

PART TWO

**UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION
BETWEEN DEVELOPED AND DEVELOPING COUNTRIES**

PREFACE

1. In order to take advantage of the accumulated technical expertise embodied in the reports of the meetings of the Group of Experts and also the texts of different model conventions for the purpose of the negotiation of bilateral tax treaties between developed and developing countries, the Ad Hoc Group of Experts on International Cooperation in Tax Matters has basically used the United Nations Model Double Taxation Convention between Developed and Developing Countries as its main reference text.
2. The articles and the commentary thereon in the United Nations Model Convention formulated by the Group of Experts contain suggestions concerning specific provisions that could be embodied in a bilateral tax treaty. Each article, therefore, takes the form of a possible text of a treaty article. Furthermore, each article is followed by observations which summarize the relevant discussion in the Group of Experts, mention the decisions taken and indicate the manner in which the provisions of the article may be interpreted.
3. In some cases, it is stated that the article in the United Nations Model Convention reproduces a provision in the OECD Model Convention. This may indicate that the text of the article remains unchanged except for minor drafting changes. When the text of an article in the United Nations Model Convention reproduces the provisions of an article of the OECD Model Convention, it should be construed as having the same meaning and being subject to the same reservations as that article, and should be interpreted in the light of the OECD commentary in effect when the United Nations Model Convention was prepared, unless a contrary interpretation is indicated in the United Nations Model Convention commentary. Because the OECD Model Convention has continued to evolve over time, it may be advisable for the reader to refer to the articles and commentaries in the OECD Model Convention to ascertain the position at the relevant time.
4. Problems may arise in the case of terms used in the OECD Model Convention and the guidelines which are not defined either in the United Nations Model Convention or in the OECD Commentary and have not been classified by the Group of Experts. Participants from developing countries in the Meeting of the Drafting Committee for the 1980 edition of the United Nations Model Convention cited as examples of such terms “landed property”, “partnership”, “general commission agent”, “jouissance shares”, “jouissance rights”, “mining shares” and “industrial, commercial or scientific equipment”. It was mentioned, for instance, that in the Republic of Korea there was no legal concept of “landed property” distinct from the concept of immovable property and that the expression in the Korean language which was most similar to the English term “partnership” did not correspond to the concept of partnership as used in the United Nations Model Convention. It may be relevant to note that the OECD Committee on Fiscal Affairs adopted on 20 January 1999 the report of the Working Group entitled “The Application of the OECD Model Tax Convention to Partnerships”. The report deals with the application to partnerships of the provisions of the OECD Model Tax Convention and, indirectly, of bilateral tax conventions based on that model. The Committee recognizes, however, that many of the principles discussed in that report may also apply, *mutatis mutandis*, to other non-corporate entities. Pending definition of such terms by the Group of Experts, the negotiating parties should endeavour to reach mutually acceptable definitions.

5. The articles in the United Nations Model Convention are not intended as a substitute for negotiations. They are not to be construed as binding provisions or as formal recommendations of the United Nations or as representing either the maximum or minimum concession that either potential contracting party should grant or demand in the give-and-take of the negotiating process. In preparing its own negotiating strategy, a participating country may wish to review the provisions of bilateral double taxation treaties entered into by the other country in order to survey concessions granted in the past, departures from the specific provisions herein propounded, and so on.¹

6. Like all model conventions, the United Nations Model Convention is not enforceable. Its provisions are not binding and should not be treated as formal recommendations of the United Nations. They aim at facilitating the negotiation of tax treaties by eliminating the need for elaborate analysis and protracted discussion of every issue *ab origine* in the case of each treaty. They are designed to constitute a framework for the negotiators, who can proceed with their work, secure in the knowledge that the articles of the United Nations Model Convention are the outcome of dispassionate in-depth examination of the issues involved by top-level experts from both developed and developing countries who, by agreeing to become members of the Group of Experts in their personal capacity, have committed themselves to expressing entirely objective opinions based solely on technical considerations.

7. The United Nations Model Convention represents a compromise between the source principle and the residence principle. However, it gives more weight to the source principle than does the OECD Model Convention, which contains a more restrictive definition of a permanent establishment and, in the areas of shipping profits, dividends, interest and royalties, relies more strongly on taxation at source at relatively lower rates or sometimes exclusive taxation by the country of residence. (The allocation of greater taxing power to the source country in the United Nations Model Convention does not mean that the withholding tax rates in the OECD Model Convention on dividends, interest or royalties are too low as a matter of principle and that the Contracting States should always strive for higher rates). As a correlative to the principle of taxation at source, the articles of the United Nations Model Convention are predicated on a recognition by the source country that taxation of income from foreign capital: (1) should take into account expenses allocable to the earnings of that income so that such income is taxed on a net basis; (2) should not be imposed at so high a rate as to unduly discourage investment; and (3) should take into account the appropriateness of a sharing of revenue with the country providing the capital. In addition, the United Nations Model Convention embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either foreign tax credit or exemption, as in the OECD Model Convention.

8. In applying the provisions of the United Nations Model Convention, a country should bear in mind the fact that the relationship between treaties and domestic law may vary from country to country and that it is important to take into account the relationship between tax treaties and domestic law. The status of a double taxation convention in the national laws of States varies widely because of the differing national methods of adopting international treaty obligations. The

¹ Bilateral double taxation treaties are published by the United Nations on a regular basis in the series entitled *International Tax Agreements*

fundamental issue is whether a State takes the view that national law and international law are part of the same system of law or are separate systems. Some States consider international law and treaties to take primacy over national laws. Many States provide in their domestic law for the primacy of their parliament or legislature, although most of these States, in practice, give primacy to international agreements in almost all circumstances. Many treaty provisions rely for their operation on terms defined by the domestic legislation of the Contracting States. In applying those provisions, many States look to the current meaning of those terms (the ambulatory approach), whereas some States look to the meaning of those terms at the time the treaty went into force (the static approach). It is relevant to mention that paragraph 2 of article 3 of the United Nations Model Convention clearly favours the ambulatory approach.

9. Tax treaties affect the tax rules prevailing under the domestic tax laws of the Contracting States by providing which Contracting State shall have jurisdiction to subject a given income item to its national tax laws and under what conditions and with what limitations it may do so. Consequently, a country wishing to enter into bilateral tax treaty negotiations should analyse carefully the applicable provisions of its domestic tax laws in order to assess the impact of the proposed treaty on their operation. Exercise of the taxing power is one of the fundamental attributes of sovereignty, often requiring sensitive political and economic choices. To the extent that treaty negotiations require a re-examination of those choices, they are likely to be complex and time consuming. To conclude a successful treaty negotiation, the treaty partners need to find ways of meshing two tax systems that may embody different goals and may employ different technical features. In some cases, the Contracting States may have quite different rules for taxing international income. One State may use the credit method for relieving double taxation, whereas the other State may use the exemption method or may not provide any form of unilateral relief. One State may have bank secrecy legislation that it wishes to maintain, whereas the other State may insist on an exchange of information provision in the proposed treaty that is inconsistent with bank secrecy. One State may tax contributions to pension funds and allow a recovery of those contributions free of tax, whereas the other State may allow a deduction for pension plan contributions and tax distributions from those funds fully. One State may tax partnerships as separate juridical persons, whereas the other State may treat them as conduits for the participating partners. In negotiating a tax treaty, the Contracting States should take into account all of these and many other aspects of the tax systems of the two States, the differences in the economies of the two States and the relative importance of particular industries in the Contracting States. (The allocation of greater taxing power to the source country in the United Nations Model Convention does not necessarily imply the difference in the economies of the two States and the relative importance of particular industries in the Contracting States). Hence, a simple side-by-side comparison of two actual treaties, or of a proposed treaty against a model treaty, will not enable meaningful conclusions to be drawn as to whether a proposed treaty reflects an appropriate balancing of interests. In many cases the differences in language are of little substantive importance, whereas in other cases, they reflect fundamental differences.

10. A bilateral tax treaty is the result of a negotiated settlement between two Contracting States that may have conflicting objectives. In the case of conflict, some compromise is necessary for the treaty negotiations to continue. To achieve its goal with respect to one provision of a treaty, a State may be compelled to offer some concessions with respect to another provision. A State may have concluded that it must obtain its desired outcome on certain issues or it will not proceed with the

negotiations. For example, a State may conclude that a treaty without an effective anti-abuse provision and an exchange of information provision is simply not worth having. Many States welcome such provisions in a treaty. If a State is unwilling to accept those provisions, however, the treaty negotiations may fail. If the process of give and take continues, it may result in a treaty that is less than ideal from the perspective of either country but is the best treaty that the two States could devise, given their difference on certain issues. Ultimately, a negotiated treaty is not likely to be ratified by the two sides unless both sides believe that the treaty represents the best outcome available to them and serves their national interests.

11. Domestic tax laws may exert an important influence on the content of bilateral tax treaties. Thus, although there was general agreement in the OECD about the principles embodied in the OECD Model Convention and although most bilateral tax treaties conform by and large with the latter, there are often substantial variations from one treaty to another, due to differences in the domestic laws and treaty policies of the various Contracting States. The OECD Model Tax Convention is drafted on the principle that the application of the provisions of a convention is a matter for the internal law of the Contracting States. The Convention is therefore largely silent about issues of application, as is the OECD Commentary to the Convention.

12. States differ widely in their approaches to providing rules and procedures for operating double taxation conventions. One issue that emerges is whether a State should use a consistent set of rules and procedures applicable to all double taxation conventions, or whether different rules and procedures should apply to each double taxation convention. Another issue is whether the rules and procedures should be the same for all forms of income. There is a trend among States towards the adoption of general regulations applicable to all double taxation conventions. These regulations are sometimes promulgated at the administrative level. Another approach is to adopt implementing provisions through domestic legislation. One developed country, for instance, has adopted provisions in its tax legislation that treat all claims for foreign tax relief alike, whether the relief claimed is under a double taxation convention or under domestic legislation.

13. Behind these differing practices and approaches is a fundamental question: Is the application of a double taxation convention a matter of tax law or of the general administrative law of the State? In a sense, of course, it is both. However, in some States the application of a double taxation convention is regarded as part of the general administration, whereas in other States, the procedures for application may be specific to taxes, or specific to the double taxation convention alone. These different approaches may also be relevant in determining whether disputes about the application of a double taxation convention should go to a tax court or an administrative court. If the application of tax treaties is governed by administrative law, it may be subject to the general administrative law principles of the country.

14. The United Nations Model Convention is divided into chapters. Chapter I contains suggested texts concerning the scope of the treaty, and Chapter II defines terms used in bilateral tax treaties. Chapter III (taxation of income), Chapter IV (taxation of capital) and Chapter V (methods for elimination of double taxation) constitute what may be regarded as the main operative segments of the Model Convention. Chapter VI contains special provisions and Chapter VII contains final provisions. A detailed summary of the Model Convention follows.

The reading to follow are based on the United Nations Model Double Taxation Convention between Developed and Developing Countries, its articles and commentaries thereon. Suggested topics include:

Article 2- an article discussing the taxes covered and effects regarding the application of rules related to elimination of double taxation.

Article 4: an article explaining the effects of including the different tie breaking rules for solving double residence issues.

Article 11: an article explaining the definition of the term “interests” and the effects of including long or short definitions, as well as stating the convenience and examples for including in tax treaties the allowance to apply domestic rules regarding thin capitalization and back to back loans.

Article 12: an article explaining the term “royalties” including the different variations of such definition.

Article 13: an article explaining the concepts of exempt income. Additionally, an article could discuss issues related to reorganization of corporations, winding-up, split-ups etc.

Article 17: an article could discuss taxation of artists, sportspersons, etc., which are subject to seasonal payments, as well as performances supported by public funds.

Article 21: an article discussing income related to financial operations, related parties, gratuitous income etc.

Article 24: an article discussing the effects of not granting full non-discrimination clauses and the reasons why some countries exclude taxes different from income taxes. CFC Rules: the different type of clauses that may be included and its particular effects.

Limitation of benefits: an article explain the different consequences of including certain clause or another for setting a limit for the application of benefits granted by de Convention.

SUMMARY OF THE CONVENTION

TITLE AND PREAMBLE

CHAPTER I

Scope of the Convention

- Article 1: _____ Persons covered
Article 2: _____ Taxes covered

CHAPTER II

Definitions

- Article 3: _____ General definitions
Article 4: _____ Resident
Article 5: _____ Permanent establishment

CHAPTER III

Taxation of income

- Article 6: _____ Income from immovable property
Article 7: _____ Business profits
Article 8: _____ Shipping, inland waterways transport and air transport (alternative A)
Article 8: _____ Shipping, inland waterways transport and air transport (alternative B)
Article 9: _____ Associated enterprises
Article 10: _____ Dividends
Article 11: _____ Interest
Article 12: _____ Royalties
Article 13: _____ Capital gains
Article 14: _____ Independent personal services
Article 15: _____ Dependent personal services
Article 16: _____ Directors' fees and remuneration of top-level managerial officials
Article 17: _____ Artistes and sports persons
Article 18: _____ Pensions and social security payments (alternative A)
Article 18: _____ Pensions and social security payments (alternative B)
Article 19: _____ Government service
Article 20: _____ Students
Article 21: _____ Other income

CHAPTER IV

Taxation of capital

Article 22: _____ Capital

CHAPTER V

Methods for elimination of double taxation

Article 23A: _____ Exemption method

Article 23B: _____ Credit method

CHAPTER VI

Special provisions

Article 24: _____ Non-discrimination

Article 25: _____ Mutual agreement procedure

Article 26: _____ Exchange of information

Article 27: _____ Members of diplomatic missions and consular posts

CHAPTER VII

Final provisions

Article 28: _____ Entry into force

Article 29: _____ Termination

TITLE OF THE CONVENTION

~~Convention between (State A) and (State B)
with respect to taxes on income and on capital¹~~

~~PREAMBLE OF THE CONVENTION²~~

~~CHAPTER I~~

~~SCOPE OF THE CONVENTION~~

~~Article 1~~ **~~PERSONS COVERED~~**

~~This Convention shall apply to persons who are residents of one or both of the Contracting States.~~

Observations

~~The Group agreed in 1999 to change the title of article 1 from ‘Personal scope’ to ‘Persons covered.’ Like the OECD Model Convention, the United Nations Model Convention applies to persons who are “residents of one or both of the Contracting States.”~~

~~Article 2~~ **~~TAXES COVERED~~**

~~1. — This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.~~

~~2. — There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.~~

~~3. — The existing taxes to which the Convention shall apply are in particular:~~

- ~~(a) — (in State A):~~
- ~~(b) — (in State B):~~

¹ States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.

² The Preamble of the Convention shall be drafted in accordance with the constitutional procedures of the Contracting States.

4. ~~The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made to their tax laws.~~

Observations

~~—— The same income or capital may be subject in the same country to various taxes, either taxes which differ in nature, or taxes of the same nature levied by different political subdivisions or local authorities. Hence, double taxation cannot be wholly avoided unless the methods for the relief of double taxation applied in each Contracting State take into account all the taxes to which such income or capital is subject. Consequently, the terminology and nomenclature relating to the taxes covered by a Convention must be clear, precise and as comprehensive as possible. As noted by the OECD Committee on Fiscal Affairs, this is necessary in order to “ensure identification of the Contracting States’ taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States’ domestic laws are modified, by means of the periodic exchange of lists and through a procedure for mutual consultation.”~~

CHAPTER II

DEFINITIONS

Article 3

GENERAL DEFINITIONS

1. — For the purposes of this Convention, unless the context otherwise requires:

- (a) — The term “person” includes an individual, a company and any other body of persons;
- (b) — The term “company” means any body corporate or any entity which is treated as a body corporate for tax purposes;
- (c) — The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
- (d) — The term “international traffic” means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
- (e) — The term “competent authority” means:
 - (i) — (in State A):
 - (ii) — (in State B):
- (f) — The term “national” means:
 - (i) — any individual possessing the nationality of a Contracting State;
 - (ii) — any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.

2. — As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Observations

— A number of general definitions are normally necessary for the understanding and application of a treaty, although terms relating to more specialized concepts are usually defined or interpreted in special provisions. There are other terms whose definitions are not included in the treaty but are left to bilateral negotiations by the parties to the treaty. The United Nations Model Convention groups in its article 3 a number of general definitions required for the interpretation of the terms used in that

instrument. These terms are “person”, “company”, “enterprise of a Contracting State”, “international traffic” and “national.” Article 3 leaves space for the designation of the “competent authority” of each Contracting State. The terms “resident” and “permanent establishment” are defined in articles 4 and 5 respectively, while the interpretation of certain terms used in the articles on special categories of income (e.g., immovable property, dividends) is clarified in the articles concerned. The parties to a treaty are left free to agree bilaterally on a definition of the term “a Contracting State” and “the other Contracting State”. They are also free to include in the possible definition of a Contracting State a reference to continental shelves. It was observed that countries that define the residence of a corporation by reference to its place of incorporation rather than its place of effective management might prefer to use the term “resident” where the term “place of effective management” appears in the definition of “international traffic.”

Under paragraph 2, any term in the treaty that is not defined by the convention takes its meaning from the domestic law of the State imposing the tax, whether or not a tax law, unless the context demands otherwise. However, where a term is defined differently for the purposes of different laws, the meaning given to that term for the purposes of the laws imposing the taxes to which the Convention applies prevail over all others, including those given for the purposes of other tax laws. The relevant domestic law is the law in force when the tax is imposed, not the law as of the time when the treaty was signed or became effective. The relevant context includes the intention of the Contracting States when the treaty was signed and the meaning of the undefined term under the domestic law of the other Contracting State.

Paragraph 2 only applies if the context does not require another interpretation. The context consists in particular of the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the articles heretofore allows the competent authorities some leeway.

It has also been decided to leave the definitions of “a Contracting State” and “the other Contracting State” to be worked out in bilateral negotiations by the parties to the treaty, who might wish to include a reference to continental shelves in the possible definition of “a Contracting State” and were free to include a definition of any other term they deemed important.

Article 4 **RESIDENT**

1. — For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. — Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

- (a) — He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);
- (b) — If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has a habitual abode;
- (c) — If he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
- (d) — If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. — Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

Observations

Article 4 of the United Nations Model Convention reproduces article 4 of the OECD Model Convention, with one substantive change, the addition in 1999 of the criterion “place of incorporation” to the list of criteria in paragraph 1 for taxation as a resident. According to the OECD Committee on Fiscal Affairs, the concept of “resident of a Contracting State” has various functions and is of importance in three cases:

- “a) — in determining a treaty’s personal scope of application;
- “b) — in solving cases where double taxation arises in consequence of double residence;
- “c) — in solving cases where double taxation arises as a consequence of taxation in the State of residence and the State of source or situs.”

Clearly, it is highly desirable that bilateral treaties should contain a definition of the concept of residence that is acceptable to both Contracting States. Under article 4, paragraph 1, the internal law definition of residence of those States will remain applicable unless there is a conflict between those laws with the result that both States claim a person as a resident. In that case the person’s residence will be determined according to the treaty definitions in paragraphs 2 and 3.

The OECD Model Convention, article 4 of which is intended to define the meaning of the term “resident of a Contracting State” and to solve cases of double residence, makes referral to domestic laws the preference criterion to be used for determining the residence of individuals and bodies corporate. However, the article also lists in decreasing order of relevance a number of subsidiary criteria to be applied when an individual is a resident of both Contracting States and the preceding criteria do not provide a clear-cut determination of his status as regards residence. If none

of these criteria suffices to determine the status of an individual as regards residence, the article provides that the question shall be settled by the competent authorities of the Contracting States by mutual agreement. In the case of bodies corporate, the article provides, in paragraph 3, that their status as regards residence shall be determined by a single criterion, namely, their “place of effective management.”

The latter term is used in several provisions of the OECD Model Convention, as is the term “place of management.” Neither term is defined explicitly in the Convention itself or in the commentary thereon, nor is it made clear whether the two terms are to be construed as having the same meaning or two different meanings. It is, however, understood that when establishing the place of effective management, circumstances which may, *inter alia*, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view, and the place where the most important accounting books are kept.

It is considered that the definition of the term “resident of a Contracting State” provided in article 4 of the OECD Model Convention and the criteria set forth therein for determining status as regards residence in various situations, constituted an acceptable means of solving cases of double taxation. It was observed that using the place of effective management as a tiebreaker rule might not be acceptable to countries that define the residence of a corporation by reference to its place of incorporation. In such circumstances, double taxation might be avoided through resort to the competent authority procedures set forth in article 25.

Article 5 PERMANENT ESTABLISHMENT

1. — For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. — The term “permanent establishment” includes especially:
 - (a) — A place of management;
 - (b) — A branch;
 - (c) — An office;
 - (d) — A factory;
 - (e) — A workshop;
 - (f) — A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. — The term “permanent establishment” likewise encompasses:
 - (a) — A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;

- (b) ~~The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve month period.~~

4. ~~Notwithstanding the preceding provisions of this article, the term “permanent establishment” shall be deemed not to include:~~

- (a) ~~The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;~~
- (b) ~~The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;~~
- (c) ~~The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;~~
- (d) ~~The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;~~
- (e) ~~The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.~~
- (f) ~~The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.~~

5. ~~Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 7 applies — is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:~~

- (a) ~~Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or~~
- (b) ~~Has no such authority, but habitually maintains in the first mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.~~

6. — Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that State or insures risks situated therein through a person other than an agent of independent status to whom paragraph 7 applies.

7. — An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. — The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Observations

Article 5 of the United Nations Model Convention incorporates several provisions of article 5 of the OECD Model Convention (either unchanged or substantially amended) and some new provisions.

The concept of permanent establishment is used in bilateral tax treaties principally for the purpose of determining the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Such treaties provide that an enterprise of one Contracting State shall be taxable on its profits in the other State only if it maintains a permanent establishment in the latter State and only to the extent that the profits earned by the enterprise in that State are attributable to that permanent establishment. The permanent establishment principle frees from taxation at the source not only occasional business transactions, but also continuing trading activities which do not entail the presence of a permanent establishment in the source country. The term “permanent establishment” was already used in the 1928 Model Conventions of the League of Nations. The United Nations Model Convention reaffirms the concept of permanent establishment and supplements it with the concept of a “fixed base”, which is used in the case of professional services or other activities of an independent character.³

Concerning the application of the OECD definition of permanent establishment to tax treaties with developing countries, a 1965 report of the OECD Fiscal Committee sets forth the following considerations:

³ In 2000, the OECD has omitted article 14 from its Model Convention.

~~“In the tax treaties between capital exporting countries and in the OECD draft, the problem posed by differences in the rules of source or in the allocation of income is solved in part by tax exemption based upon the so-called permanent establishment principle. Under this rule, income derived by an enterprise of one country from activities conducted in another country is not subject to tax in the other country unless conducted through a permanent establishment there. This does not dispose of the problem created by different rules of source, except in those cases where an enterprise of one country is engaged in business activities in the other in such a form as not to constitute a permanent establishment.~~

~~“In general, trade relations between developing and industrialized countries involve the flow of natural resource products from the developing to the industrialized country and of processed and manufactured goods from the industrialized to the developing country. Enterprises in developing countries do not engage in significant business activity in industrialized countries. Given these trading relationships, it would seem that the permanent establishment principle would favour the industrialized countries. However, with increasing industrialization in developing countries, sales and buying activity in developed countries may be facilitated by the permanent establishment concept. It may also make it possible for firms in capital exporting countries to maintain repair parts, supplies, etc. in a developing country which may otherwise not be feasible. Accordingly, there is a place for the permanent establishment principle in tax conventions with developing countries, although it may be necessary to adapt it to a certain extent to the differing relations between developing and industrialized countries.~~

~~“The need for supplementing the permanent establishment principle with rules for allocating income seems all the greater in that the permanent establishment test as such does not dispose of the kind of source problems to which attention has been called above. Developing countries tend to adopt rules which will maximise the income subject to their tax in view of their need for revenue and their limited resources, and this may well be a major source of double taxation. The adoption of rules of source, with appropriate formulae for allocating income in various types of situations, may be more important in relations between developing and industrialized countries than between industrialized countries.”⁴~~

The Group of Experts, while accepting the concept of permanent establishment as contained in the OECD Model Convention, sought to adapt it to a certain extent to the requirements of relations between developing and developed countries. It agreed, therefore, to recommend as a suggested text for an article in a bilateral tax treaty defining the term “permanent establishment” a text incorporating a number of provisions of article 5 of the UN Model Convention. The commentary on article 5 of the UN Model Convention is therefore relevant. The Group of Experts has not adopted so far, however, the December 2000 amendments to the OECD commentary on article 5 dealing with electronic commerce.

Paragraph 1 of article 5 reproduces article 5, paragraph 1, of the OECD Model Convention.

⁴ Organisation for Economic Cooperation and Development, *Fiscal Incentives for Private Investment in Developing Countries: Report of the Fiscal Committee* (Paris, 1965), paragraphs 172-174.

Paragraph 2 of article 5 reproduces the whole of paragraph 2 of article 5 of the OECD Model Convention.

Paragraph 3 of article 5 covers a broader range of activities than article 5, paragraph 3, of the OECD Convention. In subparagraph 3(a), the term “installation project” used in the OECD Model Convention is replaced by the term “assembly or installation project” which, unlike the OECD article, covers “supervisory activities” in connection with “a building site, a construction, assembly or installation project.” Moreover, while article 5 of the OECD Model Convention states that “a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months,” article 5 of the United Nations Model Convention reduces the duration of that period to six months. In special cases, the six month period in paragraph 3, subparagraphs (a) and (b) of article 5 could be reduced to a period of not less than three months in bilateral negotiations.

Some developing countries support a more elaborate version of subparagraph 3(a), which would read as follows:

~~“The term permanent establishment should likewise encompass a building site or construction or assembly project or supervisory activities in connection therewith, where such site, project or activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or activity exceed 10 per cent of the sale price of the machinery or equipment.”~~

Other members, however, believe that such a provision would not constitute an adequate solution, particularly if the machinery is delivered by an enterprise other than the one doing the construction work.

Paragraph 3 of article 5 contains a new subparagraph (b) dealing with the furnishing of services, including consultancy services, which are not covered specifically in the OECD Model Convention in connection with the concept of permanent establishment. The Group believes that management and consultancy services should be covered in the article because the provision of such services in developing countries by corporations of industrialized countries often involves very large sums of money. Accordingly, profits from such services should be taxed by developing countries in certain circumstances.

Concerning the time limit established in paragraph 3, subparagraphs (a) and (b), of article 5, some developing countries would prefer to remove the time limit altogether for two main reasons: first, because construction, assembly and similar activities could as a result of modern technology be of very short duration and still result in a considerable profit for the enterprise carrying on those activities; and, second, because the period during which the foreign personnel involved in the activities remained in the source country was irrelevant to the definition of the right of developing countries to tax the corresponding income. Other developing countries believe that any time limit should have been removed because such a limitation was apt to be used by enterprises of capital exporting countries to evade taxation in the source country. The view has been expressed that there

is no reason why a construction project should not be treated in the same manner as persons covered by article 17 of the OECD Model Convention, who are taxed at the place where their activities are performed irrespective of the duration of those activities. Nevertheless, the goal of the treaty is to promote international trade and development, and the idea behind the time limit is that business enterprises of one Contracting State should be encouraged to initiate preparatory or ancillary operations in the other Contracting State without becoming immediately subject to the tax of the latter State, so as to facilitate a more permanent and larger commitment at a later stage. It is noted that this justification for special treatment of construction sites would not justify an exemption when an enterprise of one Contracting State regularly engages in construction projects of short duration in the other Contracting State.

Most members agree that monetary limitations, if set by analogy with those applied to services of individuals in a number of tax treaties, would be meaningless in the area of the corporate services here discussed, while other members are opposed to any monetary limitations. On the other hand, some members believe that the physical presence of representatives of a foreign corporation in the source country for a minimum period, such as six months, would be a reasonable limitation which would, as a practical matter, cover most of the important situations and would preclude administrative difficulties in the case of merely sporadic activities.

Some members from developed countries believe that the time limit approach would be an acceptable solution if the words “for the same or a connected project” were inserted after the word “continue.” They believe that it is not desirable to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of three months’ duration and another with two projects, each of three months’ duration, one following the other. In this respect, other members find that the injection of a “project” limitation would be either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months’ duration.

There is general agreement that only profits from services attributable to a permanent establishment in the source country should be taxable by it.

Paragraph 4 of article 5 reproduces article 5, paragraph 4, of the OECD Model Convention, with two substantive amendments, namely, the deletion of the term “delivery” in subparagraphs (a) and (b). The term “delivery” is deleted because the presence of a stock of goods for prompt delivery facilitates the sales of the product and thereby the earning of profit in the host country by the enterprise having the facility. A continuous connection and hence the existence of such a supply of goods should constitute a permanent establishment, leaving as a separate matter the determination of the proper amount of income attributable to the permanent establishment. The Group believes that it is preferable to leave open for bilateral negotiations the question of whether cases involving deliveries made from stocks of goods should be included in or excluded from the definition of permanent establishment. Some developed countries contend that, since in the normal case only a small amount of income would be allocated if the only activity is delivery from a stock of goods, it serves no purpose to make this change.

Paragraph 5 of article 5 of the United Nations Model Convention departs substantially from and is considerably broader in scope than article 5, paragraph 5, of the OECD Model Convention, which the Group considered to be too narrow in scope because it states that only one type of agent should be deemed to create an establishment of a non-resident enterprise, exposing it to taxation in the source country. Some developing countries believe that a narrow formula might encourage tax evasion by permitting an agent who was in fact dependent to represent himself as acting on his own behalf. The Group therefore added paragraph 5(b), providing that a dependent agent without authority to make contracts for the principal is a permanent establishment if the agent habitually maintains a stock of goods from which goods are regularly delivered on behalf of the enterprise. It is the understanding of the Group that the phrase “authority to conclude contracts in the name of” in subparagraph 5(a) of article 5 means that the agent has legal authority to bind the enterprise for business purposes and not only for administrative purposes (e.g., conclusion of lease or electricity and manpower contracts).

Paragraph 6 of article 5 of the United Nations Model Convention does not correspond to any provision of the OECD Model Convention. It was included because it was the common feeling of the Group that the OECD definition of permanent establishment was not adequate to deal with certain aspects of the insurance business. Members from developing countries pointed out that if an insurance agent was independent, the profits would not be taxable in accordance with the provisions suggested in paragraph 7 of article 5 (based on article 5, paragraph 6, of the OECD Model Convention); and if the agent was dependent, no tax could be imposed because insurance agents normally had no authority to conclude contracts as would be required under the provisions contained in paragraph 5(a) of article 5 (based on article 5, paragraph 5, of the OECD Model Convention). Those members expressed the view that taxation of insurance profits in the country where the premiums were being paid was desirable and should take place independently of the status of the agent. They therefore suggested that the article should include a special provision relating to insurance business.

Once agreement was reached on the principle of including a special provision on insurance, the discussion in the Group focused mainly on cases involving representation through “an independent agent.” Members from developing countries felt that it would be desirable to provide that a permanent establishment existed in such cases because of the nature of the insurance business, the fact that the risks were situated within the country claiming tax jurisdiction, and the facility with which persons could, on a part-time basis, represent insurance companies on the basis of an “independent status,” making it difficult to distinguish between dependent and independent insurance agents. Members from developed countries, on the other hand, stressed that in cases involving independent agents, insurance business should not be treated differently from such activities as the sale of tangible commodities. Those members also drew attention to the difficulties involved in ascertaining the total amount of business done when the insurance was handled by a number of independent agents within the same country. In view of the difference in approach, the Group agreed that the case of representation through independent agents should be left to bilateral negotiations, which could take account of the methods used to sell insurance and other features of the insurance business in the countries concerned.⁵

⁵ For an illustration of the tax avoidance potential of the “independent agent” exception for insurance, see

The first sentence of paragraph 7 of article 5 reproduces article 5, paragraph 6, of the OECD Model Convention in its entirety, with a few minor drafting changes. The second sentence of paragraph 7 constitutes a new provision whose inclusion stemmed from a proposal by members from developing countries to broaden the scope of the definition of a permanent establishment by treating as a dependent agent an agent who habitually secures orders exclusively or almost exclusively for an enterprise of the other Contracting State or an affiliated enterprise **and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises.** The portion highlighted here was specifically added in 1999 to remove the anomaly or doubt to the effect that when an agent, although acting in an independent capacity, acted for only one enterprise and devoted his time and activity wholly or almost wholly on behalf of that enterprise, he lost his independent status. As redrafted, it has been made clear that to determine the status of an agent as not being of an independent status, it would be necessary to take into account the entirety of the commercial and financial relations between the enterprise and the agent which will show that they differ from those expected between independent enterprises at arm's length. Hence, as worded, the mere fact that the number of enterprises for which an agent acted as an agent of an independent status fell to one, will not change his status from being an agent of independent status to that of a dependent status.

It was stated by one member that the confinement of the activities of an agent wholly or almost wholly to those undertaken on behalf of one enterprise must be pursuant to an agreement with that enterprise for the new language of paragraph 7 of article 5 to apply. Some members from developing countries felt that the existence of such an agreement should not be a requirement for the application of the second sentence of paragraph 7 of article 5, for in practice it would annul it. As a result, this limitation on the new language of paragraph 7 was not adopted.

Paragraph 8 of article 5 reproduces article 5, paragraph 7, of the OECD Model Convention.

With the advent of electronic commerce, it has become possible for an international enterprise to maintain a virtual office in a country through a commercial web site that serves most of the purposes of an office made of bricks and mortar. The question arises, in interpreting the language of article 5, whether such a virtual office constitutes a permanent establishment. Unless article 5 is interpreted or amended so as to treat a virtual office as a permanent establishment, source taxation of business profits derived through electronic commerce may be foreclosed. However, this point is controversial as no consensus has emerged thereon.

Over the past five years, the OECD has engaged in extensive study of tax treaty issues relating to electronic commerce. In December 2000, the OECD adopted some significant changes in its commentary relating to the question whether a virtual office can be treated as a permanent establishment, and it has indicated that it intends to make additional changes in its commentary

Teisei Fire and Marine Insurance Co., 104 T.C.535 9 (1995). That case also illustrates problem of exemption re-insurance.

relating to Articles 5 and 7. It has also undertaken a study of whether the permanent establishment concept, which was adopted a century ago when international communication was slow and expensive, remains relevant to a world in which communication is inexpensive and nearly instantaneous. The Group of Experts intends to develop its own position on issues relating to electronic commerce after a full review of the work of the OECD. That position will be embodied in amendments to the United Nations Model Convention commentaries and, if necessary, in amendments to the articles in the United Nations Model Convention.

CHAPTER III

TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

1. ~~Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.~~
2. ~~The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.~~
3. ~~The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.~~
4. ~~The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.~~

Observations

~~The right to tax income from immovable property, including income from agriculture and forestry, is given to the country in which such property is situated (source country) under article 6 of the United Nations Model Convention. The principle of taxing income from immovable property at source has been universally upheld.~~

~~The taxation of income from immovable property should have as its objective the taxation of profits rather than gross income. Account should therefore be taken of the expenses involved in earning income from real property or from agriculture or forestry. That objective, however, should not preclude the use of a withholding tax on rents from real property, based on gross income; in such cases, the rate should take into account the fact that expenses were involved in the income earning. It is considered that it would be equally satisfactory if, when a withholding tax on gross rents is used, the owner of the real property could elect to have the income from the property taxed on a net basis under the regular income tax. Article 6 is not intended to preclude a country which taxes income from agriculture or other immovable property on an estimated or similar basis from utilizing that method.~~

Article 7
BUSINESS PROFITS

1. ~~The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State, but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.~~

2. ~~Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.~~

3. ~~In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken in the determination of the profits of a permanent establishment for amounts charged (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.~~

4. ~~In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.~~

5. ~~For the purpose of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.~~

6. —Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provision of this article.

[NOTE: The question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.]

Observations

Article 7 of the United Nations Model Convention consists of several provisions of Article 7 of the OECD Model Convention, either unchanged or substantially amended, and some new provisions.

A crucial question in international tax practice is the measurement of the business profits of an enterprise that are subject to taxation in a foreign country. There is general acceptance of the so-called “arm’s length” rule embodied in the OECD Model Convention. According to this rule, the profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market. The profits so attributable may be the profits shown on the books of the establishment if those books are kept in accordance with accepted accounting practices and have not been manipulated to minimize taxation in the country where the permanent establishment is located. The arm’s length rule permits the tax authorities of the country where the permanent establishment is located to rectify the accounts of the enterprise, so as to reflect properly income that the establishment would have earned if it were an independent enterprise dealing with its head office at arm’s length.

The application of the arm’s length rule is particularly important in connection with the difficult and complex problem of the deductions to be allowed to the permanent establishment. It is also generally accepted that in calculating the profits of a permanent establishment, allowance should be made for actual expenses, wherever incurred, for the purposes of the business of the permanent establishment, including executive and general administrative expenses. Apart from what may be regarded as ordinary expenses, there are some classes of expenditures that give rise to special problems. These include deemed interest and royalties etc. “paid” by the permanent establishment to its head office in return for money “loaned” or patent rights “licensed” by the latter to the permanent establishment. They further include commissions (except for the reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the establishment. In these cases, it is considered that the deemed payments should not be allowed as deductions in computing the profits of the permanent establishment. On the other hand, an allocable share of actual payments of interest and royalties, paid by the enterprise to third parties should be allowed.

According to the OECD Model Convention, only profits attributable to the permanent establishment should be taxable in the source country. In some cases the “attribution principle” has been amplified by the so-called “force of attraction” rule, which permits the enterprise, once it carries

out business through a permanent establishment in the source country, to be taxed on business profits in that country arising from transactions outside the permanent establishment.

In the light of the foregoing considerations, article 7 of the United Nations Model Convention relating to the taxation of business profits generally corresponds to the provisions of article 7 of the OECD Model Convention, either unchanged or substantially amended, although article 7 of the United Nations Model Convention also includes some new provisions. The commentary on article 7 of the OECD Model Convention is therefore relevant *mutatis mutandis* to article 7 of the United Nations Model Convention.

Paragraph 1 of article 7 reproduces article 7, paragraph 1, of the OECD Model Convention, with the addition of the provisions contained in clauses (b) and (c). In the discussion preceding the adoption of paragraph 1 of article 7 several members from developing countries expressed support for the “force of attraction” rule, although they would limit the application of that rule to business profits covered by article 7 of the OECD Model Convention and not extend it to income from capital (dividends, interests and royalties) which are expressly covered by other treaty provisions. The members supporting the application of the “force of attraction” rule also indicated that neither sales through independent commission agents nor purchase activities would become taxable to the principle under that rule. Some members from developed countries pointed out that the “force of attraction” rule had been found unsatisfactory and abandoned in recent tax treaties concluded by them because of the undesirability of taxing income from an activity that was totally unrelated to the establishment and that was in itself not extensive enough to constitute a permanent establishment. They also stressed the uncertainty that such an approach would create for taxpayers. Members from developing countries pointed out that the proposed “force of attraction” approach did remove some administrative problems in that it made it unnecessary to determine whether particular activities were or were not related to the permanent establishment or whether the income involved was attributable to it. The administrative benefit is especially important with respect to transactions that are conducted directly by the home office and are similar in nature to those conducted by the permanent establishment.

However, after discussion, there was a proposal to limit the “force of attraction” rule, so that it would apply to sales of goods or merchandise and other business activities in the following manner: if an enterprise has a permanent establishment in the other Contracting State for the purpose of selling goods or merchandise, income from sales of the same or a similar kind in that State may be taxed in that State even if the sales are not conducted through the permanent establishment; a similar rule applies to income from activities of the enterprise that are located in the taxing State and are of the same or similar kind as activities of the permanent establishment. The “force of attraction” rule shall not apply when an enterprise is able to demonstrate that the sales or business activities were carried out for reasons other than obtaining treaty benefits. This limitation recognizes the fact that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment.

Paragraph 2 of article 7 reproduces article 7, paragraph 2, of the OECD Model Convention. In the discussion relating to that paragraph, a member from a developed country pointed out that his country was having some problems with inconsistent determinations of the profits properly

attributable to a permanent establishment, especially with regard to “turn-key” contracts. Under a turn-key contract, a contractor agrees to construct a factory or similar facility and make it ready for operation. When the facility is ready for operation, it is handed over to the purchaser, who can then begin operations. The international tax problems occur when the facility is constructed in one country by a contractor resident in another country. The actual construction activities carried on in one country clearly constitute a permanent establishment within that country if of sufficiently long duration. Turn-key contracts, however, often are concluded before the creation of the permanent establishment and involved many components other than normal construction activities. They also include the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, are sometimes completed before construction activities actually start (hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment is situated.

The question thus arose as to how much of the total profits of the turn-key contract is properly attributable to the permanent establishment and thus taxable in the country where it is situated. A member from a developed country said that he knew of instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was his view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits include items of income dealt with separately in other articles of the Convention and are taxable in that country accordingly.

The Group recognized that the problem described above was a complex and potentially controversial one involving many interrelated issues, such as source of income rules and the definitions of permanent establishment and profits of an enterprise. The Group therefore decided to leave the problem to consideration in bilateral negotiations.

The first sentence of paragraph 3 of article 7 reproduces the entire text of article 7, paragraph 3, of the OECD Model Convention. The rest of the paragraph consists of provisions formulated by the Group of Experts in the original United Nations Model Convention. These provisions stemmed from a proposal by members from developing countries who felt that it would be helpful to include all necessary definitions and clarifications in the text of the article, especially with a view to assisting developing countries not represented in the Group. Some of those members also felt that provisions prohibiting the deduction of certain expenses should be included in the text of a bilateral tax treaty to make it clear that taxpayers were fully informed about their fiscal obligations. In the course of the discussion it was pointed out that additions to the OECD text would ensure that the permanent establishment would be able to deduct interest, royalties and other expenses incurred by the head office on behalf of the establishment. The Group agreed that if billings by the head office included its full costs, both direct and indirect, then there should not be a further allocation of the executive and administrative expenses of the head office, since that would produce a duplication of such charges on the transfer between the head office and the permanent establishment. It was pointed out that it was important to determine how the price was fixed and what elements of cost it included. Where an international wholesale price was used, it would normally include indirect costs. There

~~was general agreement within the Group that any duplication of costs and expenses should be prevented.~~

~~Paragraph 4 of article 7 reproduces the provision of article 7, paragraph 4, of the OECD Model Convention.~~

~~In the discussions leading to the 1980 United Nations Model Convention, the Group could not reach a consensus on provisions relating to the matters covered by article 7, paragraph 5, of the OECD Model Convention. Since no compromise could be worked out, the Group included in the article a note indicating that the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise should be settled in bilateral negotiations. The members from developing countries considered that that paragraph should either be omitted or restated to provide that in the case of a permanent establishment engaged in purchasing and other activities, profits derived from purchasing activities should be attributed to the permanent establishment. Furthermore, some members from developing countries felt that when purchasing constituted the sole activity of an enterprise in the source country, a permanent establishment would exist in that country and that since the purchasing activity contributed to the generation of the over-all profit of the enterprise, there should be an allocation of the portion of the over-all profit attributable to the permanent establishment. The members from developed countries believed that it would be desirable to incorporate the provisions of article 7, paragraph 5, in the text of article 7.~~

~~Paragraph 6 of article 7 reproduces article 7, paragraph 6, of the OECD Model Convention.~~

~~Paragraph 7 of article 7 reproduces article 7, paragraph 7, of the OECD Model Convention.~~

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Article 8 (alternative A)

- ~~1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.~~
- ~~2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.~~
- ~~3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.~~
- ~~4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.~~

Article 8 (alternative B)

1. — Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. — Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by — per cent. (The percentage is to be established through bilateral negotiations).
3. — Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. — If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
5. — The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Observations

The OECD Model Convention contains a major exception to the taxation of business profits on the basis of the principle of permanent establishment, namely, the case of profits from international sea and air transport. The latter profits are wholly exempt from tax at source and are taxed exclusively in the State in which the place of effective management of the enterprise engaged in international traffic is situated.

The exemption from tax in the source country of foreign enterprises engaged in international shipping traffic is predicated largely on the premise that the income of these enterprises is earned on the high seas, that exposure to the tax laws of numerous countries is likely to result in double taxation or at best in difficult allocation problems, and that exemption in places other than the home country ensures that the enterprises will not be taxed in foreign countries if their overall operations turn out to be unprofitable. Considerations relating to international air traffic are similar. Since many developing countries with water boundaries do not have resident shipping companies but do have ports used to a significant extent by ships from other countries, they have traditionally disagreed with the principle of such an exemption of shipping profits.

The United Nations Model Convention provides two alternative texts for the taxation of profits from shipping, inland waterways transport and air transport. Alternative A of article 8 adopts

~~the text of article 8 of the OECD Model Convention. Alternative B of article 8, in addition to permitting tax in the country of effective management or residence of an air transport or shipping enterprise, provides that the other country may also tax such profits if the shipping activities of an enterprise are more than casual.~~

~~The commentary on all of the paragraphs of article 8 of the OECD Model Convention is, therefore, relevant to article 8 (alternative A). With respect to article 8 (alternative B), the commentaries on paragraphs 2, 3 and 4 of the OECD Model Convention are relevant.~~

~~With regard to the taxation of profits from the operation of ships in international traffic, several members from developed countries supported the position taken in Article 8 of the OECD Model Convention. In their view, shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend; taxation at the place of effective management was also preferable from the viewpoint of the various tax administrations. They argued that if every country taxed a portion of the profits of a shipping line, computed according to its own rules, the sum of those portions might well exceed the total income of the enterprise. According to them, that would constitute a serious problem, especially because taxes in the developing countries were often excessively high, and the total profits of shipping enterprises were frequently quite modest. However, certain members from developed countries said they found taxation of shipping profits at the source acceptable.~~

~~Members from developing countries asserted that those countries were not in a position to forego even the limited revenue to be derived from taxing foreign shipping enterprises as long as their own shipping industries were not more fully developed. They recognized, however, that considerable difficulties were involved in determining a taxable profit in such a situation and in allocating the profit to the various countries concerned. Various methods for the determination and allocation of shipping profits were discussed.⁶~~

~~Although certain members from developed countries expressed no serious objection to that proposal, a large number of members from developed countries said they still preferred the principle of exclusive taxation by the State in which the place of effective management of the enterprise is situated. Since no consensus could be reached on a provision concerning the taxation of shipping profits that could be included in the article, it was decided that the question of such taxation should be left to bilateral negotiations.~~

~~Article 8B, allowing the taxation of shipping profits in the country where those profits originated (source country) if shipping activities in that country are more than casual, establishes an operative rule for the shipping business that is not qualified by the provisions of articles 5 and 7 relating to business profits governed by the permanent establishment rule. Such taxation thus covers both regular or frequent shipping visits and irregular or isolated visits, provided the latter are planned~~

⁶ For further details, see *Tax Treaties between Developed and Developing Countries* (United Nations publication, Sales No. E.69.XVI.2), part one, paragraphs 67-68 and *ibid.*, *Third Report* (United Nations publication, Sales No. E.72.XVI.4) part one, paragraphs 18-31.

and not merely fortuitous. The phrase “more than casual” means a scheduled or planned visit of a ship to a particular country to pick up freight or passengers. The overall net profits, in general, should be determined by the authorities of the country in which the place of effective management of the enterprise is situated (country of residence). The final conditions of the determination might be decided in bilateral negotiations. In the course of such negotiations, it might be specified, for example, whether the net profits were to be determined before the deduction of special allowances or incentives which could not be assimilated to depreciation allowances but could be considered rather as subsidies to the enterprise. It might also be specified in the course of the bilateral negotiations whether direct subsidies paid to the enterprise by a Government should be included in net profits. The method for the recognition of any losses incurred during prior years, for the purpose of the determination of net profits, also might be worked out in the negotiations. In order to implement that approach, the country of residence would furnish a certificate indicating the net shipping profits of the enterprise and the amounts of any special items, including prior year losses, which in accordance with the decisions reached in the negotiations were to be included in, or excluded from, the determination of the net profits to be apportioned or otherwise specially treated in that determination. The allocation of profits to be taxed might be based on some proportional factor specified in the bilateral negotiations, preferably the factor of outgoing freight receipts (determined on a uniform basis with or without the deduction of commissions). The percentage reduction in the tax computed on the basis of the allocated profits is intended to achieve a sharing of revenues that reflects the managerial and capital inputs originating in the country of residence.

With regard to the taxation of profits from the operation of aircraft in international traffic, several members from developing countries, although agreeing to the consensus, pointed out that no consideration had been given to the very substantial expenditure that developing countries incurred in the construction of airports. They considered that it would appear more reasonable to situate the geographical source of profits from international transportation at the place where passengers or freight were booked.

A member from a developing country suggested that the income attributable to international traffic may not include payments, such as, for lodging or any activity of transport different from exploitation of ships or aircraft, since they do not form part of activity of international transportation.

A member from a developing country suggested that the provisions of article 8 may be extended to cover rail or road transport. The Group observed that very few cases of rail or road transport involved double taxation. Consequently, it declined to include a reference to rail or road transport in the article. It suggested, however, that Contracting States may, if considered necessary, address rail or road transport during bilateral negotiations.

Article 9

ASSOCIATED ENTERPRISES

1. ~~Where:~~

- (a) ~~an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or~~

(b) ~~the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,~~

~~and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.~~

2. ~~Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.~~

3. ~~The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.~~

Observations

Article 9 of the United Nations Model Convention deals with associated enterprises. This article deals with adjustments to profits that may have to be made for tax purposes when transactions have been entered into between associated enterprises, being parent and subsidiary companies as also companies under common control, on other than arm's length basis. Article 9 of the United Nations Model Convention contains a new paragraph 3, which is not found in the OECD Model Convention.

Article 9 should be considered in conjunction with article 25 on mutual agreement and article 26 on exchange of information, just as in the case of the OECD Model Convention.

Paragraph 2 of article 9 requires a country to make an appropriate adjustment or a correlative adjustment to reflect a change in the transfer price made by a country under article 9, paragraph 1.

In 1999, the Group of Experts introduced a new paragraph 3 in article 9 to provide that the provisions of paragraph 2 shall not apply when the judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises is liable to penalty with respect to fraud, gross negligence or wilful default. This approach means that a taxpayer may be subject to non-tax and tax penalties. Some members of the Group of Experts pointed out that cases involving such penalties are likely to be exceptional and that this provision will not be applied in a routine manner.

~~With regard to transfer pricing of goods, technology, trade marks and services between associated enterprises in cases where the transfers may not have been made on “arm’s length” principles, the Group of Experts has recommended that it would be desirable to follow the OECD Transfer Pricing Guidelines.~~

Article 10 DIVIDENDS

1. ~~Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.~~

2. ~~However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:~~

- ~~(a) — per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;~~
- ~~(b) — per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.~~

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

~~This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.~~

3. ~~The term “dividends” as used in this article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.~~

4. ~~The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.~~

5. ~~Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the~~

company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Observations

A 1965 report of the OECD Fiscal Committee contains the following considerations concerning dividends:

~~“Profits realized by an investor in a developing country through a subsidiary are normally taxed as business profits in that country. It is also common for a developing country to impose an additional tax (usually by withholding at the source) on the dividends paid out of those profits. If the investor is in a country that uses the exemption method in dealing with foreign income, then any tax imposed by the developing country on the dividends is a burden on the investor and reduces his yield. If the investor is from a country that uses the credit approach, the withholding tax may or may not be a net additional burden on the investor, depending on the level of tax rates in the two countries and the method used in computing the credit for foreign taxes. Thus, in a treaty between a developing country and a capital exporting country (using the exemption or credit approach) it would be appropriate for limitations to be imposed on withholding taxes on dividends. The limit might be lower, possibly, in a treaty with a country using the exemption method than with one using the credit method, but one cannot be categorical. It would have to depend on the facts in each case, on the level of rates in the developing and capital exporting country, as well as on other factors.~~

~~“With respect to dividends received from portfolio investment in a developing country, a different treaty provision may be appropriate. Such dividends do not receive the same tax treatment either in exemption or credit countries which dividends from direct investment receive. Exemption countries normally do not exempt such dividends from tax, and the credit countries, with the notable exception of the United Kingdom and Ireland in certain cases, ordinarily do not grant a credit for the underlying corporate tax imposed by the foreign country. Under these circumstances a treaty reduction on the amount of withholding tax which a developing country imposes may not contribute much towards improving capital flows to it. What might be appropriate is the adoption of a credit mechanism by countries that use the exemption method for direct investment and liberalization of the credit allowed by other countries.”⁷~~

~~It was considered that limits on the taxation of dividends in the source country were necessary in order to avoid the heavy tax burden which might result from the combination of the source country's dividend withholding tax and its basic corporate tax rate applied to the profits from~~

⁷ Organisation for Economic Cooperation and Development, op. cit., paragraphs 176-178.

which the dividends are paid. It was possible that the combined effective tax rate levied by the source country might reach a level that significantly exceeds the effective tax rate in the beneficiary's home country.

In the light of these and other considerations, article 10 of the United Nations Model Convention dealing with dividends has reproduced the provisions of article 10 of the OECD Model Convention with three substantive changes, namely, firstly, the deletion of the phrases "5 per cent" in paragraph 2, subparagraph (a), and "15 per cent" in paragraph 2, subparagraph (b); secondly, their replacement by the phrase "___ per cent (the percentage is to be established through bilateral negotiations)," and thirdly, the replacement of the phrase "25 per cent" in that paragraph by the phrase "10 per cent." The commentary on article 10 of the OECD Model Convention is relevant *mutatis mutandis* to article 10.

Paragraph 1 of article 10 reproduces the provisions of article 10, paragraph 1, of the OECD Model Convention. The paragraph provides that dividends may be taxed in the State of the beneficiary's residence. It does not prescribe, however, that dividends should be taxed exclusively in that State and leaves open the possibility of taxation by the State of which the company paying the dividends is a resident, that is, the State in which the dividends originate (source country). When the United Nations Model Convention was first considered, many members from developing countries felt that as a matter of principle dividends should be taxed only by the source country. According to them, if both the country of residence and the source country were given the right to tax, the country of residence should grant a full tax credit regardless of the amount of foreign tax to be absorbed and, in appropriate cases, a tax-sparing credit. One of those members emphasized that there was no necessity for a developing country to waive or reduce its withholding tax on dividends, especially if it offered tax incentives and other concessions. However, the Group reached a consensus that dividends may be taxed both by the State of the beneficiary's residence and the source country. Current practice in developing/developed country treaties generally reflects this consensus. Double taxation is eliminated or reduced through a combination of exemption or tax credit in the residence country and reduced withholding rates in the source country.

Paragraph 2 reproduces the provisions of article 10, paragraph 2, of the OECD Model Convention with three substantive changes mentioned above. The Group of Experts decided to replace "25 per cent" with "10 per cent" in subparagraph (a) as the minimum capital required for direct investment dividend status in light of the fact that in some developing countries non-residents are limited to a 50 per cent ownership, so that 10 per cent represented a significant portion of such permitted ownership.

In subparagraphs (a) and (b) the phrase "___ per cent (the percentage is to be established through bilateral negotiations)" was used because the Group was unable to reach a consensus on maximum rates for source taxation of dividends. The members from developing countries, who basically preferred the principle of the taxation of dividends exclusively in the source country, considered that adoption of the maximum rates prescribed by the OECD Model Convention would entail too large a loss of revenue for the source country. Nevertheless they were not opposed to taxation in the beneficiary's country of residence provided that any reduction in withholding taxes in the source country benefited the foreign investor rather than the treasury of the Government of the

beneficiary's country of residence, as was the case under the traditional tax credit method whenever the reduction lowered the cumulative tax rate of the source country below the rate of the beneficiary's country of residence.

The OECD Model Convention, while recognizing source jurisdiction based on payment alone, greatly restricts the amount of withholding tax to be applied by the source jurisdiction. It also gives no attention to a determination of what expenses in the residence country are attributable to the dividends.⁸ This lack of attention presumably is because the expenses of a shareholder in the residence country allocable to the receipt of a dividend traditionally are not regarded as deductible in the source country, unlike expenses allocable to interest or royalties. Hence the level of source country withholding taxes on dividends has not been fixed in treaties with regard to shareholders' expenses.

Although the Group of Experts was unable to reach a consensus on an exact rate, it concluded that a reduction in the direct investment dividend rate could be justified whether the developed country uses a credit system or exemption system to reduce double taxation.

If the developed (residence) country uses a credit system, the negotiations could appropriately seek a limitation on withholding tax rates at source that would, in combination with the basic corporate tax rate of the source country, produce a combined effective rate that does not exceed the tax in the residence country.

If the developed country uses an exemption system for double taxation relief, it could, in bilateral negotiations, seek a limitation on withholding rates on several grounds: (a) that the exemption itself stresses the concept of not taxing inter corporate dividends, and a limitation of the withholding rate at source would be in keeping with that concept; (b) that the exemption and resulting departure from tax neutrality with domestic investment are of benefit to the international investor, and hence a limitation of the withholding rate at source would be in keeping with this step, since that limitation would also benefit the investor.

The Group of Experts concluded that with respect to portfolio investment dividends, both the source country and the residence country should be in a position to tax dividends paid on the shares involved, although the relatively small amount of portfolio investment and its distinctly lesser importance compared with direct investment might make the issues concerning its tax treatment less intense. However, it was decided not to recommend a maximum rate because some source countries may have varying views on the importance of portfolio investment and on the figures to be inserted.

Current developed/developing country treaty practice indicates a range of direct investment and portfolio investment withholding tax rates. In many cases, dividend withholding rates in these treaties have been higher than in treaties among OECD countries. Thus, while the OECD direct and portfolio investment rates are 5 per cent and 15 per cent, developed/developing country treaty rates

⁸ This matter was not considered by the Group of Experts.

have traditionally ranged between 5 per cent and 15 per cent for direct investments and 15 per cent and 25 per cent for portfolio investments.

Recently, some developing countries have taken the position that short term loss of revenue occasioned by low withholding rates is justified by the potential increase in foreign investment in the medium and long terms. Thus, several modern developed/developing country treaties contain the OECD Model rates for direct investment or even lower rates.

In most treaty negotiations between developed and developing countries, the maximum withholding rates on dividends are fixed partly or wholly to achieve a compromise with respect to potential revenue losses that is acceptable to both parties. The following technical factors nevertheless are often considered in fixing the rate: (a) the corporate tax system of the country of source (e.g., the extent to which the country follows an integrated or classical system) and the total burden of tax on distributed corporate profits resulting from the system; (b) the extent to which the country of residence credits the tax on the dividends and the underlying profits against its own tax, and the total tax burden imposed on the taxpayer, after relief in both countries; (c) the extent to which credit is given in the country of residence for taxes spared in the country of source; and (d) the achievement from the source country's point of view of a satisfactory balance between raising revenue and attracting foreign investment.

Also, several special features appear in developed/developing country treaties: (a) the maximum allowable tax rates are not necessarily the same for both partners, with the higher rates applying to dividends sourced in the developing country; (b) in some cases, maximum tax rates are not fixed at all; (c) reduced maximum rates apply only to income from new investment in some cases; (d) the lowest maximum rates or exemption apply in some cases to only preferred types of investments (e.g., "industrial undertakings" or "pioneer investments"); and (e) the agreements sometimes stipulate that dividends qualifying for reduced maximum rates must have been paid with respect to stock held for a specified period. In treaties involving states that have adopted an imputation system of corporation taxation (i.e., integration of company tax into shareholder's company tax or individual income tax) instead of the classical system of taxation (i.e., separate taxation of shareholder and corporation), specific provisions may ensure that the advanced credits and exemptions granted to domestic shareholders are extended to shareholders resident in the other Contracting State.

Paragraphs 3, 4 and 5 of article 10 reproduce the provisions of Article 10, paragraphs 3, 4 and 5 of the OECD Model Convention.

The inclusion of a branch profits tax provision was a key topic at the 1987 and 1991 meetings of the Group of Experts and was further discussed in the 1997 meeting (Eighth Meeting). It was considered that since only a few countries had a branch profits tax, the paragraph on that topic might be better placed in the commentary and not in the main text. It would be left to the Contracting States during the course of bilateral negotiations to incorporate in their bilateral tax treaties a provision relating to the branch profits tax if they desired. The developing countries were generally not opposed to the principle of a branch profits tax. One member from a developed country could not support the principle because such a tax appears to conflict with his country's policy of taxing

business profits only once. Some members, while noting the justification of a branch profits tax as a means for achieving neutrality in relation to the forms of business (subsidiary versus branch operation), maintained that the neutrality principle should be followed logically throughout the Model Convention.

——— In the view of a member from a developed country, a branch profits tax should permit a deduction for all deemed expenses of the permanent establishment as if the permanent establishment were a distinct and separate enterprise dealing wholly independently with the head office. That result is contrary to paragraph 3 of article 7 of the United Nations Model Convention. Another member from a developed country noted that his country imposed two separate branch profits taxes: (a) a tax analogous to a dividend withholding tax is imposed on the “dividend equivalent amount,” which is intended to approximate the amount that the branch would distribute as a dividend to its parent if it were a subsidiary; and (b) a second tax, analogous to a withholding tax on interest paid by a subsidiary resident in that country to its foreign parent, is imposed on the excess of the amount of interest deducted by the branch in computing its net income for corporate tax purposes over the amount of interest actually paid by the branch. The principal purpose of that system was to minimize the effect of tax considerations on the foreign investor’s decision whether to operate in the country in branch or subsidiary form.

If one or both of the Contracting States impose branch profits taxes, they may include in the Convention a provision on the following lines:

Notwithstanding any other provision of this Convention, where a company which is a resident of a Contracting State has a permanent establishment in the other Contracting State, the profits taxable under article 7, paragraph 1 may be subject to an additional tax in that other State, in accordance with its laws, but the additional charge shall not exceed ____ per cent of the amount of those profits.

The suggested provision does not recommend a maximum tax rate for a branch profits tax. The most common practice is to use the direct investment dividend rate [e.g., the tax rate in paragraph 2 (a)]. At the 1991 meeting of the Group of Experts there was agreement among the supporters of branch profits taxation that in view of the principles enunciated in support of the system, the rate of tax on branch profits should be the same as that on dividends from direct investments. However, in several treaties the maximum branch profits tax rate was the maximum rate for portfolio investment dividends (typically a higher rate) and in some treaties the branch tax rate was lower than the direct investment dividend rate. Although a branch profits tax is on business profits, the provision may be included in article 10, rather than in article 7, because the tax is intended to be analogous to a tax on dividends.

The branch profits tax may be imposed only on profits that are attributable to the permanent establishment. A provision common in current treaty practice is to provide further that the tax may be imposed on such profits only “after deducting therefrom income taxes and other taxes on income imposed thereon in that other State.” Other treaties do not contain this clause because the concept is already included in their branch profits tax under domestic law.

Attention was drawn at the Group's 1991 meeting to the fact that there could arise a potential conflict between a branch profits tax provision and a treaty's non-discrimination clause. Since most branch profits taxes represented a second level of tax on the profits of the foreign corporation that was not imposed on a domestic corporation carrying on the same activities, the tax could be viewed, as a technical matter, as prohibited by article 24 (non-discrimination). However, those countries that imposed that tax did so as an analogue to the dividend withholding tax paid on dividends from a subsidiary to its foreign parent. They viewed it, therefore, as appropriate to include in the non-discrimination article an explicit exception allowing the imposition of the branch tax. The non-discrimination article in several treaties with branch profits tax provisions contains the following paragraph:

~~"Nothing in this Article shall be construed as preventing either Contracting State from imposing a tax described in paragraph ... [branch profits tax provision] of Article 10 (Dividends)."~~

However, the branch profits tax provision suggested above makes this provision unnecessary because it applies notwithstanding any other provision of this Convention and thus takes precedence over other treaty provisions, including article 24 (Non-discrimination).

Some members of the Group of Experts pointed out that there are many artificial devices entered into by persons to take advantage of the provisions of article 10 through, *inter alia*, creation or assignment of shares or other rights in respect of which a dividend is paid. While substance over form rules, abuse of rights principle or any similar doctrine could be used to counter such arrangements, Contracting States which may want to specifically address the issue may include a clause on the following lines in their bilateral tax treaties during negotiations, namely:

~~The provisions of this article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this article by means of that creation or assignment.~~

Article 11 INTEREST

1. ~~Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.~~

2. ~~However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ____ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.~~

3. — ~~The term “interest” as used in this article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits and, in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this article.~~

4. — ~~The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.~~

5. — ~~Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment or fixed base, then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.~~

6. — ~~Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.~~

Observations

~~Interest, which, like dividends, constitutes income from movable capital, may be paid to individual savers who have deposits with banks or hold savings certificates, to individual investors who have purchased bonds, to individual suppliers or trading companies selling on a deferred payment basis, to financial institutions that have granted loans or to institutional investors holding bonds or debentures. Interest may also be paid on loans between associated enterprises.~~

~~At the domestic level, interest is usually deductible from the figures used for calculating profits. In this context, any tax on interest is paid by the beneficiary unless a special contract provides that the tax should be paid by the payer of the interest. Contrary to what occurs in the case of dividends, interest income is not liable to double taxation, once in the hands of the payer and again in the hands of the beneficiary. If the payer is obliged to withhold a certain portion of the interest as a tax, the interest thus withheld represents an advance on the amount of tax to which the beneficiary will be liable on his aggregate income or profits at the end of the fiscal year. At that time, the beneficiary can deduct the amount withheld by the payer from the amount of tax due from~~

him and obtain reimbursement of any sum by which the amount withheld exceeds the amount of the tax that is finally payable. This mechanism prevents the beneficiary from being taxed twice on the same interest.

At the international level, another set of circumstances usually prevails. When the beneficiary of the interest is a resident of one country and the payer of the interest is a resident of another, the same interest sometimes is subject to taxation in both countries. This double taxation may considerably reduce the net amount of interest received by the beneficiary or, if the payer has agreed to bear the cost of the tax deductible at the source, will increase the financial burden on the payer.

Under the United Nations Model Convention the maximum rate of tax to be charged on interest is to be established by the Contracting States through bilateral negotiations. In contrast, the OECD Model Convention sets a maximum of 10 per cent for the tax withheld at source. That latter convention provides, however, for taxation at source when the person paying the interest has in a Contracting State a permanent establishment or fixed base in connection with which the indebtedness on which the interest is paid was incurred.

A 1965 report of the OECD Fiscal Committee states the following considerations concerning the tax treatment of interest:

“The tax status of interest in the industrialized country is substantially the same as that of dividends from portfolio investment. Consequently, the same general conclusions might be drawn, namely, that a limitation of withholding taxes on interest or the exemption of interest, which is common in treaties between capital-exporting countries, also is not justified. However, there are additional considerations involved. Withholding is often on a gross basis and does not take into account the costs incurred by a lender. A limitation on the withholding rate compensates for the fact that it is on a gross basis. Moreover, banks and other institutions which make loans to developing countries often insist that the interest called for in the loan instrument shall be free of any taxes imposed in the country of the borrower. If the interest is subject to tax, then the borrower must assume the burden involved. There may be various factors responsible for such provision in a loan contract. It may simply be a convenient device for increasing the rate of interest that would otherwise be obtainable although in general one might expect lenders to charge whatever the traffic will bear. In addition, such a clause offers assurance to the lender that there will be no diminution in the yield from the loan as a result of changes in the tax policy of the developing country. The exemption provision in the contract may also help to widen the market for the loan instrument if the lender should later wish to sell it. Thus, exemption of interest in a tax treaty may have the effect of reducing the cost of borrowed capital. But it should also be noted that a treaty provision which provides tax exemption for interest and not for dividends may create administrative difficulties for developing countries. Investors will tend to make more loan than equity capital available to their controlled enterprises and administrators will have to determine when there is an excess of indebtedness. In view of these factors it seems clear

that there can be no hard and fast rule with respect to the tax treatment to be accorded interest in conventions between developing and industrialized countries.”⁹

Within the Group of Experts, there was strong feeling on the part of members from developing countries that the source country should have the exclusive, or at least the primary, right to tax interest. According to that view, it is incumbent on the residence countries to prevent double taxation of that income through exemption, credit or other relief measures. These members reason that interest should be taxed where it is earned, that is, where the capital is put to use. The taxing of interest by the source country also would have a significant effect on the economies of the developing countries because apart from its contribution to the revenues, the taxation at source would also reduce the outflow of the foreign exchange.

Some members from developed countries believe that the home country of the investor should have the exclusive right to tax interest, because, in their view that would promote the mobility of capital and give the right to tax to the country that is best equipped to consider the characteristics of the taxpayer. They also point out that an exemption of foreign interest from the tax of the investor’s home country might not be in the best interests of the developing countries because it could induce investors to place their capital in the developing country with the lowest tax rate. Members from developing countries contested that view and stated that tax rates were only one of the factors involved in investments. Members from developed countries also drew attention to the fact that under current conditions, the greater part of international loan capital was provided by banks, pension funds and other large financial institutions, and that imposition of high withholding taxes on such loans would either make the investment unattractive to institutional lenders, which in any case preferred loans to domestic borrowers, or increase the cost of the loan to the borrower.

During the discussions, it was stressed that in certain developing countries, interest payable to non-residents is taxed on a net basis if the lender is engaged in business in the country through a permanent establishment; otherwise it is taxed on a gross basis. This pattern of taxation is intended to take account of the fact that, in the international field, interest mainly relates to payments to financial institutions and that the gross income figure does not necessarily correspond to net income. Members from those countries generally were of the opinion that interest, other than interest earned through a permanent establishment, should be taxed on a gross basis, both for administrative convenience and for substantive reasons. They generally agreed that withholding taxes on interest income should be set at a rate corresponding to the usual corporate tax rate on net income. They conceded that the tax on interest could be higher than that on business income under their recommended approach. In that respect, one member from a developing country stressed the importance of taxing on a gross basis as a matter of practical administration, though recognizing that the actual rate on gross interest used should take account, to the extent feasible, of the fact that expenses may be involved in the earning of the interest.

The taxation of interest under article 11 of the United Nations Model Convention differs with one substantive change from the corresponding provision in the OECD Model Convention. The

⁹ Organisation for Economic Cooperation and Development, op. cit., paragraph 179.

change is the deletion of the phrase “shall not exceed 10 per cent of the gross amount of the interest” from the first sentence of paragraph 2 and its replacement by the phrase “shall not exceed ____ per cent of the gross amount of the interest (the percentage is to be established through bilateral negotiations).” As a result, the commentary to the United Nations Model Convention generally incorporates the OECD commentary to article 11.

Paragraph 1 of article 11 reproduces the provisions of article 11, paragraph 1, of the OECD Model Convention.

Paragraph 2 reproduces the provisions of article 11, paragraph 2, of the OECD Model Convention with the substantive change mentioned above. The members from developing countries agreed to the solution of taxation by both the country of residence and the source country embodied in article 11, paragraphs 1 and 2, of the OECD Model Convention but found the ceiling of 10 per cent of the gross amount of the interest mentioned in paragraph 2 thereof unacceptable. It may be noted in that connection that within OECD the 10 per cent ceiling has been considered “a reasonable maximum” in the light of the fact that the source country was already entitled to tax profits on income produced in its territory by investments financed out of funds borrowed abroad. Since the Group was unable to reach a consensus on an alternative higher ceiling, the matter was left to bilateral negotiations.

The decision not to provide a maximum withholding rate can be justified under current treaty practice. The withholding rates for interest adopted in developed/developing country treaties range more widely than those for dividends, between complete exemption and 25 per cent. There is, however, a tendency on the part of some developing countries to reduce the interest withholding rate to attract foreign investment. Thus, several developing countries have adopted rates at or below the OECD rate (10 per cent).

A precise level of withholding tax for a source country should take into account a number of factors including the following: the fact that the capital originated in the residence country; the possibility that a high source rate might cause lenders to pass the cost of the tax on to the borrowers, which would mean that the source country would increase its revenue at the expense of its own residents rather than the foreign lenders; the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment; the fact that a lowering of the withholding rate has revenue and foreign exchange consequences for the source country; and the fact that interest flows mainly in one direction, namely, from developing to developed countries.

It may be of interest to note that the withholding rates imposed on interest in developing countries seem to be somewhat lower than those imposed on dividends. Some developing countries impose no tax. A 15 per cent rate is fairly common; there are also instances of 10 and 20 per cent rates, but very few countries impose rates between 30 and 40 per cent.

When the general rate in a tax treaty with a developing country is above the OECD maximum rate (10 per cent), there is a tendency to provide lower ceilings or even exemption for interest in the following categories:

- (a) — Interest paid to governments or local governments, or to governmental agencies;
- (b) — Interest guaranteed by governments or government agencies;
- (c) — Interest paid to central banks;
- (d) — Interest paid on loans used to finance the provision of special equipment or public works;
- (e) — Interest paid on certain government approved types of investment (e.g., paid in connection with the provision of export finance);
- (f) — Interest paid to banks or other financial institutions;
- (g) — Interest paid on long term loans;
- (h) — Interest paid or deemed paid on sales of goods or services on credit.

It has also been suggested that exemption of interest may also be extended to loans granted to foreign governments, central and government banks, and government organizations which promote exports.

In the Group's 1992 report, some members referred to the desirability of exempting interest income from source country tax if it is received by government agencies on the ground that exemption would facilitate the financing of development projects, especially in developing countries. According to this view, the rate of interest paid on development projects should not be complicated by tax issues. In that regard, the view of some developing countries was that the financing of such projects would be further enhanced if the lender's country of residence also exempted the interest income from tax.

The predominant treaty practice clearly is to exempt interest income derived by a Contracting State from source country taxation. The methods for achieving this goal, however, differ widely. In some instances, interest income is exempted if it is paid by a government or to a government. In other instances, only interest paid to a government is exempt. Also the definition of "government" for purposes of the exemption is not uniform. It may or may not include, for example, local authorities, agencies, instrumentalities, central banks, and financial institutions owned by the government.

With respect to loans from banks and other financial institutions, a major justification for a reduced withholding rate is the high costs often associated with these loans. If those costs are significant, a moderate withholding tax rate on gross interest income may result in a high effective tax rate on net income. In addition, if the lender cannot get a tax credit for the withholding tax in the residence country, the borrower may bear the economic burden of the tax by paying a higher interest rate. In some cases, through a gross-up feature in the loan agreement, the borrower is made legally liable for the withholding tax. One possible way to prevent a shifting of the tax to the borrower is to allow a lender having a permanent establishment in the source country to elect to treat its interest income as business profits under article 7. In that situation, the tax would be imposed on net income rather than gross income, and a residence country using the credit method for granting relief from double taxation probably would not impose any special limitations on the credit. However, this approach would raise computational and administrative issues for banks and tax administrators. Another way to deal with the issue is to make the withholding rate low enough to produce usable foreign tax credits in the residence country.

The Group of Experts observed that long-term loans often call for special government guarantees owing to the difficulty of forecasting long-term political, economic and monetary outcomes. Moreover, the governments of the majority of developed countries, in order to promote full employment in their capital goods industries or public works enterprises, have granted privileged treatment for long-term credits in the form of credit insurance or interest rate reductions. Such privileged treatment might be granted through direct loans by government agencies or through loans made by private banks that are provided by the government with credit facilities or interest terms more favourable than those obtainable in the marketplace. The governments of developed countries are unlikely to be willing to sacrifice revenue by subsidizing loans if the corresponding advantages are cancelled out or reduced by heavy taxation in the source country. To encourage such subsidies, a developing country may wish to agree by treaty to exempt interest paid on certain loans made by the other Contracting State and also to exempt interest on long-term loans made by private banks when the loans are guaranteed or refinanced by an agency of that State.

There was no consensus on the proper treatment of interest paid or deemed to be paid with respect to an extension of credit on the sale of goods and services. It is a common practice for sellers to extend credit to purchasers without any formal interest charge if payment is made within some short period, such as 30 days. When long-term credit is extended, a typical pattern is to charge interest to the purchaser, although the interest rate may not reflect the rate that would prevail on comparable loans obtained from financial institutions. It is considered that the proper treatment of interest paid or deemed to be paid on such credit sales should be considered under article 11 rather than under article 7 (business profits). No consensus was reached, however, on the proper treatment of such interest income under article 11.

Some members of the Group of Experts suggested that the rate on interest paid with respect to credit sales should be reduced or eliminated for reasons similar to those applicable in the case of interest earned by financial institutions. They suggested that the seller very often merely passes on to the customer, without any additional charge, the price he himself has to pay to a bank or an export finance agency to finance the credit. In such circumstances, the interest is akin to a cost incurred in making a sale rather than income derived from invested capital. It was also suggested that determining an appropriate withholding rate would present serious complications. It may be considered necessary, for example, to specify separate withholding rates for short-term and long-term credit sales and to determine the implied interest rate when no explicit rate is stated. In some cases, a government or government agency directly or indirectly finances the credit sales. As discussed above, a government might be reluctant to provide a special credit arrangement to its exporters if the benefits of that arrangement go to a foreign government rather than to the exporter.

The factors suggesting an exemption or lower withholding rate for interest paid on credit sales may cause some countries to decide not to pursue the taxation of such interest. These factors, however, might not appear sufficiently persuasive to some negotiators to overcome the presumption in favour of taxing interest income under article 11. The Group of Experts concluded, therefore, that the treatment of interest on deferred payment or credit sales should be considered in the context of the article 11 but should be settled through negotiations between the parties.

Paragraphs 3, 4, 5 and 6 of Article 11 reproduce the provisions of Article 11, paragraphs 3, 4, 5 and 6, of the OECD Model Convention. It has been suggested that definition of “interest” in the bilateral tax treaty may be provided similar to that in the domestic legislation of the Contracting States, so as to encompass other operations and concepts similar to interest as contemplated in the said legislation.

Article 12 ROYALTIES

1. — Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. — However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ____ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. — The term “royalties” as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

4. — The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.

5. — Royalties shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connection with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. — Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this

article shall apply only to the last mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Observations

When the user of a patent or similar property is resident in one country and pays royalties to the owner thereof who is resident in another country, the amount paid by the user is generally subject to withholding tax in the user's country, that is, in the source country. The source country imposes its withholding tax on the gross royalty payments. It thus does not take into account any related expenses that the owner may have incurred in developing or acquiring the property.

If the owner of a patent or similar intangible property spent large sums in developing or acquiring that property, the net income derived from its royalty income may be only a small percentage of its gross royalties. Consequently, even a moderate withholding tax in the source country can result in a high tax on net income. Indeed, the tax might exceed net income in some circumstances. This possibility complicates the choice of appropriate withholding rates in the source country. That choice is further complicated by the possibility that a high withholding rate would cause a foreign owner of intangible property to increase the royalty rate it charges to users in the source country. Whether an owner would have the market power to raise its royalty rate would depend on the facts and circumstances of each case. In general, however, an owner would be expected to charge whatever the market would bear without reference to the amount of any withholding tax.

In some other circumstances, high withholding rates in the source country on royalties may make good economic sense. In many cases, the marginal costs, including opportunity costs, to an owner of exploiting its intangible property in a country may approach zero. If the owner has already recovered its costs or those costs are fixed or unavoidable, it will not be discouraged from making its property available to users in the source country as long as the withholding rate is not confiscatory. Assume, for example, that an owner of an established trade name is prepared to make that trade name available for use in a particular country by licensing it to an affiliated company. A high withholding rate in the source country should not make the license unattractive from an economic perspective as long as the rate did not make the license unprofitable. Similarly, an owner of a patent on a pharmaceutical product typically would have an economic incentive to license that product for use in a particular country even if the withholding rate on the royalty was high, assuming that the marginal costs of giving the license are trivial. More generally, a royalty that constitutes an economic rent may be taxed at high rates without creating economic inefficiencies.

In light of the uncertain economic impact of withholding taxes on royalties, the proper treatment of royalties is complex. An additional complexity is introduced if the user may make a lump sum payment for the use of the patent or similar property, in addition to or as a substitute for regular royalty payments. In that situation, it is not entirely clear whether the lump sum payment should be characterized as a royalty or as a payment for an ownership right in the intangible property. Additional issues arise in distinguishing royalty payments from payments for technical services.

The OECD Model Convention lays down the principle of exclusive taxation of royalties in the State of the beneficial owner's residence. In accordance with this principle, it generally provides that royalties arising in a Contracting State and paid to a resident of the other Contracting State are taxable only in that other State. The OECD Model provides, nevertheless, that the source country may impose a tax on royalties if the right or property in respect of which the royalties are paid is "effectively connected" with a permanent establishment located in that country. This treatment of royalties was not adopted.

The taxation of royalties under article 12 of the United Nations Model Convention departs from the corresponding provision in the OECD Model Convention in some important respects. There are a number of substantive changes in paragraphs 1, 3 and 4, and new paragraphs 2 and 5 have been inserted. The remaining paragraphs have been renumbered accordingly. Because of these changes, the commentary on article 12 of the United Nations Model Convention adopts only some provisions of the OECD commentary.

During the discussion in the Group of Experts, the members from developing countries expressed the view that in order to facilitate the conclusion of tax treaties between those countries and developed countries, the primary right to tax royalties should be given to the country where that income arose, that is, to the source country. Those members observed that patents and processes were usually licensed to developing countries after they had been fully exploited elsewhere. According to them, although it would be going too far to assert that such properties were made available to developing countries only when they had become obsolete, it would be no overstatement to say that they frequently arrived at a late stage, when the expenses incurred in connection with their development had already been largely recouped.

Members from developed countries considered that it would be unrealistic to assume that enterprises selected the oldest patents for licensing to developing countries. In their view, an enterprise normally would license its patents to foreign subsidiaries and therefore would select the most up-to-date inventions, in the hope of expanding existing markets or of opening new ones. They contended that patents are instruments for promoting industrial production and an enterprise would have an economic incentive to make the industrial production of its affiliates as profitable as possible. Several developed countries hold as a matter of principle that the country of residence of the owner of a patent or similar property should have the exclusive or primary right to tax royalties paid thereon.

Because there is no consensus concerning a specific rate for the withholding tax to be charged on royalties on a gross basis, the rate should be established through bilateral negotiations. This situation is reflected in paragraph 2 of article 12. The following considerations might be taken into account in such negotiations:

First, in establishing a withholding tax on the gross royalty in a tax treaty, the country of source should recognize both current expenses allocable to the royalty and expenditures incurred in the development of the property giving rise to the royalty. In addition, the source country should consider that expenditures incurred in the development of a particular property may be properly allocable in some circumstances to profits derived currently or in the past or future from other

property. Furthermore, the country of source should take into account that expenditures not directly incurred in the development of a particular property might have contributed significantly to that development.

Second, as a technical matter, if an expense ratio were agreed upon in fixing a gross rate in the source country, it would appear as a consequence that the country of the recipient, if following a credit method, would apply that expense ratio as the basis for determining the application of its credit, whenever feasible.

Assume, for example, that the Contracting States agreed that on average one-third of gross royalty income represents a recovery of development and other expenditures. As a result, the source country reduced its withholding rate from 30 percent to 20 percent. In determining whether that withholding tax of 20 percent qualifies for a tax credit, the residence country also should assume that one-third of the royalty represented return of expenses and two-thirds represented net profits. This issue should be addressed, therefore, in applying the provisions of article 23B (Credit method).

In addition, various members of the Group mentioned factors that might influence the determination of the appropriate withholding tax on gross royalties in a treaty between a developed and developing country. Those factors include the following:

- (a) — The need for revenue and conservation of foreign exchange by the developing country;
- (b) — The fact that royalty payments flow almost entirely from developing countries to developed countries;
- (c) — The extent of assistance that developed countries should, for a variety of reasons, extend to developing countries, and the special importance of providing such assistance in the context of royalty payments;
- (d) — The desirability of preventing a shifting of the tax burden to the licensees through the license arrangement;
- (e) — The ability that taxation at source provides to a developing country to make selective judgments by which, through reduced taxation or exemption, it could encourage those license arrangements it considers desirable for its development;
- (f) — The lessening of the risks of tax evasion if there is at least some taxation at the source;
- (g) — The fact that the country of the licensor frequently supplies the facilities and activities necessary in the development of the patent and thus undertakes the risks associated with the patent;
- (h) — The fact that the country of the licensor may have obtained substantial collateral benefits from having the development of technology conducted within its borders and

~~may have provided tax incentives to the licensor in the hope of obtaining those benefits;~~

- ~~(i) The desirability of obtaining and encouraging a flow of technology to developing countries;~~
- ~~(j) The desirability of enlarging the field of activity of the licensor in the utilization of its research;~~
- ~~(k) The benefits that developed countries obtain from world development in general;~~
- ~~(l) The relative importance of revenue sacrifice; and~~
- ~~(m) The relationship of the royalty rate decision to other decisions in the negotiations.~~

~~There is a special problem involving the broad definition of royalties under paragraph 3 of article 12, which includes “information concerning industrial, commercial or scientific experience.” A member from a developed country explained that in his view the problem was that the definition made an imperfect distinction between revenues that constitute royalties in the strict sense and payments received for brain work and technical services, such as surveys of any kind (engineering, geological research etc.). The member also mentioned the problem of distinguishing between royalties akin to income from capital and payments received for services. Given the broad definition of “information concerning industrial, commercial or scientific experience,” certain countries tended to regard the provision of brain work and technical services as the provision of “information concerning industrial, commercial or scientific experience” and to regard payment for it as therefore taxable as royalties under article 12.~~

~~In order to avoid those difficulties, a member from a developed country proposed that the definition of royalties be restricted by excluding payments received for “information concerning industrial, commercial or scientific experience.” It may be relevant to note that paragraph 2 of article 12 of the OECD Model Convention (corresponding to paragraph 3 of the United Nations Model Convention) was amended by deleting the words “or the use of, or the right to use, industrial, commercial or scientific equipment.”¹⁰ The member also suggested that there be a protocol annexed to the treaty making it clear that such payments should be deemed to be profits of an enterprise to which article 7, dealing with business profits, would apply, and that payments received for studies or surveys of a scientific or technical nature, such as geological surveys, or for consultancy or supervisory services, should be deemed to be profits of an enterprise to which the provisions of article 7 would apply. It was pointed out that the effect of those different provisions would be to ensure that the source country could not tax such payments unless the enterprise had a permanent establishment, as defined by the treaty, situated in that country, and that taxes should be payable only on the net income element of such payments attributable to that permanent establishment.~~

¹⁰ Report of the OECD: “The Revision of the Model Convention” adopted by the Council of the OECD on 23 July 1992.

In order to resolve the problem of the definition of royalties, the Group agreed to consider income from consulting activities as business profits and to include in article 5, paragraph 3, a new subparagraph (b) which provides that the term permanent establishment should likewise encompass “the furnishing of services, including consultancy services, by an enterprise through employees or other personnel, where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve-month period.”

It is considered that income from film rentals should not be treated as industrial and commercial profits but should be dealt with in the context of royalties. The tax would thus be levied on a gross basis but expenses would be taken into account in fixing the withholding rate. With regard to expenses, various factors could be regarded as peculiarly relevant to film rentals. As a general rule, the expenses of film producers might be much higher and the profits lower than in the case of industrial royalties. On the other hand, a considerable part of film expenses represent high salaries paid to actors and other participants who were taxed solely by the country of residence, and not by the source country, and might therefore not justify any great reduction of the withholding tax at source. However, the amounts involved are, nevertheless, real costs for the producer and should be taken into account, while, at the same time, all countries involved should join in efforts to make sure that such income does not escape tax. Further, although the write-off of expenses in the country of residence does not mean that the expenses should not be taken into account at source, at some point old films could present a different expense situation. It has also been suggested that the definition of “royalties” in the bilateral tax treaty may also include those incomes for the use or right to use the intangible property as also for the filming/shooting videos and tapes or other means of reproduction for the use or in connection with television and payment for reception or the right to receive for transmission of visual images or sound or both transmitted to the public via satellite or cable, optic fibre or similar technology, as also whatever gains arise from the sale of the rights or ownership with reference to the above-mentioned activities.

Some members believe that because copyright royalties represent cultural efforts, they should be exempted from tax by the source country. The grounds for an exemption for cultural efforts that result in the earning of income are unclear. Others argue that since tax on that income would be levied by the residence country, the reduction at source would not benefit the author. Other members are in favour of exempting copyright royalties at the source, not necessarily for cultural reasons, but because the residence country is in a better position to evaluate the expenses and personal circumstances of the creator of the royalties, including the period of time over which the books or other copyrighted items were created. A reduction of the withholding rate in the source country might be appropriate if the tax otherwise would be too high to be absorbed by the tax credit of the residence country. However, some source countries might not be willing to accept a lowering of the withholding rate for that reason. Further, the party dealing with the source country might be the publisher and not the author, and arguments supporting the exemption of the author’s income because of his personal situation obviously do not apply to the publisher.

Paragraphs 3, 4 and 6 of article 12 reproduce the provisions of article 12, paragraphs 2, 3 and 4 of the OECD Model Convention with some modifications. First, the United Nations Model

Convention retains the words “or the use of, or right to use industrial, commercial or scientific equipment” in paragraph 3, although those words were dropped from the OECD Model in 1992. There is also a minor change in paragraph 4 of article 12, namely the addition of “and 2” after “the provisions of paragraph 1.”

As to paragraph 5, providing that royalties have their source in the country of residence of the payer, a member from a developed country suggested that some countries might wish to substitute a rule that would identify the source of a royalty as the State where the property or right giving rise to the royalty (the patent etc.) was used. If the two parties in bilateral negotiations differed on the appropriate rule, a possible solution would be a rule that generally would accept the place of residence of the payer as the source of royalty but would adopt a place of use rule if one of the parties used that rule in its domestic legislation.

Article 13 CAPITAL GAINS

1. — ~~Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.~~

2. — ~~Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.~~

3. — ~~Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.~~

4. — ~~Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:~~

(a) — ~~Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.~~

(b) — ~~For the purpose of this paragraph, “principally” in relation to ownership of immovable property means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.~~

5. — ~~Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of ___ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.~~

6. — ~~Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.~~

Observations

The taxation of capital gains is contained in the first three paragraphs of article 13 followed by a new amended paragraphs (paragraphs 4 modified in 1999), paragraph 5 and by the text of article 13, paragraph 4, of the OECD Model Convention, renumbered as paragraph 6 and adjusted to take into account the insertion of the new paragraphs. The commentary on article 13 of the United Nations Model Convention is relevant.

Paragraph 4 of article 13 allows a Contracting State to tax gains on an alienation of shares of a company or on an alienation of interests in other entities when the property of the company or other entity consists principally of immovable property located in that State. The paragraph is not found in the OECD Model Convention. It is designed to prevent avoidance of taxes on the gains from the sale of immovable property through the use of real estate holding companies and similar devices. Taxing the gain derived from the sale of an interest in such an entity is necessary, due to the ease with which taxpayers otherwise would avoid tax on the sale of immovable property. In some cases, the ownership of the shares carries the right to occupy the immovable property. In order to achieve its objective, paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State.

In 1999, the Group of Experts decided to amend paragraph 4 to expand its scope to include interests in partnerships, trusts and estates that own immovable property directly or indirectly. The Group also agreed to narrow the scope of that paragraph by excluding entities if the immovable property they own consists principally of immovable property that they have used in their business activities. However, this exclusion will not apply to an immovable property management company, partnership, trust or estate. In order to fulfil its purpose, paragraph 4 must apply whether the company, partnership, trust or estate owns the immovable property directly or owns it indirectly through one or more interposed entities. Contracting States may agree in bilateral negotiations that paragraph 4 also should apply to gains from the alienation of other corporate interests or from the alienation of rights forming part of a substantial participation in a company. For the purpose of paragraph 4, the term “principally” in relation to the ownership of immovable property by an entity means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the entity.

With regard to paragraph 5, a number of members considered that a Contracting State should retain the right to tax the gain on the sale of shares of a company resident in that State whether the sale occurred within or outside the State. It was recognized, however, that for administrative reasons the right to tax should be limited to a sale of substantial participation in a company. The determination of what was a substantial participation was left to bilateral negotiations. For example,

~~an agreed percentage of voting power might be used to determine what constituted “substantial participation” in a company.~~

~~The Group noted that some countries might take as their negotiating position that the Contracting State where the company was resident should tax the alienation of shares in that company only when a substantial portion of the assets were located within that State. Other countries might prefer that paragraph 5 be omitted entirely.~~

~~A 1992 addition to the commentary on OECD article 13, paragraph 4 (corresponding to paragraph 6 of article 13 of the United Nations Model Convention) is relevant:~~

~~“If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid up capital, the difference between the selling price and par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated profits and not as a capital gain. The article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in article 10: such taxation is permitted because such difference is covered by the definition of the term “dividends” contained in paragraph 3 of article 10 and interpreted in paragraph 28 of the commentary relating thereto. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with article 11...”~~

~~The Group noted further that some countries might feel it undesirable to add to the situations mentioned in paragraphs 1, 2 and 3 only the situations mentioned in paragraphs 4 and 5, especially when they considered that tax avoidance situations of special interest to them required attention. Such countries might wish to replace paragraphs 4, 5 and 6 of article 13 by the following paragraph:~~

~~“Gains from the alienation of any property, other than those gains mentioned in paragraphs 1, 2 and 3, shall be assessed and taxed in accordance with the laws in force in either or both of the Contracting States.”~~

Article 14

~~INDEPENDENT PERSONAL SERVICES~~

~~1. — Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:~~

~~(a) — If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or~~

- (b) — ~~If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.~~

2. — ~~The term “professional services” includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.~~

Observations

The OECD Model Convention previously contained separate articles on independent personal services (article 14)⁴ and dependent personal services (article 15). The provisions of article 14 are similar to those of article 7 on business profits and are based on the same principles. In 2000, the OECD Model Convention was modified to eliminate article 14, with the understanding that income previously taxable under article 14 would now be taxable under article 7. Under the prior version of the OECD Model Convention, article 14 would now be taxable under article 7. Under the prior version of the OECD Model Convention, article 14 would subject income derived by an individual in respect of professional services or other activities of an independent character to taxation in the source country only where the individual has a “fixed base” in that country for the purpose of performing his activities. The OECD believed that the concept of a fixed base and a permanent establishment are very similar, but it felt that there was some uncertainty as to whether the various special rules of article 5 applied under article 14. It was thought to be unclear, for example, whether the rules respecting agents constituting a permanent establishment applied in determining whether a person providing independent services had a fixed base. It was also thought to be unclear whether the exclusions for various activities of a preliminary character were applicable in determining whether a taxpayer had a fixed base. By eliminating article 14, the OECD made clear that the rules defining a fixed base are identical to the rules defining a permanent establishment. It was also thought to be unclear whether a corporation or other legal entity could perform activities of an independent character within the meaning of article 14.

Originally, the Group of Experts agreed to recommend two substantive changes in the text of article 14 of the 1977 version of the OECD Model Convention. Those changes would have added two exceptions, in addition to the fixed base exception, to the basic principle that income derived by a resident of a Contracting State in respect of professional services or other similar independent activities should be taxed only in that State. These two additional exceptions, relating to the length of stay in the source country and the amount of remuneration earned in that country, were embodied in subparagraphs (b) and (c), respectively, of paragraph 1, article 14, as adopted in 1980. However, in 1999, the Group of Experts decided to omit the third criterion, namely, that source taxation was permitted if the amount of remuneration exceeded a threshold amount. As a result, the United Nations Model Convention currently provides that income derived from independent personal

⁴ In 2000, OECD has omitted article 14 from its Model Convention.

services may be taxable only if the taxpayer has a fixed base or is present in the source country for a period exceeding the threshold number of days.

In the course of the discussion preceding the adoption of article 14, some members from developing countries expressed the view that it would not be justifiable to limit taxation by the source country by the criteria of existence of a fixed base and length of stay, and that the source of income should be the only criterion. In contrast, some members from developed countries felt that the exportation of skills, like the exportation of tangible goods, should not give rise to taxation in the country of destination, unless the person concerned had a fixed base in that country comparable to a permanent establishment; they therefore supported the fixed base criterion. They also considered that taxation in the source country would be justified by the continued presence in that country of the person rendering the service. Some members from developing countries also expressed support for the fixed base criterion.

Other members from developing countries expressed a preference for the length of stay criterion.

Several members from developing countries proposed a third criterion, namely, that of the amount of remuneration. Under that criterion remuneration for independent personal services could be taxed by the source country if it exceeded a specified amount, regardless of the existence of a fixed base or the length of stay in that country. In 1999, the Group of Experts observed that any monetary ceiling limit probably would become meaningless over a period of time due to inflation and would only have the effect of limiting the amount of potentially valuable services that the country will be able to import. Moreover, the provision to this effect appeared only in six per cent of the existing bilateral tax treaties finalized between 1980 to 1997. The Group of Experts, accordingly, decided to delete subparagraph (c) of paragraph 1 of article 14, as contained in the 1980 Model.

Article 15

DEPENDENT PERSONAL SERVICES

1. — Subject to the provisions of articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. — Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first mentioned State if:

- (a) — The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned; and

- (b) ~~The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and~~
- (c) ~~The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.~~

3. ~~Notwithstanding the preceding provisions of this article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.~~

Observations

The 1965 report of the OECD Fiscal Committee mentioned earlier describes the following considerations concerning dependent personal services:

~~“The OECD draft convention provides for the taxation of income from dependent personal services in the country where the services are performed. However, if the services involved are supplied by an employee of a foreign enterprise, he must be present in the country for a period of six months or more before he becomes taxable. Such a rule, if used in conventions between developing and capital exporting countries, may seem to favour the latter. However it is important to note that skilled personnel are one of the great needs of developing countries. Such persons are in demand everywhere. If they are to become involved in the tax systems of developing countries after relatively brief stays in such countries, it may constitute a barrier to their going to such countries. This has been recognized by the tax laws of some developing countries, and it is not uncommon for them to grant exemption in such cases unilaterally. It is conceivable that the personal service article will bear modification, perhaps by lengthening the duration that a technician may remain in a host country without becoming subject to tax there. However, due consideration will have to be given to the desirability of permitting individuals to be wholly free of taxes.”⁵~~

~~In connection with the taxation of remuneration of dependent personal services, the commentary on article 15 in the United Nations Model Convention is therefore relevant.~~

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

1. ~~Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.~~

⁵ Organisation for Economic Cooperation and Development, op. cit., paragraph 175.

2. — Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

Observations

As in the case of the United Nations Model Convention, the OECD Model Convention contains a separate article on directors' fees, which applies solely to payments received in the recipient's capacity as a member of the Board of Directors of a company. The article, which is based on the assumption that it might sometimes be difficult to ascertain where the services in question are performed, stipulates that such payments may be taxed in the Contracting State where the company concerned is a resident.

An article in a bilateral tax treaty relating to the taxation of directors' fees and remuneration of top-level managerial officials may be based on the text of article 16 of the United Nations Model Convention, which, unlike the OECD Model Convention, is supplemented by the addition of a second paragraph dealing with payments received by top-level managerial officials. The whole of the OECD Model commentary on article 16 is therefore relevant to paragraph 1 of article 16.

The Group observed that the top-level managerial positions of a company resident in a Contracting State might be occupied by persons resident in the other Contracting State. In that situation, the principle applicable by the first Contracting State to the taxation of directors' fees also should apply to the taxation of the remuneration paid to such top-level managerial officials. The term "top-level managerial positions" refers to a limited group of positions that involve primary responsibility for the overall direction of the affairs of the company, apart from the activities of the directors. The term covers a person acting as both a director and a top-level manager.

Article 17

ARTISTES AND SPORTS PERSONS

1. — Notwithstanding the provisions of articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sports person, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. — Where income in respect of personal activities exercised by an entertainer or a sports person in his capacity as such accrues not to the entertainer or sports person himself but to another person, that income may, notwithstanding the provisions of articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sports person are exercised.

Observations

The OECD Model Convention contains an article (article 17) which covers the activities of sportsmen as well as those of entertainers, and provides that the activities of such persons shall be taxed in the State in which the activities are exercised. Article 17 constitutes an exception to the

~~rules laid down in article 7 of the OECD Model Convention (formerly article 14) relating to the taxation of independent personal services, and paragraph 2 of article 15 of that Convention on dependent personal services. Paragraph 2 of article 17 is designed to help counter certain tax avoidance devices. Under a common device, the remuneration for the performance of an entertainer or sports person is paid, not to the entertainer or sports person himself, but to another person, e.g., a so-called artiste company. In the absence of paragraph 2, the source country would not be able to tax the income either as personal service income of the entertainer or sports person because the income is not earned by that person, and it would not be able to tax the artiste company, because the company would not have a permanent establishment in that country.~~

~~It is considered that the term “sports person” which, unlike the term “entertainer” is not followed in paragraph 1 by illustrative examples, is nevertheless likewise to be construed in a broad manner consistent with the spirit and the purpose of the article 17. It has been suggested that income earned by artistes and sports persons by the direct use, rent or other forms of assets in relation to the exercise of their professional activities should also be treated as professional income and chargeable as such.~~

Article 18 PENSIONS AND SOCIAL SECURITY PAYMENTS

Article 18 (alternative A)

- ~~1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.~~
- ~~2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security of a Contracting State or political subdivision or a local authority thereof shall be taxable only in that State.~~

Article 18 (alternative B)

- ~~1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment, may be taxed in that State.~~
- ~~2. However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.~~
- ~~3. Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.~~

Observations

The United Nations Model Convention stipulates that private pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

During the discussion, several members of the Group of Experts from developing countries expressed the view that pensions should not be taxed exclusively in the beneficiary's country of residence. They pointed out that since pensions were in substance a form of deferred compensation for services performed in the source country, they should be taxed at source as normal employment income would be. They further observed that pension flows between some developed and developing countries were not reciprocal and in some cases represented a relatively substantial net outflow for the developing country. Several members said they favoured exclusive taxation of pensions at source but would be willing to grant an exemption from source taxation for amounts equivalent to the personal exemptions allowable in the source country. Other members were generally of the view that pensions should be taxed only in the beneficiary's country of residence. They suggested that because the amounts involved were generally not substantial, developing countries would not suffer measurably if they agreed to taxation in the country of residence. Those members also made the point that the country of residence was probably in a better position than the source country to structure its taxation of pensions to the taxpayer's ability to pay.

A question was raised as to how pension payments would be taxed in the case of employees who had performed services consecutively in several different countries, a fairly common practice among employees of transnational corporations. If such employees were taxed in each jurisdiction in which they had previously worked to earn the pension, then each pension payment might be taxed in a number of jurisdictions. It also was observed that it would be very difficult for the head office of a company to allocate each pension among the various countries where the pensioner had worked during his years of employment. It was generally agreed therefore that taxation of pension at source should be construed to mean taxation at the place where the pension payments originated, not the place where the services had been performed.

The Group was unable to reach a consensus that would have enabled it to recommend an article suggesting the manner in which pension payments (but not including social security payments) should be taxed, that is, whether tax jurisdiction over such payments should be recognized as belonging to the source country or the country of residence or to both. Hence the two alternatives suggested by the Group in article 18 (alternative A) and article 18 (alternative B) respectively.

Neither article 18 nor article 19 of the OECD Model Convention refers specifically to pensions that are part of a social security system. That omission is due to the fact that some States consider such pensions to be similar to government pensions and therefore liable to taxation under the source principle, whereas other States hold the view that such pensions should be assimilated to private pensions and should be taxable only in the State of residence of the recipient. That being so, the Committee on Fiscal Affairs of the OECD suggests in the Commentary on article 18 that States advocating the application of the source principle might seek in bilateral negotiations to include in the article modelled on article 18 in their bilateral treaties a paragraph drafted along the following

lines: “Notwithstanding the provisions of paragraph 1, pensions and other payments made under the social security legislation of a Contracting State may be taxed in that State.”⁶

The premise for assigning to the source country the exclusive right to tax payments under a government pension plan (a public pension plan that is part of the social security system) is predicated on the rationale that those payments are wholly or largely financed out of the tax revenues of that country. That premise is likely to be valid if the potential beneficiaries do not make any contributions to the plan or if the payments are supplemented by the tax revenues of the source country. It is not likely to be valid, however, if the social security system functions on the basis of the capitalization principle rather than the distribution principle.

Article 19 GOVERNMENT SERVICE

1. ~~(a) Salaries, wages and other similar remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.~~

~~(b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:~~
 - ~~(i) is a national of that State; or~~
 - ~~(ii) did not become a resident of that State solely for the purpose of rendering the services.~~
2. ~~(a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.~~

~~(b) However, such pensions shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.~~
3. The provisions of articles 15, 16 and 18 shall apply to salaries, wages and other similar remuneration and to pensions, in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Observations

⁶ Organisation for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital* (Paris, 1992), commentary on article 18, paragraph 2.

The United Nations Model Convention allows the State paying the remuneration in respect of government services to tax that remuneration. Such an approach is in conformity with the rules of international courtesy and mutual respect between sovereign States and with the provisions of the Vienna Conventions on Diplomatic and Consular Relations.⁷ However, taking into account the fact that, as a result of the growth of the public sector in many countries, government activities abroad have been considerably extended, the United Nations Model Convention allows the State where the services are performed to tax the remuneration in the case of remuneration paid by one Contracting State to an individual in respect of services rendered in the other Contracting State if the individual is a resident of the latter State and also a national of that State and did not become a resident of that State solely for the purpose of rendering the service.

The United Nations Model Convention, in the case of public pensions, generally gives the Contracting State making the pension payments the exclusive right to tax those pensions. As an exception to that rule, the right to tax a pension is granted to the Contracting State where the recipient of a pension is resident if that person is also a national of that State. According to the OECD Committee on Fiscal Affairs, this approach is likewise in keeping with the Vienna Conventions on Diplomatic and Consular Relations, according to which the receiving State is allowed to tax remuneration paid to certain categories of personnel of foreign diplomatic missions and consular posts who are permanent residents or nationals of that State.

The taxation of remuneration in respect of government service and social security payments is contained in the text of article 19 of the United Nations Model Convention and the whole of the commentary on article 19 is relevant.

Although the provisions of article 19 generally were acceptable, the Group of Experts observed that some developing countries might desire to limit, by reference to a ceiling amount, the restriction in paragraph 2(b) on the taxation of pensions by the Government making the pension payments when the recipient is a resident or a national of another country. The Group also felt that some developing countries might prefer that payments dealt with in article 19 should be taxed only by the beneficiary's country of residence.

Article 20 STUDENTS

Payments which a student or business apprentice, who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first mentioned State solely for the purpose of his education or training, receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Observations

⁷ Ibid., commentary on article 19, paragraph 1.

~~Article 20 of the United Nations Model Convention, as presently worded, reproduces substantially article 20 of the OECD Model Convention. In 1999, the Group of Experts agreed to drop what had been paragraph 2 of the 1980 version of the Model Convention. That paragraph guaranteed to students and apprentices the same exemptions and reliefs granted to domestic taxpayers. In its current form, article 20 of the United Nations Model Convention provides that payments received by students or business apprentices for the purpose of their maintenance, education or training and from sources outside the State where the student or business apprentice concerned is staying shall be exempted from tax in that State. This provision extends to individuals who leave home to study or train in the other Contracting State and thereby lose their residence status in their home State. It does not extend, however, to an individual who was once a resident of a Contracting State but who subsequently moved his residence to a third State before visiting the other Contracting State.~~

~~Some members of the Group felt that students or business apprentices should be exempted from tax on income received from employment in the Contracting State which they were visiting during their period of study or training. However, it was recognized that this exemption could in some situations be regarded as discriminatory against local students or business apprentices receiving employment income. It was observed that some countries in bilateral negotiations might wish to expand the exemption in article 20 by adding a paragraph permitting a further exemption (beyond that generally applicable as a personal exemption or similar allowance under the internal law of the Contracting State) of employment income under certain conditions. That further exemption would be limited, however, by some income ceiling or by confining the exemption to amounts required for maintenance and support. In setting a ceiling amount, some countries might wish to utilize as a guide the additional costs incurred as a result of the fact that the students or business apprentices were visitors. If such further exemption were to be permitted, it would be appropriate to place a time limit on the exemption. Presumably students would be given a longer time limit than apprentices.~~

Article 21

OTHER INCOME

~~1. — Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles shall be taxable only in that State.~~

~~2. — The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.~~

~~3. — Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may be taxed in that other State.~~

Observations

~~The United Nations Model Convention contains a separate article (article 21) on “other income.” This article reproduces Article 21 of the OECD Model Convention in its entirety and also has an additional paragraph 3 containing a general provision relating to items of income of a resident of a Contracting State not dealt with in the preceding articles and arising in the other Contracting State. The article covers not only income of a class not expressly dealt with in the preceding articles, but also income from sources not expressly mentioned therein. The scope of the article is not confined to income arising in a Contracting State but extends also to income from third States.~~

~~In sharp contrast to the OECD Model Convention, the United Nations Model Convention does not assign the exclusive right to tax “other income” to the State of residence of the recipient. Paragraph 3 of article 21 is intended to permit the country where the income arises to tax such income if its law so provides, whereas paragraph 1 permits taxation in the country of residence. Residency is determined under the rules of article 4. The primary right to tax in the residence country generally is denied when the income is associated with the activity of a permanent establishment or fixed base that a resident of a Contracting State has in the other Contracting State. In such cases, a primary right to tax is given to the Contracting State where the permanent establishment or fixed base is situated; the residence State retains the right to tax as well but must relieve the double taxation that results.~~

~~An article in a bilateral tax treaty relating to the taxation of income other than that covered in the preceding articles may be based on the text of article 21 of the United Nations Model Convention which contains a new paragraph 3 providing a general rule relating to items of income of a resident of a Contracting State not dealt with in the preceding articles and arising in the other Contracting State. Consequently the commentary on article 21 of the United Nations Model Convention is relevant.~~

~~The Group observed that the provisions of paragraph 3 would permit the country where the income arises to tax such income if its law so provides whereas the provisions of paragraph 1 would permit taxation in the country of residence. The concurrent application of the provisions contained in the two paragraphs might result in double taxation. In such a situation, the provisions of article 23A or 23B, as appropriate, would be applicable, as in other cases of double taxation. The Group further observed that in some cases paragraphs 2 and 3 might overlap in such cases; however, they produce the same result.~~

CHAPTER IV

TAXATION OF CAPITAL

Article 22

CAPITAL

1. ~~Capital represented by immovable property referred to in article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.~~

2. ~~Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.~~

3. ~~Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.~~

[4. ~~All other elements of capital of a resident of a Contracting State shall be taxable only in that State.~~]

~~(The Group decided to leave to bilateral negotiations the question of the taxation of the capital represented by immovable property and movable property and of all other elements of capital of a resident of a Contracting State. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.)~~

Observations

~~The United Nations Model Convention, article 22, deals with taxes on capital, to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties. If the negotiating parties decide to include an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.~~

~~If in a case the provisions of paragraph 4 are applied to elements of movable property under usufruct, double taxation subsists because of the disparity between domestic laws, the States concerned may resort to the mutual agreement procedure or settle the question by means of bilateral negotiations.~~

~~This article does not provide any rule about the deductions of debts. The laws of different countries are too diverse to allow a common solution to the treatment of debt. Paragraph 4 of article 24 addressed the problem that might arise in the treatment of debts when the taxpayer and the creditor are not residents of the same State.~~

CHAPTER V

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23 A

EXEMPTION METHOD

1. — Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. — Where a resident of a Contracting State derives items of income which, in accordance with the provisions of articles 10, 11 and 12, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

3. — Where in accordance with any provision of this Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Article 23 B

CREDIT METHOD

1. — Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State; and as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. — Where, in accordance with any provision of this Convention, income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Observations

The United Nations Model Convention takes the same approach as the OECD Model Convention concerning methods for the elimination of double taxation and has reproduced the two alternative versions of article 23 of the OECD Model Convention, namely article 23 A on the exemption method and article 23 B on the credit method.

The Group agreed that, generally speaking, the method by which a country would give relief from double taxation depended primarily on its general tax policy and the structure of its tax system. Owing to the differences that existed in the various tax systems as regards the objectives pursued, it was further agreed that bilateral tax treaties provide the most flexible instrument for reconciling conflicting tax systems and for the avoidance or mitigation of double taxation.

Members from developing countries felt that, as regards relief measures to be applied by developing countries, the methods of tax exemption, tax credit (including tax-sparing credit) could be used as appropriate. The exemption method was considered eminently suitable when exclusive tax jurisdiction over certain income was allotted to the country of source under a treaty; it might take therein the form of an exemption with progression. The main defect of the foreign tax credit method, from the point of view of developing countries, is that special tax concessions granted by them may in large part enure to the benefit of the treasury of the capital-exporting country rather than to the foreign investor for whom the benefits were designed. When the investor's home country applied the principle of the foreign tax credit, the most effective method of preserving the effect of the tax incentives and concessions extended by developing countries would be the application of a tax-sparing credit in addition to the regular tax credit.

The effectiveness of the tax incentive measures introduced by most developing countries depends upon the interrelationships between the tax systems of the developing countries and those of the capital-exporting countries where the investment originates. It may be of primary importance to developing countries to ensure that the tax incentive measures shall not be made ineffective by taxation in the capital-exporting countries using the foreign tax credit system. This undesirable result is to some extent avoided in bilateral tax treaties through a "tax-sparing credit", by which a developed country grants a credit not only for the tax paid but for the tax spared by incentive legislation in the developing country. It is also avoided by the exemption method. The members of the Group of Experts from developing countries considered it necessary to underline their understanding that either the exemption method or the tax-sparing clause is, for these countries, a basic and fundamental aim in the negotiation of tax treaties. On the other hand, some members noted that studies have shown that tax factors may not themselves be decisive in the process of investment decisions. For a detailed discussion of this subject, please see pages 265-268 of the *United Nations Model Double Taxation Convention between Developed and Developing Countries*.

CHAPTER VI

SPECIAL PROVISIONS

Article 24 NON-DISCRIMINATION

1. — ~~Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of article 1, also apply to persons who are not residents of one or both of the Contracting States.~~
2. — ~~Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.~~
3. — ~~The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.~~
4. — ~~Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first mentioned State.~~
5. — ~~Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first mentioned State are or may be subjected.~~
6. — ~~The provisions of this article shall, notwithstanding the provisions of article 2, apply to taxes of every kind and description.~~

Observations

Article 24 of the United Nations Model Convention reproduces article 24 of the OECD Model Convention. In 1999, the definition of the term “national” which had previously been included in this article was moved to article 3 as was also done in the OECD Model Convention. The provisions in article 24 on non-discrimination establish the principle that for purposes of taxation, discrimination on the grounds of nationality is forbidden and that subject to reciprocity the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

Long before the emergence of the classical type of double taxation treaty at the end of the nineteenth century, the principle of non-discrimination in fiscal matters had been embodied in many different types of international agreements under which each Contracting State undertook to grant nationals of the other Contracting State the same treatment as its own nationals (consular or establishment conventions, treaties of friendship or commerce etc.). In view of the long-standing acceptance of the principle of non-discrimination in international fiscal relations, which in the twentieth century has been included in virtually all bilateral treaties for the avoidance of double taxation, the Group had no difficulty in agreeing that the principle should be embodied in the articles.

A question was raised as to whether paragraph 4 of that article was suitable for inclusion in a tax treaty between developed and developing countries. It was suggested that paragraph would not be acceptable to a country that disallowed a deduction for disbursements made to a foreign-owned corporation unless the corporation was being taxed in that country. After substantial discussion, the feeling of the Group was that the special circumstances mentioned above ought not to be the basis for treaty guidelines of broad application. If a country felt that paragraph 4 was inconsistent with its domestic rules on deductions, it should raise the issue in bilateral negotiations.

Some members from developing countries proposed that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises were treated alike; they said that change represented a notable departure from the general principle of taxing foreign persons on the same basis as nationals but that the problems of tax compliance in cases in which foreign ownership was involved and the politically sensitive position of foreign-owned enterprises in developing countries warranted the change. Therefore, they proposed that paragraph 5 of article 24 of the OECD Model Convention be amended to read as follows:

“5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar enterprises the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of third countries.”

— They went on to point out that the proposed change in paragraph 5 had been included in several tax treaties to which developed countries were parties. Some members from developed

countries pointed out that such a proposal would in fact limit the effect of the non-discrimination between enterprises owned by non-residents, thus leaving the door open to discrimination against enterprises owned by non-residents as a class.

Several members from developed countries expressed reservations concerning the proposed change and pointed out that they considered the OECD non-discrimination article as the backbone of the Convention. They recalled that the antecedents of the non-discrimination article in the present OECD Model Convention dated from the nineteenth century. They felt that if such a fundamental principle were to be altered, it would have a significant effect on international tax relations generally. Further, because the proposed change was motivated in part by problems with tax compliance involving foreign ownership of enterprises, most particularly by problems with transfer pricing, it was suggested that the problems might be dealt with more properly in other parts of the tax convention, such as in article 9 dealing with associated enterprises.

Some members from developing countries indicated that some countries, although recognizing the essential importance of and need for the article on non-discrimination, might wish to modify certain paragraphs of that article in bilateral negotiations. It was suggested, for example, that because of the difficulties involved in determining what constitutes reasonable amounts in the case of transfer payments on account of royalties, technical assistance fees and so on, a country might desire to deny deductions for such payments when made by an enterprise situated within its territory to a foreign controlling company, whether the latter was resident in another Contracting State or in a third country. Another example cited was that of a country granting tax preferences with a view to the attainment of certain national objectives might wish to make a given percentage of local ownership of the enterprise involved a condition for the granting of such tax preferences. The Group recognized that special situations such as those mentioned as examples should be resolved in bilateral negotiations.

It may be noted that some countries have provided explicitly by treaty that measures reasonably designed to combat tax evasion and avoidance do not constitute a violation of the non-discrimination rule. Contracting States wishing to include such a provision in their treaty through bilateral negotiations might consider adoption of the following language:

“Nothing in this article relates to any provision of the taxation laws of a Contracting State reasonably designed to prevent the avoidance or evasion of taxes, provided that such provisions (other than provisions in international agreements) do not discriminate between citizens or residents of the other Contracting State and those of any third State.”

Article 25

MUTUAL AGREEMENT PROCEDURE

1. — Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be

~~presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.~~

~~2. — The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.~~

~~3. — The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.~~

~~4. — The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above mentioned bilateral actions and the implementation of the mutual agreement procedure.~~

Observations

~~Difficulties of interpretation or application are likely to occur in connection with the implementation of a bilateral tax treaty, as in connection with the implementation of any treaty. These difficulties might impair or impede the normal operation of the provisions of the treaty as originally conceived by the negotiating parties. Hence the need for a mutual agreement procedure for resolving any disagreement arising out of the implementation of the treaty in the broadest sense of the term. Such a mutual agreement procedure is clearly a special procedure outside the domestic law. The mutual agreement procedure is designed not only to furnish a means of settling questions relating to the interpretation and application of the Convention, but also to provide (a) a forum in which residents of the States involved can protest actions not in accordance with the Convention and (b) a mechanism for eliminating double taxation in cases not provided for in the Convention.~~

~~The United Nations Model Convention sets forth in article 25 a mutual agreement procedure for resolving difficulties arising out of the application of the Convention in the broadest sense of the term. Under such a procedure, the competent authorities of the two Contracting States are to endeavour by mutual agreement to resolve the situation of taxpayers subjected to taxation not in accordance with the provisions of the Convention. They are also invited and authorized to resolve by mutual agreement problems relating to the interpretation or application of the Convention and, furthermore, to consult together for the elimination of double taxation in cases not provided for in the Convention. Concerning the practical operation of the mutual agreement procedure, the competent authorities are merely authorized to communicate with each other directly, without going~~

through diplomatic channels and, if it seems advisable to them, to have an oral exchange of opinion through a joint commission appointed especially for the purpose. It has been suggested that the Contracting States may provide an arbitration clause through which the controversies concerning the interpretation or the application of the Convention may be resolved.

The OECD Model Convention commentary on article 25 states that in practice the mutual agreement procedure applies most frequently to cases of double taxation that the Convention was specifically intended to avoid. Disagreements over the proper application of the arm's length standard, embodied in article 9, have created many cases that have gone to the competent authorities for resolution. Among the most common cases cited in the OECD commentary are the following:

1. Questions relating to attribution to a permanent establishment of a proportion of the executive and general administrative expenses incurred by the enterprise, under paragraph 3 of article 7;
2. The taxation in the State of the payer "in case of a special relationship between the payer and the beneficial owner" of the excess part of interest and royalties, under the provisions of article 9, paragraph 6 of article 11 or paragraph [6] of article 12;
3. Cases of application of legislation to deal with thin capitalization when the State of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to article 9 or paragraph 6 of article 11;
4. Cases where lack of information as to the taxpayer's actual situation has led to misapplication of the Convention, especially in regard to the determination of residence (paragraph 2 of article 4), the existence of a permanent establishment (article 5), or the temporary nature of the services performed by an employee (paragraph 2 of article 15).

The commentary also notes that "on the whole the mutual agreement procedure has proved satisfactory" and that "the most recent treaty practice shows that article 25 represents the maximum that Contracting States are prepared to accept." The commentary adds that it must, however, be admitted that the procedure "is not yet entirely satisfactory from the taxpayer's viewpoint ... because the competent authorities are required only to seek a solution and are not obliged to find one."

In the light of the foregoing and in view of the need to provide for a mutual agreement procedure, article 25 of the United Nations Model Convention, reproduces the text of article 25 of the OECD Model Convention with one substantive change, namely, the addition of the second and third sentences of paragraph 4 of article 25. It may be relevant to note that the OECD eliminated the second sentence of paragraph 4 in 1995, which had been in the OECD Model since 1963. The commentary on article 25 of the OECD Model Convention is relevant *mutatis mutandis* to article 25. According to the Group, the procedure is designed not only to provide a means of settling questions relating to the interpretation and application of the treaty, but also to provide a forum in which residents of the States involved can protest actions not in accordance with the treaty and a mechanism for eliminating double taxation in cases not provided for in the treaty. The mutual agreement procedure applies in connection with all articles of the Convention and in particular to article 7 on business profits, article 9 on associated enterprises, article 11 on interest, article 12 on royalties and article 23 on methods for the elimination of double taxation. However, some countries

may need to modify this grant of power to their competent authorities in conformity with their domestic laws.

With regard to paragraph 4 of article 25, the Group emphasized the following essential elements in respect of income and expense allocations, including transfer pricing:

1. — Transactions between related entities should be governed by the standard of “arm’s length dealing.” As a consequence, if an actual allocation is considered by the tax authorities of a treaty country to depart from that standard the taxable profits may be re-determined;
2. — Taxpayers are entitled to invoke the mutual agreement procedure when they consider that such action by one or both of the tax authorities regarding such re-determination is contrary to the arm’s length standard;
3. — The implementation of the mutual agreement procedure is delegated to the competent authorities of the treaty countries, with adequate powers to ensure full implementation and with the expectation that such implementation will enable the mutual agreement procedure to be an effective instrument for carrying out the purpose of the treaty. The Group stressed that such delegation included power to establish time limits within which matters should be presented by the interested parties to the appropriate competent authority. This delegation of the power to set time limits would make unnecessary the last sentence of paragraph 1 of article 25 of the United Nations Model Convention, which limits to three years the time for presenting a case under that article.

N.B. For more detailed suggestions on procedural and substantive aspects of the mutual agreement procedure, see part three, chapters I and II.

Article 26 EXCHANGE OF INFORMATION

1. — The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, in so far as the taxation thereunder is not contrary to the Convention, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State, it shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and

techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

- (a) To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- (b) To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
- (c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

Observations

The aim of double taxation treaties is to promote international movements of capital and persons through the elimination of international double taxation without creating enhanced opportunities for tax evasion and avoidance. The issue of tax evasion, although obviously important to developed countries, is even more important to developing countries. Experience has shown quite clearly that a tax administration which relies only on the information available to it within its national jurisdiction is not equipped to deal effectively with the problems posed by tax evasion. The provisions of a tax treaty between a developing and a developed country providing for taxation of net income (or some reasonable approximation of net income) cannot operate appropriately if the developing country is unable to obtain, within a reasonable time, reliable outside information about the fiscal affairs of foreign enterprises engaged in business activities within its borders. To serve the goal of preventing international double taxation, therefore, a bilateral tax treaty should include provisions ensuring cooperation between the Contracting States with respect to the supply of information necessary to apply the provisions of the treaty or to enforce the domestic laws of the Contracting States concerning taxes covered by the treaty. Obviously cooperation on the exchange of information is also helpful in achieving the treaty goal of mitigating international tax evasion and avoidance.

The United Nations Model Convention deals with the subject of information exchange in article 26, which provides for the exchange of information concerning taxes covered by the Convention as is necessary for carrying out the provisions of the Convention or of the domestic laws of the Contracting States; the exchange of information is not restricted by article 1 of the Convention, so that the information may include particulars about non residents. It has also been suggested that the exchange of information may extend to all the taxes levied in the Contracting States and not restricted to those mentioned in the Convention.

The information obtained under article 26 may be disclosed only to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. A Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at

the disposal of the other Contracting State. Information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons, provided that the tax authorities would make similar investigations or examination for their own purposes. Contracting States do not have to supply information the disclosure of which would be contrary to public policy.

Mention may be made here of the Convention on Administrative Assistance in Tax Matters concluded by the Nordic countries, which contains detailed provisions on the exchange of information. The Nordic Multilateral Convention is divided into five parts, the most essential of which are those concerning the procurement of information and tax enforcement, including assistance in collecting taxes due. The Convention also contains general provisions, provisions concerning the service of documents and special provisions. In addition to the income and capital taxes dealt with in the conventions for the avoidance of double taxation between the Nordic countries, the Nordic Multilateral Convention covers inheritance or estate taxes, gift taxes, certain indirect taxes (such as motor vehicle taxes and value added taxes), social security and some other public charges and advance payments of taxes. The Nordic Multilateral Convention originally provided that the assistance could take the form of tax collection and enforcement, service of documents and exchange of information, either automatically or on request. The 1976 Additional Agreement extended the scope of an exchange of information system to cover the spontaneous exchange of information. It also made it possible for tax officials of one Nordic country to take part in tax investigations in another Nordic country if the tax matter is of a substantial interest to that former country.

Under the Nordic Multinational Convention, requests for assistance (including the provision of information) cannot be made unless the requesting State in accordance with its own legislation would be able to provide corresponding assistance to the requested State. Information must be processed in accordance with the legislation of the requested State and requests for procurement of information may be refused when a business, manufacturing or professional secret would be disclosed if the request were complied with. If a tax matter is of substantial interest to a requesting State, its representatives may be allowed to be present at an investigation of that tax matter in the requested State. Information revealed in the course of the investigation is to be treated as secret and must not be disclosed to persons or authorities including courts and other judicial authorities, other than those concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes which are the subject of the Convention. The competent authority is required, in so far as it is possible on the basis of available statements of income or similar information, to send to the competent authorities in each of the other Contracting States, as soon as possible after the end of each calendar year and without being specially requested to do so, information concerning individuals and legal persons resident in that State regarding:

- (a) Dividends paid by joint stock companies and similar legal persons;
- (b) Interest on bonds and similar securities;
- (c) Balances with banks, savings banks and similar institutions and interest on such balances;

- (d) ~~Royalties and other charges paid periodically for the utilization of copyrights, patents, designs, trade marks or other such rights or property;~~
- (e) ~~Wages, salaries, fees, pensions and annuities;~~
- (f) ~~Damages, insurance payments and other similar compensation obtained in connection with trade or business activities; and~~
- (g) ~~Other income or property to the extent set out in a further agreement which may be concluded between the competent authorities of the Contracting State for the implementation of the Convention.~~

~~Another multinational convention of note is the Mutual Administrative Assistance in Tax Matters Convention prepared by the OECD and the Council of Europe. It opened for signature in 1988 and went into force in 1995. It has been ratified by the Nordic countries plus the Netherlands, Poland and the United States. In addition to providing for a broad exchange of information, it also provides for mutual assistance in serving of process and in collection of taxes due.~~

~~It is considered that the exchange of information constitutes a valuable means of preventing tax evasion. In that perspective, article 26 of the United Nations Model Convention generally corresponds to the provisions of article 26 of the OECD Model Convention with three substantive changes in paragraph 1, namely, the insertion of the phrase “in particular for the prevention of fraud or evasion of such taxes” in the first sentence, the insertion of the words “However, if the information is originally regarded as secret in the transmitting State” at the beginning of the fourth sentence and the addition of a new sentence (sixth and last sentence). The latter sentence is the key to the approach advocated by the Group; it would stress the importance of the competent authorities in implementing fully the provisions on the exchange of information and would give them the necessary authority to do so. In other words, it would obligate the competent authorities to implement fully the provisions on the exchange of information.~~

~~The Group observed that the reference to fraud or evasion in paragraph 1 was intended to focus attention on the importance of exchanges of information that would assist the treaty partners in combating such practices. Because a number of countries were concerned with the need for information to assist in the administration of specific statutory provisions against tax avoidance and others were concerned with the need for information to assist in detecting other aspects of tax avoidance, the Group considered it advisable to include the reference in the last sentence of paragraph 1 to exchanges of information regarding tax avoidance where the treaty partners deemed it appropriate. The reference in the same sentence to the consultations aimed at developing appropriate conditions, methods and techniques was designed to enable the treaty partners to work out the modalities for exchanges of information between them.~~

~~During the course of the discussion, members from developing countries observed that the proliferation of transnational corporations and the ever-growing sophistication and complexity of the forms taken by international business transactions was resulting in increasing tax avoidance and evasion. The view was expressed that such a situation might have reached a point that it might negate completely the effects of treaties for the avoidance of double taxation. In this context, the question is raised whether steps should be taken outside and in addition to the existing framework of tax treaties. One member from a developing country, supported by other members from developing countries, suggested that the quickest and most effective way of ensuring the exchange of~~

~~information required to combat tax evasion efficiently would be through the conclusion of a multilateral agreement dealing specifically with the exchange of information and mutual assistance in tax administration.~~

~~In discussing the problems of tax havens, the Group indicated, that as a protection against improper manipulation of treaty benefits, consideration should be given in bilateral negotiations to the inclusion of a separate article along the following lines:~~

~~“Each of the Contracting States should endeavour to collect on behalf of the other Contracting State such taxes imposed by that other Contracting State to the extent necessary to ensure that any exemption or reduced rate of tax granted under the treaty by that other Contracting State should not be enjoyed by persons not entitled to such benefits.”~~

~~[N.B. For further discussion of the question of the exchange of information, see part three, chapter III.]~~

Article 27

~~MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS~~

~~Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.~~

Observations

~~Article 27 of the United Nations Model Convention relating to members of diplomatic missions and consular posts reproduces the text of article 27 of the OECD Model Convention. Consequently the whole of the commentary on the latter article is relevant to article 27.~~

CHAPTER VII

FINAL PROVISIONS

Article 28

ENTRY INTO FORCE

1. ~~This Convention shall be ratified and the instruments of ratification shall be exchanged at _____ as soon as possible.~~

2. ~~The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:~~

(a) ~~(in State A):~~

(b) ~~(in State B):~~

Article 29

TERMINATION

~~This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year _____. In such event, the Convention shall cease to have effect:~~

(a) ~~(in State A):~~

(b) ~~(in State B):~~

Observations on articles 28 and 29

~~Articles 28 and 29 of the United Nations Model Convention relating to the entry into force and termination of the Convention reproduce the texts of articles 29 and 30 of the OECD Model Convention. The whole of the commentary on those articles is therefore relevant to articles 28 and 29.~~

~~Some Contracting States may wish to address the possibility that a State may adopt domestic legislation that would override a part of the Convention. These States may seek a provision such as the following:~~

~~“When the competent authority of one of the Contracting States considers that the law of the other Contracting State is or may be applied in a manner that eliminates or significantly limits a benefit provided by the Convention, that State shall inform the other Contracting State in a timely manner and may request consultations with a view to restoring the balance of benefits of the Convention. If so requested, the other State shall begin such consultations within months of the date of such request.~~

~~“If the Contracting States are unable to agree on the way in which the Convention should be modified to restore the balance of benefits, the affected State may terminate the Convention in accordance with the procedures of Article 29, notwithstanding the requirement of that Article that the Convention remain in effect until after the year _____ or take such other action regarding this Convention as may be permitted under the general principles of international law.”~~

~~It may be relevant to mention that a treaty override in violation of international law creates negative effects on mutual trust among Contracting States. It should be noted that the right to terminate a treaty under customary international law, as embodied in the Vienna Convention on the Law of Treaties, is available only for a material breach of a treaty and only after protest has been made to the offending State through appropriate channels.~~

Terminal clause

~~[N.B. The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the treaty shall be drafted in accordance with the constitutional procedures of both Contracting States.]~~