4 are not required in such a case to ensure the taxation right of the State of residence.

16.2 Paragraph 4 applies where the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income or capital falls under a provision of the Convention that does not allow the State of source to tax the item while the State of residence adopts a different interpretation under which the item falls under a provision of the Convention that allows the State of source to tax the item. For example, on the one hand, the State of source considers that services performed by an enterprise of the

State of residence through employees are not performed, for the same or a connected project, within its territory for more than 183 days within a twelve-month period and, therefore, considers that, according to Articles 5 and 7, it may not tax the income attributable to those services. On the other hand, the State of residence of the enterprise considers that those services are performed, for the same or a connected project, during more than 183 days in the State of source. The State of residence considers therefore that the income attributable to those services is taxable in the State of source in accordance with Articles 5 and 7. In the absence of paragraph 4, the State of residence should, according to its interpretation of the Convention, exempt the income attributable to those services according to paragraph 1. In such case, to the extent that the difference of views is not solved through the mutual agreement procedure (which the taxpayer is unlikely to initiate as he benefits from this difference of views which results in non-taxation), paragraph 4 allows the State of residence not to apply paragraph 1 thereby avoiding double non taxation.

16.3 Paragraph 4 is only applicable to the extent that the State of source "applies the provisions of this Convention" to either exempt an item of income or to restrict its right to tax under paragraphs 2 of Articles 10, 11 or 12. Clearly, therefore, paragraph 4 will not apply to cases where the Convention gives an unlimited right to tax to the State of source but that State, pursuant to its domestic law, does not exercise this right. For example, both Contracting States consider that services are performed, for the same or a connected project, during more than 183 days in the State of source and the income attributable to those services is taxable in the State of source in accordance with Articles 5 and 7. Under the domestic law of the State of source, however, non-residents are only taxable on profits attributable to a permanent establishment situated in the State and no tax is therefore payable on the income. In such a case, the State of source cannot be said to have applied the provisions of the Convention to exempt the income since these provisions clearly provide that the income may be taxed by that State. Paragraph 4 therefore does not apply and the State of residence must exempt the income according to paragraph 1.

16.4 Paragraph 4 also applies where the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income falls under the provisions of paragraph 2 of Article 10, 11 or 12 that provides for limited taxation in the State of source while the State of residence adopts a different interpretation and considers that the item falls under a provision of the Convention that allows the State of source to tax the item without any limitation. For example, on the one hand, the State of source considers that royalties paid by one of its resident and beneficially owned by a resident of the other Contracting State are taxable at the limited rate provided for in paragraph 2 of Article 12. On the other hand, the State of residence of the beneficial owner considers that the right in respect of which the royalties are paid is effectively connected with a permanent establishment situated in the State of source through which the beneficial owner carries on business. The State of residence considers therefore that the royalties are taxable in the State of source without any limitation in accordance with paragraph 4 of Article 12 and are exempted under the provisions of paragraph 1. In such case, to the extent that the difference of views is not solved through the mutual agreement procedure, paragraph 4 allows the State of residence not to apply paragraph 1.

16.5 Where the State of source applies the provisions of paragraph 2 of Article 10, 11 or 12, the State of residence, in order to eliminate double taxation, should grant a credit pursuant

to paragraph 2 of Articles 23 A. This should be the case even if the State of residence has interpreted the facts of the case or the provisions of the Convention in such a way that would result in the State of source having an unlimited right to tax the income under the convention, which would mean that the State of residence should normally exempt that income under the provisions of paragraph 1. Applying the credit method in that case is more efficient than trying to determine, pursuant to the mutual agreement procedure how the treaty requires that double taxation be relieved. The last part of paragraph 4, which is not found in the OECD Model, has been added for the sake of clarity in order to make that point explicit. In paragraph 2, some States may require a credit for taxes payable in the other Contracting State to be granted subject to the provisions of their domestic law regarding the allocation of a credit for foreign taxes but without affecting the general principle provided in such paragraph. Such wording would generally allow the application of the credit resulting from paragraph 4. However, where the reference to domestic law is not so limited, the Contracting States should verify during the negotiations that no inconsistency between the domestic law and the treaty rules exist that could prevent the granting of the credit (e.g. the domestic law of the State of residence may not provide for a credit for foreign taxes where an item of income is taxed under its domestic law as a business profit attributable to a permanent establishment and not as a royalty).

16.6 Where the State of source applies the provisions of paragraph 2 of Article 10, 11 or 12 to an income, some States may prefer not to deny the application of the provisions of paragraph 1 despite the fact that the State of source must limit its tax on such income. Those States may limit the scope of paragraph 4 to cases where the State of source applies the provisions of the Convention to exempt an income or capital from tax and delete the part dealing with Articles 10, 11 and 12.

16.7 The quoted paragraph 56.3 of the OECD Commentary clarifies that paragraph 1 does not impose an obligation on the State of residence to give exemption in cases of conflicts of qualification and that paragraph 4 is therefore not required to avoid double non-taxation in those cases. The State of residence could, however, have an obligation to give exemption under paragraph 1 in cases of conflict of qualification if that State did not agree with the interpretation given in the quoted paragraphs 32.6 and 32.7 of the OECD Commentary to the phrase “in accordance with the provisions of this Convention” in Article 23 or if the wording of paragraph 1 in the relevant bilateral Convention was different from that used in the Model Tax Convention and does not allow such interpretation. In such situations, paragraph 4 also ensures that the State of residence is not obliged to exempt the relevant income.

Paragraph 19 of the Commentary on Article 23 of the UN Model is deleted.

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