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United Nations Model Tax Convention update

NOTE ON PROPOSED UPDATE OF UNITED NATIONS MODEL TAX CONVENTION

Summary

This note has been prepared by the Subcommittee on the United Nations Model Tax Convention Update. The Subcommittee is mandated to:

> "… collate all the work on the Model update that has been completed by the Committee, drawing upon the work of relevant Working Groups. It will also review the existing Commentary and identify desirable amendments to the Commentary. It will report back to the next annual session of the Committee with a report on work-in progress on the update. It will report back to the 2011 annual session with a proposed final draft of the Model Update."

This document reflects a text for discussion of the update, reflecting decisions already taken by the Committee as well as proposals to ensure that the new version of the UN Model best meets the needs of Member States.

Text that has already been agreed by the Committee to be deleted is denoted by black strikethrough type. Text now proposed for deletion is denoted by red strikethrough (matters regarded as substantive) and blue strikethrough (matters regarded as more editorial in nature).

Text already agreed for inclusion is denoted by black bold-faced type unless otherwise specifically noted. Text now proposed for inclusion is denoted by red bold-faced type (matters regarded as substantive) and blue bold-faced type (matters regarded as more editorial in nature).

For convenience, the proposed changes are outlined in Document CRP.2 and a series of additional (Add.) documents. The numbering sequence continues from CRP.2 to CRP.2/Add.1 and CRP.2/Add.2.

Commentary on chapter I

SCOPE OF THE CONVENTION

NOTE BY THE SECRETARIAT: THE COMMENTARY ON ARTICLE 1 REFLECTS THE REVISED COMMENTARY ADOPTED BY THE COMMITTEE AT ITS FOURTH ANNUAL SESSION IN 2008. TEXT IN MARK-UP REFLECTS SUGGESTED CHANGES TO THE AGREED NEW COMMENTARY ON ARTICLE 1[1].

Article 1

PERSONS COVERED

A. GENERAL CONSIDERATIONS

1. Article 1 of the United Nations Model Convention reproduces Article 1 of the OECD Model Convention.

2. The title of ~~a~~**A**rticle 1 ~~has been~~ **was** changed in 1999 from "Personal scope" to "Persons covered". The first article of the Convention should normally specify the types of persons or taxpayers to whom the Convention applies. The title "Personal scope" did not convey the scope of application of the Convention. Hence, the title of ~~a~~**A**rticle 1 has been appropriately changed to "Persons covered" to convey the correct scope of the Convention.

3. Like the OECD Model Convention, the United Nations Model Convention applies to persons who are "residents of one or both of the Contracting States". The personal scope of most of the earliest conventions was more restrictive, in that it encompassed "citizens" of the Contracting States. However, in some early conventions that scope was wider, covering "taxpayers" of the Contracting States, that is persons who, although not residing in either State, are nevertheless liable to tax on part of their income or capital in each of them. In some articles there are exceptions to this rule, for example in ~~a~~**A**rticles 24, paragraph 1, 25, paragraph 1, and 26, paragraph 1.

4. The United Nations Model Convention does not contain special provisions relating to partnerships. The Contracting States are therefore left free to examine the problems concerning partnerships in bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate. The OECD Committee on Fiscal Affairs has 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 of the provisions of the OECD Model Tax Convention, and indirectly of bilateral tax conventions based on that Model, to partnerships. The Committee recognizes, however, that many of the principles discussed in that report may also apply, mutatis

[1] Paragraphs 8 to 11 from the 1999 UN Model Commentary on Article 1 were deleted by the Committee in 2008. Those deleted paragraphs have not been reproduced here.

mutandis, to other non-corporate entities. In this report, references to "partnerships" cover entities which qualify as such under civil or commercial law as opposed to tax law. The wide differences in the views of the OECD member countries stem from the fact that their domestic laws treat partnerships in different ways. In some OECD countries, partnerships are treated as taxable units and sometimes even as companies, while other OECD countries do not tax the partnership as such and only tax individual partners on their shares of partnership income. Similar differences in the tax treatment of partnerships exist in the developing countries.

5. An important question is whether a partnership should itself be allowed the benefits of the Convention. If, under the laws of a Contracting State, partnerships are taxable entities, a partnership may qualify as a resident of that Contracting State under paragraph 1 of article 4 and therefore be entitled to benefits of the Convention. However, if a partnership is a conduit and only partners are taxed on partnership income, the partnership may also be disregarded under the Convention, at least in the absence of special rules in the Convention providing otherwise.

6. The application of the Convention to partners may also depend on the laws of the Contracting States. The laws of the Contracting States also determine the treatment under the Convention of a disposition of a partnership interest.

7. If the Contracting States differ in their treatments of partnerships, different articles of the Convention can apply to the same transaction in the two States, which may result in double taxation or non-taxation in both States.

Improper use of tax treaties

8. Provisions of tax treaties are drafted in general terms and taxpayers may be tempted to apply these provisions in a narrow technical way so as to obtain benefits in circumstances where the Contracting States did not intend that these benefits be provided. Such improper uses of tax treaties ~~is~~are a source of concern to all countries but particularly for countries that have limited experience in dealing with sophisticated tax-avoidance strategies.

9. The Committee considered that it would therefore be helpful to examine the various approaches through which those strategies may be dealt with and to provide specific examples of the application of these approaches. In examining this issue, the Committee recognized that for tax treaties to achieve their role, it is important to maintain a balance between the need for tax administrations to protect their tax revenues from the misuse of tax treaty provisions and the need to provide legal certainty and to protect the legitimate expectations of taxpayers.

1. Approaches to prevent the improper use of tax treaties

10. There are a number of different approaches used by countries to prevent and address the improper use of tax treaties. These include:

- **specific legislative anti-abuse rules found in domestic law**
- **general legislative anti-abuse rules found in domestic law**
- **judicial doctrines that are part of domestic law**
- **specific anti-abuse rules found in tax treaties**
- **general anti-abuse rules in tax treaties**
- **the interpretation of tax treaty provisions**

11. These various approaches are examined in the following sections.

Specific legislative anti-abuse rules found in domestic law

12. Tax authorities seeking to address the improper use of a tax treaty may first consider the application of specific anti-abuse rules included in their domestic tax law.

13. Many domestic rules may be relevant for that purpose. For instance, controlled foreign corporation (CFC) rules may apply to prevent certain arrangements involving the use, by residents, of base or conduit companies that are residents of treaty countries; foreign investment funds (FIF) rules may prevent the deferral and avoidance of tax on investment income of residents that invest in foreign investment funds established in treaty countries; thin capitalization rules may apply to restrict the deduction of base-eroding interest payments to residents of treaty countries; transfer pricing rules (even if not designed primarily as anti-abuse rules) may prevent the artificial shifting of income from a resident enterprise to an enterprise that is resident of a treaty country; exit or departure taxes rules may prevent the avoidance of capital gains tax through a change of residence before the realization of a treaty-exempt capital gain and dividend stripping rules may prevent the avoidance of domestic dividend withholding taxes through transactions designed to transform dividends into treaty-exempt capital gains.

14. A common problem that arises from the application of many of these and other specific anti-abuse rules to arrangements involving the use of tax treaties is that of possible conflicts with the provisions of tax treaties. Where two Contracting States take different views as to whether a specific anti-abuse rule found in the domestic law of one of these States conflicts with the provisions of their tax treaty, the issue may be addressed through the mutual agreement procedure having regard to the following principles.

15. Generally, where the application of provisions of domestic law and of those of tax treaties produces conflicting results, the provisions of tax treaties are intended to prevail. This is a logical consequence of the principle of "*pacta sunt servanda*" which is incorporated in Article 26 of the *Vienna Convention on the Law of Treaties*. Thus, if the application of these rules had the effect of increasing the tax liability of

a taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions should prevail under public international law.

16. As explained below, however, such conflicts will often be avoided and each case must be analysed based on its own circumstances.

17. First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 of the Convention specifically authorizes the application of domestic transfer pricing rules in the circumstances defined by that Article. Also, many treaties include specific provisions clarifying that there is no conflict (or, even if there is a conflict, allowing the application of the domestic rules) in the case, for example, of thin capitalization rules, CFC rules or departure tax rules or, more generally, domestic rules aimed at preventing the avoidance of tax.

18. Second, many tax treaty provisions depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person, the determination of what is immovable property and of when income from corporate rights might be treated as a dividend. More generally, paragraph 2 of Article 3 makes domestic rules relevant for the purposes of determining the meaning of terms that are not defined in the treaty. In many cases, therefore, the application of domestic anti-abuse rules will impact how the treaty provisions are applied rather than produce conflicting results.

19. Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied on a proper interpretation of the treaty. In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the treaty and the domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equity ratio. While this greatly facilitates their application, it will sometimes result in the application of these rules to transactions that do not constitute abuses. In such cases, of course, a proper interpretation of the treaty provisions that would disregard abusive transactions only will not allow the application of the domestic rules if they conflict with provisions of the treaty.

General legislative anti-abuse rules found in domestic law

20. Some countries have included in their domestic law a legislative anti-abuse rule of general application, which is intended to prevent abusive arrangements that are not adequately dealt with through specific rules or judicial doctrines.

21. As is the case for specific anti-abuse rules found in domestic law, the main issue that arises with respect to the application of such general anti-abuse rules to improper uses of a treaty is that of possible conflicts with the provisions of the

treaty. To the extent that the application of such general rules ~~are~~is restricted to cases of abuse, however, such conflicts should not arise. This is the general conclusion of the OECD, which is reflected in paragraphs 22 and 22.1 of the Commentary on Article 1 of the OECD Model and with which the Committee agrees:

> **22. Other forms of abuse of tax treaties (e.g. the use of a base company) and possible ways to deal with them, including "substance-over-form", "economic substance" and general anti-abuse rules have also been analysed, particularly as concerns the question of whether these rules conflict with tax treaties […]**
>
> **22.1 Such rules are part of the basic domestic rules set by domestic tax laws for determining which facts give rise to a tax liability; these rules are not addressed in tax treaties and are therefore not affected by them. Thus, as a general rule and having regard to paragraph 9.5, there will be no conflict […]**

22. Having concluded that the approach of relying on such anti-abuse rules does not, as a general rule, conflict with tax treaties, the OECD was therefore able to conclude that "[…] States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into."[2]

23. That conclusion leads logically to the question of what is an abuse of a tax treaty. The OECD did not attempt to provide a comprehensive reply to that question, which would have been difficult given the different approaches of its Member countries. Nevertheless, the OECD presented the following general guidance, which was referred to as a "guiding principle"[3]:

> **"A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."**

24. The members of the Committee endorsed that principle. They considered that such guidance as to what constitutes an abuse of treaty provisions serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers. Clearly, countries should not be able to escape their treaty obligations simply by arguing that legitimate transactions are abusive and domestic

[2] Paragraph 9.4 of the Commentary on Article 1 of the OECD Model.

[3] Paragraph 9.5 of the Commentary on Article 1 of the OECD Model.

tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.

25. Under the guiding principle presented above, two elements must therefore be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:

- **a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and**
- **obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions.**

26. These two elements will also often be found, explicitly or implicitly, in general anti-avoidance rules and doctrines developed in various countries.

27. In order to minimize the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not solely the alleged intention of the parties. Thus, the determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements.

Judicial doctrines that are part of domestic law

28. In the process of determining how domestic tax law applies to tax avoidance transactions, the courts of many countries have developed different judicial doctrines that have the effect of preventing domestic law abuses. These include the business purpose, substance over form, economic substance, step transaction, abuse of law and *fraus legis* approaches. The particular conditions under which such judicial doctrines apply often vary from country to country and evolve over time based on refinements or changes resulting from subsequent court decisions.

29. These doctrines are essentially views expressed by courts as to how tax legislation should be interpreted and as such, typically become part of the domestic tax law.

30. While the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties*, nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty to similar transactions.

Specific anti-abuse rules found in tax treaties

31. Some forms of treaty abuses can be addressed through specific treaty provisions. A number of such rules are already included in the UN Model; these include, in particular, the reference to the agent who maintains a stock of goods for delivery purposes (subparagraph 5 b of Article 5), the concept of "beneficial owner" (in Articles 10, 11, and 12), the "special relationship" rule applicable to interest and royalties (paragraph 6 of Article 11 and paragraph 6 of Article 12), the rule on alienation of shares of immovable property companies (paragraph 4 of Article 13) and the rule on "star-companies" (paragraph 2 of Article 17). Another example would be the modified version of the limited force-of-attraction rule of paragraph 1 of Article 7 that is found in some tax treaties and that applies only to avoidance cases.

32. Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers. This is acknowledged in paragraph 9.6 of the Commentary of the OECD Commentary, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches.[4]

33. One should not, however, underestimate the risks of relying extensively on specific treaty anti-abuse rules to deal with tax treaty avoidance strategies. First, specific anti-abuse rules ~~can only be~~ **are often drafted once a particular avoidance strategy has been identified. Second, the inclusion of a specific anti-abuse provision in a treaty can weaken the case as regards the application of general anti-abuse rules or doctrines to other forms of treaty abuses. Adding specific anti-abuse rules to a tax treaty could be wrongly interpreted as suggesting that an unacceptable avoidance strategy that is similar to, but slightly different from, one dealt with by a specific anti-abuse rule included in the treaty is allowed and cannot be challenged under general anti-abuse rules. Third, in order to specifically address complex avoidance strategies, complex rules may be required. This is especially the case where these rules seek to address the issue through the application of criteria that leave little room for interpretation rather than through more flexible criteria such as the purposes of a transaction or arrangement. For these reasons, whilst the inclusion of specific anti-abuse rules in tax treaties is the most appropriate approach to deal with certain situations, it cannot, by itself, provide a comprehensive solution to treaty abuses.**

General anti-abuse rules found in tax treaties

[4] "9.6 The potential application of general anti-abuse provisions does not mean that there is no need for the inclusion, in tax conventions, of specific provisions aimed at preventing particular forms of tax avoidance. Where specific avoidance techniques have been identified or where the use of such techniques is especially problematic, it will often be useful to add to the Convention provisions that focus directly on the relevant avoidance strategy […]."

34. There are a few examples of treaty provisions that may be considered to be general anti-abuse rules. One such provision is paragraph 2 of Article 25 of the treaty between Israel and Brazil, signed in 2002:

> **A competent authority of a Contracting State may deny the benefits of this Convention to any person, or with respect to any transaction, if in its opinion the granting of those benefits would constitute an abuse of the Convention according to its purpose. Notice of the application of this provision will be given by the competent authority of the Contracting State concerned to the competent authority of the other Contracting State.**

35. In some cases, countries have merely confirmed that Contracting States were not prevented from denying the benefits of the treaty provisions in abusive cases. In such cases, however, it cannot be said that the power to deny the benefits of treaty arises from the provision itself. An example of that type of provision is found in paragraph 6 of Article 29 of the Canada Germany treaty signed in 2001:

> **Nothing in the Agreement shall be construed as preventing a Contracting State from denying benefits under the Agreement where it can reasonably be concluded that to do otherwise would result in an abuse of the provisions of the Agreement or of the domestic laws of that State**.

36. A country that would not feel confident that its domestic law and approach to the interpretation of tax treaties would allow it to adequately address improper uses of its tax treaties could of course consider including a general anti-abuse rule in its treaties. The guiding principle referred to above could form the basis for such a rule, which could therefore be drafted along the following lines:

> **"Benefits provided for by this Convention shall not be available where it may reasonably be considered that a main purpose for entering into transactions or arrangements has been to obtain these benefits and obtaining the benefits in these circumstances would be contrary to the object and purpose of the relevant provisions of this Convention."**

When considering such a provision, some countries may prefer to replace the phrase "a main purpose" by "the main purpose" to make it clear that the provision should only apply to transactions that are, without any doubt, ~~purely~~ **primarily tax-motivated. Other countries, however, may consider that, based on their experience with similar general anti-abuse rules found in domestic law, words such as "the main purpose" would impose an unrealistically high threshold that would require tax administrations to establish that obtaining tax benefits is objectively more important than the combination of all other alleged purposes, which would risk rendering the provision ineffective. A State that wishes to include a general anti-abuse rule in its treaties will therefore need to adapt the wording to its own circumstances, particularly as regards the approach that its courts have adopted with respect to tax avoidance.**

37. Many countries, however, will consider that including such a provision in their treaties could be interpreted as an implicit recognition that, absent such a provision, they cannot use other approaches to deal with improper uses of tax treaties. This would be particularly problematic for countries that have already concluded a large number of treaties that did not include such a provision. For that reason, the use of such a provision would probably be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches.

The interpretation of tax treaty provisions

38. Another approach that has been used to counter improper uses of treaties has been to consider that there can be abuses of the treaty itself and to disregard abusive transactions under a proper interpretation of the relevant treaty provisions that takes account of their context, the treaty's object and purpose as well as the obligation to interpret these provisions in good faith[5]. As already noted, a number of countries have long used a process of legal interpretation to counteract abuses of their domestic tax laws and it seems entirely appropriate to similarly interpret tax treaty provisions to counteract tax treaty abuses. As noted in paragraph 9.3 of the Commentary on Article 1 of the OECD Model Tax Convention:

> **Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This interpretation results from the object and purpose of tax conventions as well as the obligation to interpret them in good faith (see Article 31 of the *Vienna Convention on the Law of Treaties*).**

39. Paragraphs 23 to 27 above provide guidance as to what should be considered to be a tax treaty abuse. That guidance would obviously be relevant for the purposes of the application of this approach.

2. Examples of improper uses of tax treaties

40. The following paragraphs illustrate the application of the approaches described above in various cases involving the improper use of tax treaty provisions (these examples, however, are not intended to prejudge the legal treatment of these transactions in domestic law or under specific treaties).

Dual residence and transfer of residence

5 As prescribed by Article 31 of the Vienna Convention on the Law of Treaties.

41. There have been cases where taxpayers have changed their tax residence primarily for the purposes of getting tax treaty benefits. The following examples illustrate some of these cases

- ***Example 1*: Mr. X is a resident of State A who has accumulated significant pension rights in that country. Under the treaty between State A and State B, pensions and other similar payments are only taxable in the State of residence of the recipient. Just before his retirement, Mr. X moves to State B for two years and becomes resident thereof under the domestic tax law of that country. Mr. X is careful to use the rules of paragraph 2 of Article 4 to ensure that he is resident of that country for the purposes of the treaty. During that period, his accrued pension rights are paid to him in the form of a lump-sum payment, which is not taxable under the domestic law of State B. Mr. X then returns to State A.**

- ***Example 2*: Company X, a resident of State A, is contemplating the sale of shares of companies that are also residents of State A. Such a sale would trigger a capital gain that would be taxable under the domestic law of State A. Prior to the sale, company A arrange for meetings of its board of directors to now take place in State B, a country that does not tax capital gains on shares of companies and in which the place where a company's directors meet is usually determinative of that company's residence for tax purposes. Company X claims that it has become a resident of State B for the purposes of the tax treaty between States A and B pursuant to paragraph 3 of Article 4 of that treaty, which is identical to this model convention. It then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (paragraph 5 of that Article would not apply as company X does not own substantial participations in the relevant companies).**

- ***Example 3*: Ms. X, a resident of State A, owns all the shares of a company that is also a resident of State A. The value of these shares has increased significantly over the years. Both States A and B tax capital gains on shares; however, the domestic law of State B provides that residents who are not domiciled in that State are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. In contemplation of the sale of these shares, Ms. X moves to State B for two years and becomes resident, but not domiciled, in that State. She then sells the shares and claims that the capital gain may not be taxed in State A pursuant to paragraph 6 of Article 13 of the treaty (the relevant treaty does not include a provision similar to paragraph 5 of this Convention).**

42. Depending on the facts of a particular case, it might be possible to argue that a change of residence that is primarily intended to access treaty benefits constitutes an abuse of a tax treaty. In cases similar to these three examples, however, it would

typically be very difficult to find facts that would show that the change of residence has been done primarily to obtain treaty benefits, especially where the taxpayer has a permanent home or is present in another State for extended periods of time. Many countries have therefore found that specific rules were the best approach to deal with such cases.

43. One approach used by some of these countries has been to include in their tax treaties provisions allowing a State of which a taxpayer was previously resident to tax certain types of income, e.g. capital gains on significant participations in companies or lump-sum payments of pension rights, realized during a certain period following the change of residence. An example of such a provision is found in paragraph 5 of Article 13 of the treaty signed in 2002 by the Netherlands and Poland, which reads as follows:

> **The provisions of paragraph 4 shall not affect the right of each of the Contracting States to levy according to its own law a tax on gains from the alienation of shares or "jouissance" rights in a company, the capital of which is wholly or partly divided into shares and which under the laws of that State is a resident of that State, derived by an individual who is a resident of the other Contracting State and has been a resident of the first-mentioned State in the course of the last ten years preceding the alienation of the shares or "jouissance" rights.**

44. Countries have also dealt with such cases through the use of so-called "departure tax" or "exit charge" provisions, under which the change of residence triggers the realization of certain types of income, e.g. capital gains on shares. In order to avoid a conflict with the provisions of a tax treaty, such domestic rules may deem the realization of the income to take place immediately before the change of residence; they may also be combined with treaty provisions allowing for their application.

45. A proper interpretation of the provisions of paragraphs 2 and 3 of Article 4 may also be useful in dealing with cases similar to these examples. Concepts such as "centre of vital interests" and "place of effective management" require a strong relationship between a taxpayer and a country. The fact that a taxpayer has a home available to him in a country where he sojourns frequently is not enough to claim that that country is his centre of vital interests; likewise, the mere fact that meetings of a board of directors of a company take place in a country is not sufficient to conclude that this is where the company is effectively managed. Also, some countries have replaced paragraph 3 of Article 4, which deals with cases of dual residence of legal persons on the basis of their place of effective management, by a rule that leaves such cases of dual residence to be decided under the mutual agreement procedure. An example of such a provision is found in paragraph 3 of Article 4 of the treaty signed in 2004 by Mexico and Russia, which reads as follows:

> **Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavour to settle the question and to determine the mode of application of the Agreement to such person. In the absence of such agreement, such person shall be considered to be outside the scope of this Agreement, except for the Article "Exchange of information".**

46. Example 3 raises the potential for tax avoidance arising from remittance-based taxation. This issue is dealt with in paragraph 26.1 of the Commentary on Article 1 of the OECD Model Tax Convention, which suggests that, in order to deal with such situations, countries may include a specific anti-abuse provision in their tax treaties with countries that allow that form of taxation:

> **26.1 Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:**
>
> > **Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State.**
>
> **In some States, the application of that provision could create administrative difficulties if a substantial amount of time elapsed between the time the income arose in a Contracting State and the time it were taxed by the other Contracting State in the hands of a resident of that other State. States concerned by these difficulties could subject the rule in the last part of the above provision, i.e. that the income in question will be entitled to benefits in the first-mentioned State only when taxed in the other State, to the condition that the income must be so taxed in that other State within a specified period of time from the time the income arises in the first-mentioned State.**

Treaty shopping

47. "Treaty shopping" is a form of improper use of tax treaties that refers to arrangements through which persons who are not entitled to the benefits of a tax treaty use other persons who are entitled to such benefits in order to indirectly access these benefits. For example, a company that is a resident of a treaty country would act as a conduit for channelling income that would economically accrue to a person that is not a resident of that country so as to improperly access the benefits provided by a tax treaty. The conduit entity is usually a company, but may also be a partnership, trust or similar entity that is entitled to treaty benefits. Granting treaty benefits in these circumstances would be detrimental to the State of source since the benefits of the treaty would then be extended to persons who were not intended to obtain such benefits.

48. A treaty shopping arrangement may take the form of a "direct conduit" or that of a "stepping stone conduit", as illustrated below.[6]

49. Company X, resident of State A, receives dividends, interest or royalties from company Y resident of State B. Company X claims that, under the tax treaty between States A and B, it is entitled to full or partial exemption from the domestic withholding taxes provided for under the tax legislation of State B. Company X is wholly-owned by a resident of third State C who is not entitled to the benefits of the treaty between States A and B. Company X was created for the purpose of obtaining the benefits of the treaty between States A and B and it is for that purpose that the assets and rights giving rise to the dividends, interest or royalties have been transferred to it. The income is exempt from tax in State A, e.g. in the case of dividends, by virtue of a participation exemption provided for under the domestic laws of State A or under the treaty between States A and B. In that case, company X constitute a direct conduit of its shareholder resident of State C.

50. The basic structure of a stepping stone conduit is similar. In that case, however, the income of company X is fully taxable in State A and, in order to eliminate the tax that would be payable in that country, company X pays high interest, commissions, service fees or similar deductible expenses to a second related conduit company Z, a resident of State D. These payments, which are deductible in State A, are tax-exempt in State D by virtue of a special tax regime available in that State[7]. The shareholder resident of State C is therefore seeking to access the benefits of the tax treaty between States A and B by using company X as a stepping stone.

51. In order to deal with such situations, tax authorities have relied on the various approaches described in the previous sections.

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6 " Double Taxation Convention and the Use of Conduit Companies", in volume II of the loose-leaf version of the *OECD Model Tax Convention*, OECD, R(6)-1, at page R(6)-4, paragraph 4.

7 Id.

52. For instance, specific anti-abuse rules have been included in the domestic law of some countries to deal with such arrangements. One example is that of the US regulations dealing with financing arrangements. For the purposes of these regulations, a financing arrangement is a series of transactions by which the financing entity advances money or other property to the financed entity, provided that the money or other property flows through one or more intermediary entities. An intermediary entity will be considered a "conduit", and its participation in the financing arrangements will be disregarded by the tax authorities if (*i*) tax is reduced due to the existence of an intermediary, (*ii*) there is a tax avoidance plan, and (*iii*) it is established that the intermediary would not have participated in the transaction but for the fact that the intermediary is a related party of the financing entity. In such cases, the related income shall be re-characterized according to its substance.

53. Other countries have dealt with the issue of treaty shopping through the interpretation of tax treaty provisions. According to a 1962 decree of the Swiss Federal Council, which is applicable to Swiss treaties with countries that, under the relevant treaties, grant relief from withholding tax that would otherwise be collected by these countries, a claim for such relief is considered abusive if, through such claim, a substantial part of the tax relief would benefit persons not entitled to the relevant tax treaty. The granting of a tax relief shall be deemed improper (a) if the requirements specified in the tax treaty (such as residence rule, beneficial ownership, tax liability, etc.) are not fulfilled and (b) if it constitutes an abuse. The measures which the Swiss tax authorities may take if they determine that a tax relief has been claimed improperly include (a) refusal to certify a claim form, (b) refusal to transmit the claim form, (c) revoking a certification already given, (d) recovering the withholding tax, on behalf of the State of source state, to the extent that the tax relief has been claimed improperly, and (e) informing the tax authorities of the State of source that a tax relief has been claimed improperly.

54. Other countries have relied on their domestic legislative general anti-abuse rules or judicial doctrines to address treaty shopping cases. As already noted, however, legislative general anti-abuse rules and judicial doctrines tend to be the most effective when it is clear that transactions are intended to circumvent the object and purpose of tax treaty provisions.

55. Treaty shopping can also, to some extent, be addressed through anti-abuse rules already found in most tax treaties, such as the concept of "beneficial ownership".

56. Some countries, however, consider that the most effective approach to deal with treaty shopping is to include in their tax treaties specific anti-abuse rules dealing with that issue. Paragraphs 13 to 21.4 of the Commentary on Article 1 of the OECD Model Convention, which are reproduced below, include various examples of such rules. The Committee considers that these examples are helpful in dealing with

treaty shopping concerns that may arise with respect to treaties between developing and developed countries.

Conduit company cases

13. Many countries have attempted to deal with the issue of conduit companies and various approaches have been designed for that purpose. One solution would be to disallow treaty benefits to a company not owned, directly or indirectly, by residents of the State of which the company is a resident. For example, such a "look-through" provision might have the following wording:

> **"A company that is a resident of a Contracting State shall not be entitled to relief from taxation under this Convention with respect to any item of income, gains or profits if it is owned or controlled directly or through one or more companies, wherever resident, by persons who are not residents of a Contracting State."**

Contracting States wishing to adopt such a provision may also want, in their bilateral negotiations, to determine the criteria according to which a company would be considered as owned or controlled by non-residents.

14. The "look-through approach" underlying the above provision seems an adequate basis for treaties with countries that have no or very low taxation and where little substantive business activities would normally be carried on. Even in these cases it might be necessary to alter the provision or to substitute for it another one to safeguard bona fide business activities.

15. General subject-to-tax provisions provide that treaty benefits in the State of source are granted only if the income in question is subject to tax in the State of residence. This corresponds basically to the aim of tax treaties, namely to avoid double taxation. For a number of reasons, however, the Model Convention does not recommend such a general provision. Whilst this seems adequate with respect to a normal international relationship, a subject-to-tax approach might well be adopted in a typical conduit situation. A safeguarding provision of this kind could have the following wording:

> **"Where income arising in a Contracting State is received by a company resident of the other Contracting State and one or more persons not resident in that other Contracting State**

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law."

The concept of "substantial interest" may be further specified when drafting a bilateral convention. Contracting States may express it, for instance, as a percentage of the capital or of the voting rights of the company.

16. The subject-to-tax approach seems to have certain merits. It may be used in the case of States with a well-developed economic structure and a complex tax law. It will, however, be necessary to supplement this provision by inserting bona fide provisions in the treaty to provide for the necessary flexibility (~~cf~~ see paragraph 19 below); moreover, such an approach does not offer adequate protection against advanced tax avoidance schemes such as "stepping-stone strategies".

17. The approaches referred to above are in many ways unsatisfactory. They refer to the changing and complex tax laws of the Contracting States and not to the arrangements giving rise to the improper use of conventions. It has been suggested that the conduit problem be dealt with in a more straightforward way by inserting a provision that would single out cases of improper use with reference to the conduit arrangements themselves (the channel approach). Such a provision might have the following wording:

"Where income arising in a Contracting State is received by a company that is a resident of the other Contracting State and one or more persons who are not residents of that other Contracting State

a) have directly or indirectly or through one or more companies, wherever resident, a substantial interest in such company, in the form of a participation or otherwise, or

b) exercise directly or indirectly, alone or together, the management or control of such company

any provision of this Convention conferring an exemption from, or a reduction of, tax shall not apply if more than 50 per cent of such income is used to satisfy claims by such persons (including interest, royalties, development, advertising, initial and travel expenses, and depreciation of any kind of business assets including those on immaterial goods and processes)."

18. A provision of this kind appears to be the only effective way of combatting "stepping-stone" devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underlie the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. States that consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause.

19. The solutions described above are of a general nature and they need to be accompanied by specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

a) General bona fide provision

"The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention."

b) Activity provision

"The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations."

c) Amount of tax provision

"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."

d) Stock exchange provision

"The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned — directly or through one or more companies each of which is a resident of the first-mentioned State — by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered."

e) Alternative relief provision

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term "shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention."

These provisions illustrate possible approaches. The specific wording of the provisions to be included in a particular treaty depends on the general approach taken in that treaty and should be determined on a bilateral basis. Also, where the competent authorities of the Contracting States have the power to apply discretionary provisions, it may be considered appropriate to include an additional rule that would give the competent authority of the source country the discretion to allow the benefits of the Convention to a resident of the other State even if the resident fails to pass any of the tests described above.

20. Whilst the preceding paragraphs identify different approaches to deal with conduit situations, each of them deals with a particular aspect of the problem commonly referred to as "treaty shopping". States wishing to address the issue in a comprehensive way may want to consider the following example of detailed limitation-of-benefits provisions aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States, keeping in mind that adaptations may be necessary and that many States prefer other approaches to deal with treaty shopping:

> **1. Except as otherwise provided in this Article, a resident of a Contracting State who derives income from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a "qualified person" as defined in paragraph 2 and meets the other conditions of this Convention for the obtaining of such benefits.**
>
> **2. A resident of a Contracting State is a qualified person for a fiscal year only if such resident is either:**

a) **an individual;**

b) **a qualified governmental entity;**

c) **a company, if**

- ***(i)*** **the principal class of its shares is listed on a recognised stock exchange specified in subparagraph *a*) or *b*) of paragraph 6 and is regularly traded on one or more recognised stock exchanges, or**

(ii) **at least 50 per cent of the aggregate vote and value of the shares in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision *i*) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;**

d) **a charity or other tax-exempt entity, provided that, in the case of a pension trust or any other organization that is established exclusively to provide pension or other similar benefits, more than 50 per cent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or**

e) **a person other than an individual, if:**

(i) **on at least half the days of the fiscal year persons that are qualified persons by reason of subparagraph a), b) or d) or subdivision c) (i) of this paragraph own, directly or indirectly, at least 50 per cent of the aggregate vote and value of the shares or other beneficial interests in the person, and**

(ii) **less than 50 per cent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the ordinary course of business for services or tangible property and payments in respect of financial obligations to a bank, provided that where such a bank is not a resident of a Contracting State such payment is attributable to a permanent establishment of that bank located in one of the Contracting States).**

3. ***a*) A resident of a Contracting State will be entitled to benefits of the Convention with respect to an item of income, derived from the other State, regardless of whether the resident is a qualified person, if the resident is actively carrying on business in the first-mentioned State (other than the business of making or managing investments for the resident's own account, unless these activities are banking, insurance or securities activities carried on by a bank, insurance company or registered securities dealer), the income derived from the other Contracting State is derived in connection with, or is incidental to, that business and that resident satisfies the other conditions of this Convention for the obtaining of such benefits.**

***b*) If the resident or any of its associated enterprises carries on a business activity in the other Contracting State which gives rise to an item of income, subparagraph a) shall apply to such item only if the business activity in the first-mentioned State is substantial in relation to business**

carried on in the other State. Whether a business activity is substantial for purposes of this paragraph will be determined based on all the facts and circumstances.

***c*) In determining whether a person is actively carrying on business in a Contracting State under subparagraph a), activities conducted by a partnership in which that person is a partner and activities conducted by persons connected to such person shall be deemed to be conducted by such person. A person shall be connected to another if one possesses at least 50 per cent of the beneficial interest in the other (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) or another person possesses, directly or indirectly, at least 50 per cent of the beneficial interest (or, in the case of a company, at least 50 per cent of the aggregate vote and value of the company's shares) in each person. In any case, a person shall be considered to be connected to another if, based on all the facts and circumstances, one has control of the other or both are under the control of the same person or persons.**

4. Notwithstanding the preceding provisions of this Article, if a company that is a resident of a Contracting State, or a company that controls such a company, has outstanding a class of shares

***a)* which is subject to terms or other arrangements which entitle its holders to a portion of the income of the company derived from the other Contracting State that is larger than the portion such holders would receive absent such terms or arrangements ("the disproportionate part of the income"); and**

***b)* 50 per cent or more of the voting power and value of which is owned by persons who are not qualified persons the benefits of this Convention shall not apply to the disproportionate part of the income.**

5. A resident of a Contracting State that is neither a qualified person pursuant to the provisions of paragraph 2 or entitled to benefits under paragraph 3 or 4 shall, nevertheless, be granted benefits of the Convention if the competent authority of that other Contracting State determines that the establishment, acquisition or maintenance of such person and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the Convention.

6. For the purposes of this Article the term "recognised stock exchange" means:

***a)* in State A ……..;**

***b)* in State B ……..; and**

c) **any other stock exchange which the competent authorities agree to recognize for the purposes of this Article."**

Provisions which are aimed at entities benefiting from preferential tax regimes

21. Specific types of companies enjoying tax privileges in their State of residence facilitate conduit arrangements and raise the issue of harmful tax practices. Where tax-exempt (or nearly tax-exempt) companies may be distinguished by special legal characteristics, the improper use of tax treaties may be avoided by denying the tax treaty benefits to these companies (the exclusion approach). As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause which would apply to the income received or paid by such companies and which could be drafted along the following lines:

"No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention."

The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).

21.1 Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.

21.2 Where it is not possible or appropriate to identify the companies enjoying tax privileges by reference to their special legal characteristics, a more general formulation will be necessary. The following provision aims at denying the benefits of the Convention to entities which would otherwise qualify as residents of a Contracting State but which enjoy, in that State, a preferential tax regime restricted to foreign-held entities (i.e. not available to entities that belong to residents of that State):

"Any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State shall not be entitled

to the benefits of this Convention if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust or partnership, or to any other person) is substantially lower than the amount that would be imposed by that State if all of the shares of the capital stock of the company or all of the interests in the trust or partnership, as the case may be, were beneficially owned by one or more residents of that State."

Provisions which are aimed at particular types of income

21.3 The following provision aims at denying the benefits of the Convention with respect to income that is subject to low or no tax under a preferential tax regime:

"1. The benefits of this Convention shall not apply to income which may, in accordance with the other provisions of the Convention, be taxed in a Contracting State and which is derived from activities the performance of which do not require substantial presence in that State, including:

a) **such activities involving banking, shipping, financing, insurance or electronic commerce activities; or**

b) **activities involving headquarter or coordination centre or similar arrangements providing company or group administration, financing or other support; or**

c) **activities which give rise to passive income, such as dividends, interest and royalties where, under the laws or administrative practices of that State, such income is preferentially taxed and, in relation thereto, information is accorded confidential treatment that prevents the effective exchange of information.**

2. For the purposes of paragraph 1, income is preferentially taxed in a Contracting State if, other than by reason of the preceding Articles of this Agreement, an item of income:

a) **is exempt from tax; or**

b) **is taxable in the hands of a taxpayer but that is subject to a rate of tax that is lower than the rate applicable to an equivalent item that is taxable in the hands of similar taxpayers who are residents of that State; or**

c) **benefits from a credit, rebate or other concession or benefit that is provided directly or indirectly in relation to that item of income, other than a credit for foreign tax paid."**

Anti-abuse rules dealing with source taxation of specific types of income

21.4 The following provision has the effect of denying the benefits of specific Articles of the convention that restrict source taxation where transactions have been entered into for the main purpose of obtaining these benefits. The Articles concerned are 10, 11, 12 and 21; the provision should be slightly modified as indicated below to deal with the specific type of income covered by each of these Articles:

> **"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 [Article 10: "shares or other rights"; Article 11: "debt-claim"; Articles 12 and 21: "rights"] in respect of which the [Article 10: "dividend"; Article 11: "interest"; Articles 12 "royalties" and Article 21: "income"] is paid to take advantage of this Article by means of that creation or assignment."**

57. When considering these examples, countries should take account of their ability to administer the various approaches that are proposed. For many developing countries, it may be difficult to apply very detailed rules that require access to substantial information about foreign entities. These countries might consider that a more general approach, such as the one proposed in paragraph 21.4, might be more adapted to their own circumstances.

Triangular Cases

58. With respect to tax treaties, the phrase "triangular cases" refer to the application of tax treaties in situations where three States are involved. A typical triangular case that may constitute an improper use of a tax treaty is one in which:

- **dividends, interest or royalties are derived from State S by a resident of State R, which is an exemption country;**
- **that income is attributable to a permanent establishment established in State P, a low tax jurisdiction where that income will not be taxed.[8]**

59. Under the State R-State S tax treaty, State S has to apply the benefits of the treaty to such dividends, interests or royalties because these are derived by a resident of State R, even though they are not taxed in that State by reason of the exemption system applied by that State.

60. Paragraph ~~53~~71 of the Commentary on Article 24 of the OECD Model Tax Convention, which is reproduced in the Commentary on Article 24 below, discusses this situation and suggests that it may be dealt with through the inclusion of a specific provision in the treaty between States R and S:

[8] Triangular Cases", in volume II of the loose-leaf version of the *OECD Model Tax Convention*, OECD, R(11)-3, at paragraph 53.

> **[…] If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets such as shares, bonds or patents to permanent establishments in States that offer very favourable tax treatment, and in certain circumstances the resulting income may not be taxed in any of the three States. To prevent such practices, which may be regarded as abusive, a provision can be included in the convention between the State of which the enterprise is a resident and the third State (the State of source) stating that an enterprise can claim the benefits of the convention only if the income obtained by the permanent establishment situated in the other State is taxed normally in the State of the permanent establishment.**

61. A few treaties include a provision based on that suggestion.[9] If, however, similar provisions are not systematically included in the treaties that have been concluded by the State of source of such dividends, interest or royalties with countries that have an exemption system, there is a risk that the relevant assets will be transferred to associated enterprises that are residents of countries that do not have that type of provision in their treaty with the State of source.

Attributing Profits or Income to a Specific Person or Entity

62. A taxpayer may enter into transactions or arrangements in order that income that would normally accrue to that taxpayer accrues to related person or entity so as to obtain treaty benefits that would not otherwise be available. Some of the ways in which this may be done (e.g. treaty shopping and the use of permanent establishments in low-tax countries) have already been discussed. The following discusses other income shifting scenarios.

i) Non arm's length transfer prices

63. It has long been recognized that profits can be shifted between associated enterprises through the use of non arm's length prices and the tax legislation of most countries now include transfer pricing rules that address such cases. These rules are specifically authorized by Article 9 of the UN and OECD Model Tax Conventions. This, however, is a complex area, as shown by the extensive guidance produced by the OECD[10] as to how these rules should operate.

ii) Thin capitalisation

[9] See for example, paragraph 5 of Article 30 of the France-United States treaty.

[10] OECD, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*, OECD, Paris, 1995 (as updated) **[As per 2011, the Committee of Experts is currently producing a manual on the practical aspects of transfer pricing with a focus on the issues faced by developing countries.]** (***** During the EGM in June 2011 it was suggested to include a reference to the UN transfer pricing manual)

64. In almost all countries, interest is a deductible expense whereas dividends, being a distribution of profits, are not deductible. A foreign company that wants to provide financing to a wholly-owned subsidiary may therefore find it beneficial, for tax purposes, to provide that financing through debt rather than share capital, depending on the overall tax on the interest paid. A subsidiary may therefore end up with almost all of its financing being provided in the form of debt rather than share capital, a practice known as "thin capitalisation".

65. According to the OECD report on Thin Capitalisation,[11] countries have developed different approaches to deal with this issue. These approaches may be broadly divided between those that are based on the application of a general anti-abuse rules or the arm's length principle and those that involve the use of fixed debt-equity ratios.

66. The former category refers to rules that require an examination of the facts and circumstances of each case in order to determine whether the real nature of the financing is that of debt or equity. This may be implemented through specific legislative rules, general anti-abuse rules, judicial doctrines or the application of transfer pricing legislation based on the arm's length principle.

67. The fixed ratio approach is typically implemented through specific legislative anti-abuse rules; under this approach, if the total debt/equity ratio of a particular company exceeds a predetermined ratio, the interest on the excessive debt may be disallowed, deferred or treated as a dividend.

68. To the extent that a country's thin capitalisation rule applies to payments of interest to non-residents but not to similar payments that would be made to residents, it could be in violation of paragraph 4 of Article 24, which provides that "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". There is a specific exception to that rule, however, where paragraph 1 of Article 9, which deals with transfer pricing adjustments, applies. For that reason, as indicated in the Commentary on paragraph 4 of Article 24:[12]

> **Paragraph 4 does not prohibit the country of the borrower from ~~treating interest as a dividend under~~applying its domestic rules on thin capitalisation insofar as these are compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11. However, if such treatment results from rules which are not compatible with the said Articles and which only apply to non-resident**

[11] "Thin Capitalisation", in volume II of the loose-leaf version of the *OECD Model Tax Convention*, R(4)-1, available at www. oecd.org/dataoecd/42/20/42649592.pdf.

[12] Paragraph ~~56~~74 of the Commentary on Article 24 of the OECD Model Tax Convention, which is reproduced under paragraph 5 of the Commentary on Article 24 of this Model.

> **creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.**

69. Paragraph 3 of the OECD Commentary on Article 9, which is reproduced under paragraph 6 of the Commentary on the same provision of this Model, clarifies that paragraph 1 of Article 9 allows the application of domestic rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation. While this would typically be the case of thin capitalisation rules that are based on the arm's length principle, a country that has adopted thin capitalisation rules based on a fixed ratio approach would, however, typically find it difficult to establish that its thin capitalisation rule, which does not refer to what independent parties would have done, satisfies that requirement.

70. For that reason, countries that have adopted thin capitalisation rules based on a fixed ratio approach often consider that they need to include in their treaties provisions that expressly allow the application of these rules. For example, Article 13 of the Protocol to the treaty between France and Estonia provides as follows:

> **The provisions of the Convention shall in no case restrict France from applying the provisions of Article 212 of its tax code (code général des impôts) relating to thin capitalization or any substantially similar provisions which may amend or replace the provisions of that Article.**

iii) The use of base companies

71. Base companies situated in low-tax jurisdictions may be used for the purposes of diverting income to a country where that income will be subjected to taxes that are substantially lower than those that would have been payable if the income had been derived directly by the shareholders of that company.

72. Various approaches have been used to deal with such arrangements. For example, a company that is a mere shell with no employee and no substantial economic activity could, in some countries, be disregarded for tax purposes pursuant to general anti-abuse rules or judicial doctrines. It could also be possible to consider that a base company that is effectively managed by shareholders who are residents of another State has its residence or a permanent establishment in that State. The first approach is described by paragraph 10.1 of the Commentary on Article 1 of the OECD Model Tax Convention, according to which claims to treaty benefits

> **[…] may be refused where careful consideration of the facts and circumstances of a case shows that the place of effective management of a subsidiary does not lie in its alleged state of residence but, rather, lies in the state of residence of the parent company so as to make it a resident of that latter state for domestic law and treaty purposes (this will be relevant where**

the domestic law of a state uses the place of management of a legal person, or a similar criterion, to determine its residence).

73. The second approach is described in paragraph 10.2 of that Commentary, which reads as follows:

Careful consideration of the facts and circumstances of a case may also show that a subsidiary was managed in the state of residence of its parent in such a way that the subsidiary had a permanent establishment (e.g. by having a place of management) in that state to which all or a substantial part of its profits were properly attributable.

74. These approaches, however, might not be successful in dealing with arrangements involving companies that have substantial management and economic activities in the countries where they have been established. One of the most effective approaches to dealing with such cases is the inclusion, in domestic legislation, of controlled foreign corporation (CFC) legislation. While the view has sometimes be expressed that such legislation could violate certain provisions of tax treaties, the Committee considers that this would not be the case of typical CFC rules, as indicated in paragraph 23 ~~if~~ of the Commentary on Article 1 of the OECD Model Tax Convention (and as further explained in paragraphs ~~10.1~~13 of the Commentary on Article 7 and 37 of the Commentary on Article 10 of that Model):

23. The use of base companies may also be addressed through controlled foreign companies provisions. A significant number of Member and non-member countries have now adopted such legislation. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs ~~10.1~~13 of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are read in their context. Thus, whilst some countries have felt it useful to expressly clarify, in their conventions, that controlled foreign companies legislation did not conflict with the Convention, such clarification is not necessary. It is recognised that controlled foreign companies legislation structured in this way is not contrary to the provisions of the Convention.

iv) Directors' fees and remuneration of top-level managers

75. According to Article 16 (Directors' Fees), directors' fees and the remuneration of officials in a top-level managerial position of a company may be taxed in the State of residence of the company regardless of where the services of these directors and top-level managers are performed. A "salary split" arrangement could be used in order to reduce the taxes that would be payable in that State pursuant to that Article. Assume, for example, that company A, a resident of State A, has two subsidiaries, companies B and C, which are residents of States X and Y respectively. Mr. D, a resident of State X, is a director and an official in a top-level managerial position of subsidiary B. State X levies an income tax at progressive rates of up to 50%. State Y has a similar income tax system but with a very low tax rate. Countries X and Y have a tax treaty which provides that State X applies the exemption method to income that may be taxed in State Y. For the purpose of reducing the tax burden of Mr. D, company A may appoint him as a director and an official in a top-level managerial position of company C and arrange for most of his remuneration to be attributed to these functions.

76. Paragraph 1 of Article 16 applies to directors' fees that a person receives "in his capacity" as a director of a company and paragraph 2 applies to salaries, wages and other similar remuneration that a person receives "in his capacity" as an official in top-level managerial position of a company. Thus, apart from the fact that such an arrangement could probably be successfully challenged under general anti-abuse rules or judicial doctrines, it could also be attacked through a proper analysis of the services rendered by Mr. D to each company from which he receives his income, as well as an analysis of the fees and remuneration paid to other directors and top-level managers of company C, in order to determine the extent to which director's fees and remuneration received from that company by Mr. D can reasonably be considered to be derived from activities performed as a director or top-level manager of that company.

v) Attribution of interest to a tax-exempt or government entity

77. According to paragraph 13 of the Commentary on Article 11, countries may agree during bilateral negotiations to include in their treaties an exemption for interest of the following categories:[13]

- **Interest paid to Governments or government agencies;**
- **Interest guaranteed by Governments or government agencies;**
- **Interest paid to central banks;**
- **Interest paid to banks or other financial institutions;**
- **Interest on long-term loans;**
- **Interest on loans to financing special equipment or public works; or**

[13] Many treaties additionally exempt from source taxation interest paid to financial institutions, interest on sales on credit or interest paid to tax-exempt entities such as pension funds (see paragraphs 7.7-7.12 of the Commentary on Article 11 of the OECD Model Tax Convention).

- **Interest on other government-approved types of investments (e.g., export finance).**

78. Where a tax treaty includes one or more of these provisions, it may be possible for a party that is entitled to such an exemption to engage into back-to-back arrangements with other parties that are not entitled to that exemption or, where a contract provides for the payment of interest and other types of income that would not be exempt (e.g. royalties), to attribute a greater share of the overall consideration to the payment of interest. Such arrangements would constitute improper uses of these exemptions.

79. While it could be argued that an easy solution would be to avoid including such exemptions in a tax treaty, it is important to note that these are included for valid policy purposes, taking into account that source taxation on gross payments of interest will frequently act as a tariff and be borne by the borrower. Also, as long as a country has agreed to include such exemptions in one of its treaties, it becomes difficult to refrain from granting these in treaty negotiations with other similar countries.

80. Many of the approaches referred to above in the case of treaty shopping may be relevant to deal with back-to-back arrangements aimed at accessing the benefits of these exemptions. Also, cases where the consideration provided for in a mixed contract has been improperly attributed to interest payments can be challenged using specific domestic anti-abuse rules applicable to such cases, general domestic anti-abuse rules or doctrines or a proper interpretation of the treaty provisions. Where the overall consideration is divided among related parties, paragraph 6 of Article 11 and paragraph 1 of Article 9 may also be relevant to ensure that the benefit of the treaty exemption only applies to the proper amount of interest. Finally, some states have included specific anti-abuse rules in their treaties to deal with such back-to-back arrangements. An example of such a rule is found in paragraph b) of Article 7 of the Protocol to the treaty signed in 2002 by Australia and Mexico, which reads as follows:

> **The provisions of […]paragraph [2 of Article 11] shall not apply to interest derived from back-to-back loans. In such case, the interest shall be taxable in accordance with the domestic law of the State in which it arises.**

Hiring out of Labour

81. [The Commentary on Article 15 reproduces the part of the Commentary on the OECD Model Convention that deals with arrangements known as "international hiring-out of labour"]. This refers to cases where a local enterprise that wishes to hire a foreign employee for a short period of time enters into an arrangement with a non-resident intermediary who will act as the formal employer. The employee thus appears to fulfil the three conditions of paragraph 2 of Article 15 so as to qualify for the tax exemption in the State where the employment will be exercised. The

Comment [MB1]: The OECD Commentary referred to here were updated as part of the 2010 update and this paragraph should probably be adjusted. The EGM in June suggested to address this paragraph in connection with the new OECD Commentary on Article 15.

Commentary on Article 15 includes guidance on how this issue can be dealt with, recognizing that domestic anti-abuses rules and judicial doctrines, as well as a proper construction of the treaty, offer ways of challenging such arrangements.

Artistes and sportspersons

82. A number of older tax treaties do not include paragraph 2 of Article 17 (Artistes and sportspersons), which deals with the use of so-called "star-companies". In order to avoid the possible application of provisions based on paragraph 1 of that Article, residents of countries that have concluded such treaties may be tempted to arrange for the income derived from their activities as artistes or sportspersons, or part thereof, to be paid to a company set up for that purpose.

83. As indicated in the Commentary on Article 17, which reproduces paragraph 11 of the OECD Commentary on that Article, such arrangements may ~~d~~be dealt with under domestic law provisions that would attribute such income to the artistes or sportspersons:

> **[…] The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, e.g. a so-called artiste company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the artiste or sportsman nor as profits of the enterprise, in the absence of a permanent establishment. Some countries "look through" such arrangements under their domestic law and deem the income to be derived by the artiste or sportsman; where this is so, paragraph 1 enables them to tax income resulting from activities in their territory [...]**

84. Paragraph 11.2 of the OECD Commentary, which was added in 2003, clarifies that a State could also rely on its general anti-avoidance rules or judicial doctrines to deal with abusive arrangements involving star-companies:

> **11.2 As a general rule it should be noted, however, that, regardless of Article 17, the Convention would not prevent the application of general anti-avoidance rules of the domestic law of the State of source which would allow that State to tax either the entertainer/sportsman or the star-company in abusive cases, as is recognised in paragraph 24 of the Commentary on Article 1."**

85. Finally, as regards the anti-abuse rule found in paragraph 2 of Article 17, tax administrations should note that the rule applies regardless of whether or not the star-company is a resident of the same State as the artiste or sportsperson. This clarification was also added to the OECD Commentary in 2003:

11.1 The application of paragraph~~s~~ 2 is not restricted to situations where both the entertainer or sportsman and the other person to whom the income accrues, e.g. a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer or sportsman is not a resident of that other State. Conversely, where the income of an entertainer resident in one of the Contracting States accrues to a person, e.g. a star-company, who is a resident of a third State with which the State of source does not have a tax convention, nothing will prevent the Contracting State from taxing that person in accordance with its domestic laws.

Transactions that modify the treaty classification of income

86. Articles 6 to 21 allocate taxing rights differently depending on the nature of the income. The classification of a particular item of income for the purposes of these rules is based on a combination of treaty definitions and domestic law. Since taxpayers determine the contents of the contracts on which classification for the purposes of domestic law and treaty provisions is typically based, they may, in some cases, try to influence that classification so as to obtain unintended treaty benefits.

87. The following paragraphs provide a few examples of arrangements that seek to change the treaty classification of income. Depending on the circumstances, such arrangements may be addressed through specific domestic or treaty anti-abuse rules or under general anti-abuse rules or judicial doctrines. A practical issue, however, will often be that, in some of these cases, it will be difficult to discover and establish the connection between various transactions that will be entered into for the purpose of altering the treaty classification.

(i) Conversion of dividends into interest

88. Converting dividends into interest will be advantageous under a treaty that provides for source taxation of dividends but not of interest payments. Assume that X, a resident of State R, owns all the shares of company A, which is a resident of State S. In contemplation of the payment of an important dividend, X arranges for the creation of holding company B, which will also be a resident of State S; X is the only shareholder of company B. X then sells the shares of company A to company B in return for interest-bearing notes (State R and State S allow that transfer to be carried out free of tax). The payment of interest from company B to company X will be made possible by the payment of dividends by company A to company B, which will escape tax in State S under a participation exemption or similar regime or because of the deduction of interest payments on the notes issued to X; X will thus

indirectly receive the dividend paid by company A in the form of interest payments on the notes issued by company B and will avoid source taxation in State S.

(ii) Allocation of price under a mixed contract

89. A mixed contract covers different considerations, such as the provision of goods, services, know-how and the licensing of intangibles. These generate different types of income for treaty purposes. In many cases, the acquirer will be indifferent to the allocation of the price between the various considerations and the provider may therefore wish, in the relevant contract, to allocate a disproportionate part of the price to items of income that will be exempt in the State of source. For instance, a franchising contract may involve the transfer of goods to be sold, the provision of various services, the provision of know-how and royalties for the use of intellectual property (e.g. trademarks and trade names). To the extent that the non-resident franchisor does not have a permanent establishment in the State of residence of the franchisee, Article 7 would not allow that State to tax the business profits attributable to the provision of inventory goods and services but Article 12 would allow the taxation of the royalties and the payments related to know-how. Since all of these payments would normally be deductible for the franchisee, it may not care about how the overall price is allocated. The contract may therefore be drafted so as to increase the price for the provision of the goods and services and reduce the royalties and the price for the provision of know-how.

90. Since the parties to the contract are independent, domestic transfer pricing legislation and Article 9 of the Convention would typically not apply to such transactions. Developing countries may be particularly vulnerable to such transactions since custom duties, which would typically have made it less attractive to allocate the price to the transfer of goods, are gradually being reduced and the determination of the proper consideration for intangible property is often a difficult matter, even for sophisticated tax administrations.

(iii) Conversion of royalties into capital gains

91. A non-resident who owns the copyrights in a literary work wishes to grant to a resident of State S the right to translate and reproduce that work in that State in consideration for royalty payments based on the sales of the translated work. Instead of granting a license to the resident, the non-resident enters into a "sale" agreement whereby all rights related to the translated version of that work in State A are disposed of by the non-resident and acquired by the resident. The consideration for that "sale" is a percentage of the total sales of the translated work. The contract further provides that the non-resident will have the option to reacquire these rights after a period of five years.

92. Some countries have modified the definition of royalties to expressly address such cases. For example, subparagraph 3 a) of Article 12 of the treaty between the United States and India provides that

The term "royalties" as used in this Article means:
a) payments of any kind received as a consideration for the use of, or the right to use, any copyright […] ***including gains derived from the alienation of any such right or property which are contingent on the productivity, use, or disposition thereof …*** **[emphasis added]**

(iv) Use of derivative transactions

93. Derivative transactions can allow taxpayers to obtain the economic effects of certain financial transactions under a different legal form. For instance, depending on the treaty provisions and domestic law of each country, a taxpayer may obtain treaty benefits such as no or reduced source taxation when it is in fact in the same economic position as a foreign investor in shares of a local company. Assume, for instance, that company X, a resident of State A, wants to make a large portfolio investment in the shares of a company resident in State B, while company Y, a resident in State B, wants to acquire bonds issued by the government of State A. In order to avoid the cross-border payments of dividends and interest, which would attract withholding taxes, company X may instead acquire the bonds issued in its country and company Y acquire the shares of the company resident in its country that company X wanted to invest into. Companies X and Y would then enter into a swap arrangement under which they would agree to make swap payments to each other based on the difference between the dividends and interest flows that they receive each year; they would also enter into future contracts to buy from each other the shares and bonds at some future time. Through these transactions, the taxpayers would have mirrored the economic position of cross-border investments in the shares and bonds without incurring the liability to source withholding taxes (except to the extent that the swap payments, which would only represent the difference between the flows of dividends and interest, would be subject to such taxes under Article 21 and the domestic law of each country).

Transactions that seek to circumvent thresholds found in treaty provisions

94. Tax treaty provisions sometimes use thresholds to determine a country's taxing rights. One example is that of the lower limit of source tax on dividends found in subparagraph 2 *a*) of Article 10, which only applies if the beneficial owner of the dividends is a company which holds directly at least 10% of the capital of the company paying the dividends.

95. Taxpayers may enter into arrangements in order to obtain the benefits of such provisions in unintended circumstances. For instance, a non-resident shareholder who owns less than 10% of the capital of a resident company could, in contemplation of the payment of a dividend, arrange for his shares to be temporarily transferred to a resident company or non-resident company in the hands of which the dividends would be exempt or taxed at the lower rate. Such a transfer could be structured in such a way that the value of the expected dividend would be transformed into a capital gain exempt from tax in the source State. As

noted in the Commentary on Article 10, which reproduces paragraph 17 of the OECD Commentary on that Article:

> **The reduction envisaged in subparagraph a) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph a) a provision along the following lines:**
>
> **provided that this holding was not acquired primarily for the purpose of taking advantage of this provision.**

The following are other examples of arrangements intended to circumvent various thresholds found in the Convention.

Time limit for certain permanent establishments

96. Article 5(3) of the Convention includes a rule according to which, in certain circumstances, the furnishing of services by a foreign enterprise during a certain period under the same or connected projects will constitute a permanent establishment. Taxpayers may be tempted to circumvent the application of that provision by splitting a single project between associated enterprises or by dividing a single contract into different ones so as to argue that these contracts cover different projects. Paragraphs 11 and 12 of the Commentary on Article 5 deal with such arrangements.

Thresholds for the source taxation of capital gains on shares

97. Paragraph 4 of Article 13 allows a State to tax capital gains on shares of a company (and on interests in certain other entities) the property of which consists principally of immovable property situated in that State. For the purposes of that provision, the property of such an entity is considered to consist principally of immovable property situated in a State if the value of such immovable property exceeds 50% of the value of all assets of the entity.

98. One could attempt to circumvent that provision by diluting the percentage of the value of an entity that derives from immovable property situated in a given State in contemplation of the alienation of shares or interests in that entity. In the case of a company, that could be done by injecting a substantial amount of cash in the company in exchange for bonds or preferred shares the conditions of which would provide that such bonds or shares would be redeemed shortly after the alienation of the shares or interests.

99. Where the facts establish that assets have been transferred to an entity for the purpose of avoiding the application of paragraph 4 of Article 13 to a prospective alienation of shares or interests in that entity, a country's general anti-abuse rules or judicial doctrines may well be applicable. Some countries, however, may wish to provide expressly in their treaties that paragraph 4 will apply in these circumstances. This could be done by adding to Article 13 a provision along the following lines:

> **For the purposes of paragraph 4, in determining the aggregate value of all assets owned by a company, partnership, trust or estate, the assets that have been transferred to that entity primarily to avoid the application of the paragraph shall not be taken into account.**

3. The importance of proper mechanisms for the application and interpretation of tax treaties

100. The Committee recognizes the role that proper administrative procedures can play in minimizing risks of improper uses of tax treaties. Many substantive provisions in tax treaties need to be supported by proper administrative procedures that are in line with the procedural aspects of domestic tax legislation. Developing countries may consider developing their own procedural provisions regarding treaty application by learning from countries that have successful experience of treaty application.

101. The Committee also recognizes the importance of proper mechanisms for tax treaty interpretation. In many countries, there is a long history of independent judicial interpretations of tax treaties, which provide guidance to tax administration. Countries that have a weaker judicial system or where there is little judicial expertise in tax treaty interpretation may consider alternative mechanisms to ensure correct, responsive and responsible treaty interpretations.

102. Whilst anti-abuse rules are important for preventing the improper use of treaties, the application of certain anti-abuse rules may be challenging for tax administrations, especially in developing countries. For instance, whilst an effective application of domestic transfer pricing rules may help countries to deal with certain improper uses of treaty provisions, countries that have limited expertise in the area of transfer pricing may be at a disadvantage. In addition, countries that have inadequate experience of combating improper uses of treaties may feel uncertain about how to apply general anti-abuse rules, especially where a purpose-test is involved. This increases the need for appropriate mechanisms to ensure a proper interpretation of tax treaties.

103. Developing countries may also be hesitant to adopt or apply general anti-abuse rules if they believe that these rules would introduce an unacceptable level of uncertainty that could hinder foreign investment on their territory. Whilst a ruling system that would allow taxpayers to quickly know whether anti-abuse rules would

be applied to prospective transactions could help reduce that concern, it is important that such a system safeguards the confidentiality of transactions and, at the same time, avoids discretionary interpretations (which, in some countries, could carry risks of corruption). Clearly, a strong independent judicial system will help to provide taxpayers with the assurance that anti-abuse rules are applied objectively. Similarly, an effective application of the mutual agreement procedure ~~should contribute to the resolution of~~**will ensure that disputes concerning the application of anti-abuse rules according to internationally accepted principles so as to maintain the integrity of tax treaties.**

Article 2

TAXES COVERED BY THE CONVENTION

A. GENERAL CONSIDERATIONS

1. Article 2 of the United Nations Model Convention reproduces ~~paragraphs 1, 2 and 3 of~~ Article 2 of the OECD Model Convention.~~, whereas paragraph 4 differs from paragraph 4 of the OECD Model Convention.~~

2. This article is designed to clarify the terminology and nomenclature concerning the taxes to be covered by the convention. In this connection, it may be observed that 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 treaty must be clear, precise and comprehensive as possible. As noted in the OECD Commentary on Article 2 of the OECD Model Convention, this is necessary:

> 1. ~~t~~**[T]**o 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 periodical exchange of lists and through a procedure for mutual consultation~~**and to ensure for each Contracting State notification of significant changes in the taxation laws of the other State.**~~"~~ ~~[para. 1]~~

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 2

Paragraph 1

3. This paragraph states that the Convention applies to taxes on income and on capital, irrespective of the authority on behalf of which such taxes are imposed (e.g., the State itself or its political subdivisions or local authorities) and irrespective of the method by which the taxes are levied (e.g., by direct assessment or by deduction at the source, in the form of surtaxes or surcharges or as additional taxes).

Paragraph 2

4. This paragraph defines taxes on income and on capital, as taxes 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 capital appreciation and taxes on the total amounts of wages or salaries paid by enterprises. Practices regarding the coverage of taxes on the total amount of wages and salaries paid by enterprises vary from country to country and this matter should be taken into account in bilateral negotiations. According to **paragraph 3 of** the Commentary on Article 2~~, paragraph 2,~~ of the OECD Model Convention, ~~the last-named~~ taxes **on the total amount of wages** do not include "social security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received". The OECD Commentary further observes:

> **4.** ~~"~~Clearly a State possessing taxing powers—and it alone—may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty.~~" [para. 4]~~
>
> **5.** ~~"~~The Article does not mention 'ordinary taxes' or 'extraordinary taxes'. Normally, it might be considered justifiable to include extraordinary taxes in a Model Convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. They may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But, as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions.~~" [para. 5]~~

Paragraph 3

5. This paragraph provides the Contracting States an opportunity to enumerate the taxes to which the Convention is to apply. According to the Commentary on Article 2, paragraph 3, of the OECD Model Convention, the list "is not exhaustive", for "it serves to illustrate the preceding paragraphs of the ~~a~~**A**rticle". In principle, however, it is expected to be "a complete list of taxes imposed in each State at the time of signature and covered by the Convention".

Paragraph 4

6. The Commentary on Article 2, paragraph 4 of the OECD Model Convention is applicable:

7. This paragraph provides, since the list of taxes in paragraph 3 is purely declaratory, that the Convention is also to apply to all identical or substantially similar taxes that are imposed in a Contracting State after the date of signature of the Convention in addition to, or in place of, the existing taxes in that State.

8. Each State undertakes to notify the other of any significant changes made to its taxation laws by communicating to it, for example, details of new or substituted taxes. Member countries are encouraged to communicate other significant developments as well, such as new regulations or judicial decisions; many countries already follow this practice. Contracting States are also free to extend the notification requirement to cover any significant changes in other laws that have an impact on their obligations under the convention. Contracting states wishing to do so may replace the last sentence of the paragraph by the following:

The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws or other laws affecting their obligations under the Convention.

~~This paragraph supplements paragraph 3 by stating that the Convention is to 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. According to the Commentary on Article 2, paragraph 4, of the OECD Model Convention, "this provision is necessary to prevent the Convention from becoming inoperative in the event of one of the States modifying its taxation laws". Prior to the amendment in 1999, the second sentence of paragraph 4 read as under:~~

> ~~"At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws."~~

~~It was considered that the scope of this provision was very wide since, in practice, most Contracting States do not communicate with each other on each change in their tax laws. Moreover, the requirement to exchange information on changes in tax laws should extend only to significant changes in law which affect the application of the Convention. Such a provision can be found in several bilateral tax treaties. Hence, it was decided to change the second sentence of paragraph 4 as under:~~

> ~~"The competent authorities of the Contracting States shall notify each other of significant changes made to their tax law."~~

Commentary on chapter II

DEFINITIONS

Article 3

GENERAL DEFINITIONS

A. GENERAL CONSIDERATIONS

1. Article 3 of the United Nations Model Convention ~~reproduces~~ is the same as Article 3 of the OECD Model Convention, except that Article 3 of the OECD Model Convention defines the terms “enterprise” and “business” while Article 3 of the United Nations Model Convention does not. This is because the OECD Model Convention has deleted Article 14 (Independent Personal Services) while the United Nations Model Convention still maintains it.

2. Several general definitions are normally necessary for the understanding and application of a bilateral tax convention, although terms relating to more specialized concepts are usually defined or interpreted in special provisions. On the other hand, there are terms whose definitions are not included in the convention but are left to bilateral negotiations.

3~~2~~. Article 3 of the United Nations Model Convention, like Article 3 of the OECD Model Convention, sets forth a number of general definitions required for the interpretation of the terms used in the Convention. These terms are “person”, “company”, “enterprise of a Contracting State”, “international traffic”, “competent authority” 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 convention are left free to agree bilaterally on a definition of the terms “a Contracting State” and “the other Contracting State”. They also may include in the definition of a Contracting State a reference to continental shelves.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 3 Paragraph 1

(a) The term “person”

4~~3~~. The term “person”, which is defined in subparagraph (a) as including an individual, a company and any other body of persons, should be interpreted very broadly. According to the Commentary on Article 3 of the OECD Model Convention, the term also includes “any entity ~~which~~**that**, although ~~itself not a body of persons~~ **not incorporated**, is treated as a body corporate for tax purposes [e.g., a foundation]”.

(b) The term “company”

5~~4~~. The definition of the term “company”, like the corresponding definition in the OECD Model Convention, is formulated with special reference to **A**~~a~~rticle 10 on dividends. The definition is relevant to that **A**~~a~~rticle and to **A**~~a~~rticle 5, paragraph 8, and **A**~~a~~rticle 16, corresponding respectively to Article 5, paragraph 7, and Article 16 of the OECD Model Convention.

(c) The term “enterprise of a Contracting State”

6~~5~~. Subparagraph (c) defines the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State”. It does not define the term “enterprise” per se, because, as noted in the Commentary on the OECD Model Convention, “[t]he question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States”.

(d) The term “international traffic”

7~~6~~. The definition of the “international traffic” is based on the principle that the right to tax profits arising from the operation of ships or aircraft in international traffic resides only in the Contracting State in which the place of effective management is situated. This principle is set forth in **A**~~a~~rticle 8 A, paragraph 1 (corresponding to Article 8, paragraph 1, of the OECD Model Convention), and in **A**~~a~~rticle 8 B, paragraph 1, and the first sentence of paragraph 2 (provided in the latter case that the shipping activities concerned are not more than casual). However, the Contracting States may agree on a bilateral basis to substitute a reference to residence in subparagraph (d) if appropriate to conform to the general tenor of the other articles relating to international traffic. In such cases, as noted in the Commentary on the OECD Model Convention, “the words ‘an enterprise ~~which~~**that** has its place of effective management in a Contracting State’ should be replaced by ‘an enterprise of a Contracting State’ or ‘a resident of a Contracting State’”.

8~~7~~. As also noted in the OECD Commentary, “[t]he definition of the term “international traffic” is broader than the term **is** normally ~~signifies~~ **understood** [in order] to preserve for the State of the place of effective management the right to tax purely domestic traffic as well as international traffic between third States, and to allow the other Contracting State to tax traffic solely within its borders”.

(e) The term “competent authority”

9~~8~~. As in the OECD Model Convention, the definition of the term “competent authority” is left to the Contracting States, which are free to designate one or more authorities as being competent for the purpose of applying the Convention. This approach is necessary because in some countries the implementation of double taxation conventions may not lie solely within the jurisdiction of the highest tax authorities in so far as some matters may be reserved to, or may fall within the competence of, other authorities.

(f) The term “national”

10~~9~~. Initially, the definition of the term “national” occurred in paragraph 2 of ~~a~~**A**rticle 24 relating to “Non-discrimination”. As a result, the definition of the term “national” would have restricted application only for the purposes of Article 24. Since the term “national” has been referred to in other articles of the Convention as well, namely, ~~a~~**A**rticle 4.2 (c) and (d), ~~a~~**A**rticle 19, ~~a~~**A**rticle 24 and ~~a~~**A**rticle 25, it was decided in 1999 to shift the definition of the term “national” from paragraph 2 of ~~a~~**A**rticle 24 to subparagraph (f) of paragraph 1 of ~~a~~**A**rticle 3. For natural persons, the definition merely states that the term applies to any individual possessing the nationality of a Contracting State. It has not been found necessary to introduce into the text of the Convention any considerations on the signification of the concept of nationality, any more than it seemed appropriate to make any special comment on the meaning and application of the word. In determining what is meant by “the nationals of a Contracting State” in relation to individuals, reference must be made to the sense in which the term is usually employed and each State’s rules on the acquisition or loss of nationality.

11~~10~~. Subparagraph (f) is more specific as to legal persons, partnerships and associations. By declaring that any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State is considered to be a national, the provision disposes of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, some States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.

12~~11~~. Moreover, in view of the legal relationship created between the company and the State under whose laws it is constituted, which resembles the relationship of nationality for individuals, it seems appropriate not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term “national”.

Paragraph 2

13~~12~~. Like article 3, paragraph 2, of the OECD Model Convention, this paragraph contains a general rule concerning the meaning of terms used but not defined in the Convention. According to the OECD Commentary, it amended paragraph 2 in 1995 in order:

13.1 “. . . to conform its text more closely to the general and consistent understanding of member States. For purposes of paragraph 2, the meaning of any term not defined in the Convention may be ascertained by reference to the meaning it has for the purpose of any relevant provision of the domestic law of a Contracting State, whether or not a tax law. However, where a term is defined differently for the purposes of different laws of a Contracting State, the meaning given to that term for purposes of the laws imposing the taxes to which the Convention applies shall prevail over all others, including those given for the purposes of other tax laws. States that are able to enter into mutual agreements (under the provisions of Article 25 and, in particular, paragraph 3 thereof) that establish the meanings of terms not defined in the Convention should take those agreements into account in interpreting those terms~~.” [para. 13.1]~~

When a conflict arises between the legislation in force when the Convention was signed and that in force when the tax is imposed, the latter interpretation prevails.

13. The OECD Commentary states:

12 ~~“~~However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the Article therefore allows the competent authorities some leeway.~~” [para. 12]~~

13 ~~“~~Consequently, the wording of paragraph 2 provides a satisfactory balance between, on the one hand, the need to ensure the permanency of commitments entered into by States when signing a convention (since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention) and, on the other hand, the need to be able to apply the Convention in a convenient and practical way over time (the need to refer to outdated concepts should be avoided).~~” [para. 13]~~

Article 4

RESIDENT

A. GENERAL CONSIDERATIONS

1. Article 4 of the United Nations Model Convention reproduces Article 4 of the OECD Model Convention with one adjustment, namely, 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 Commentary on Article 4 of the OECD Model Convention:

1. ~~“~~The concept of ‘resident of a Contracting State’ has various functions and is of importance in three cases:

(a) in determining a convention’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 in the State of source or situs.~~” [para. 1]~~

2. Like Article 4 of the OECD Model Convention, ~~a~~**A**rticle 4 of the United Nations Model Convention defines the expression “resident of a Contracting State” and establishes rules for resolving cases of double residence. In the two typical cases of conflict between two residences and between residence and source or situs, the conflict arises because, under their domestic laws, one or both Contracting States claim that the person concerned is resident in their territory. In this connection the OECD Commentary provides the following clarification:

3. ~~“~~Generally the domestic laws of the various States impose a comprehensive liability to tax—‘full tax liability’—based on the taxpayers’ personal attachment to

the State concerned (the ‘State of residence’). This liability to tax is not imposed only on persons who are ‘domiciled’ in a State in the sense in which ‘domicile’ is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State. Some legislations impose full liability to tax on individuals who perform services on board ships which have their home harbour in the State.” ~~[para. 3]~~

4. “Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as ‘resident’ and, consequently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on ‘residence’ have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.” ~~[para. 4]~~

5. “This manifests itself quite clearly in the cases where there is no conflict at all between two residences, but where the conflict exists only between residence and source or situs. But the same view applies in conflicts between two residences. The special point in these cases is only that no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned. In these cases special provisions must be established in the Convention to determine which of the two concepts of residence is to be given preference.” ~~[para. 5]~~

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 4

Paragraph 1

3. The **former** Group **of Experts** decided to adopt as paragraph 1 of ~~a~~**A**rticle 4, the paragraph 1 of Article 4 of the OECD Model Convention, and had initially decided not to adopt the second sentence which reads: “This term [resident of a Contracting State], 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”. The second sentence, which was included in the OECD Convention to deal, for example, with the special situation of foreign diplomats and consular staffs serving in a country which taxed residents on the basis of their worldwide income, who might be considered (under the domestic law of the country in which they are serving) as residents but, because of their special status, might nevertheless be taxable only on income from sources in that State, has been incorporated in 1999 in paragraph 1 of ~~a~~**A**rticle 4 of the United Nations Model Convention as well.

4. The OECD Commentary observes:

8.1 “In accordance with the provisions of the second sentence of paragraph 1, **however**, a person is not to be considered a ‘resident of a Contracting State’ in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in ~~the~~ **that** State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g. in the case of foreign diplomatic and consular staff serving in their territory.

8.2 According to its wording and spirit the **second sentence** ~~provision would~~ also exclude**s** from the definition of a resident of a Contracting State foreign held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. **It also excludes companies and other persons who are not subject to comprehensive liability to tax in a Contracting State because these persons, whilst being residents of that State under that State's tax law, are considered to be residents of another State pursuant to a treaty between these two States.** ~~This, however, has inherent difficulties and limitations. Thus it has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended.~~ The exclusion of certain companies **or other persons** from the definition would not of course prevent Contracting States from exchanging information about their activities~~. [~~(cf. paragraph 2 of the ~~OECD~~ Commentary on ~~a~~**A**rticle 26) ~~(reproduced in paragraph 3 of the Commentary on Article 26 below)]~~. Indeed States may feel it appropriate to develop spontaneous exchanges of information about persons who~~companies which~~ seek to obtain unintended treaty benefits ~~unintended by the Model Convention." [para. 8]~~

5. Paragraph 1, similar to the corresponding provision of the OECD Model Convention, refers to the concept of residence contained in the domestic laws of the Contracting States and lists the criteria for taxation as a resident: domicile, residence, place of management (to which the United Nations Model Convention adds "place of incorporation") or any other criterion of a similar nature. Thus formulated, the definition of the term "resident of a Contracting State" is, according to the OECD Commentary, aimed at covering, as far as individuals are concerned, "[…] the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax)". [para. 8]

6. The OECD Commentary observes as under:

8.4 ~~"~~It has been the general understanding of most Member ~~states~~**countries** that the government of each State, as well as any political subdivision or local authority thereof, is a resident of that State for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, Article 4 was amended to conform the text of the Model to this understanding.~~" [para. 8.1]~~

Comment [UN2]: Paragraph 8.1 was replaced as paragraph 8.4 as part of the 2008 OECD update.

(It may be mentioned that in 1999, the United Nations Model Convention also adopted the same amendment.)

8.5 Paragraph 1 refers to persons who are "liable to tax" in a Contracting State under its laws by reason of various criteria. In many States, a person is considered liable to comprehensive taxation even if the Contracting State does not in fact impose tax. For example, pension funds, charities and other organizations may be exempted from tax, but they are exempt only if they meet

all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting State. Furthermore, if they do not meet the standards specified, they are also required to pay tax. Most States would view such entities as residents for purposes of the Convention (see, for example, paragraph 1 of Article 10 and paragraph 5 of Article 11).

8.6 In some States, however, these entities are not considered liable to tax if they are exempt from tax under domestic tax laws. These States may not regard such entities as residents for purposes of a convention unless these entities are expressly covered by the convention. Contracting States taking this view are free to address the issue in their bilateral negotiations.

8.7 Where a State disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the income of the partnership "flows through" to the partners under the domestic law of that State, the partners are the persons who are liable to tax on that income and are thus the appropriate persons to claim the benefits of the conventions concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity. For States which could not agree with this interpretation of the Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two States.

Paragraph 2

7. This paragraph, which reproduces Article 4, paragraph 2, of the OECD Model Convention, 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. It may be noted that in 1999, the word "only" has been inserted in subparagraphs (a), (b) and (c) of paragraph 2, following the changes previously made to the OECD Model Convention. The OECD Commentary states:

> **9.** ~~"~~This paragraph relates to the case where, under the provisions of paragraph 1, an individual is a resident of both Contracting States.~~" [para. 9]~~

> **10.** ~~"~~To solve this conflict special rules must be established which give the attachment to one State a preference over the attachment to the other State. As far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State. The facts to which the special rules will apply are those

existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. [Assume that] in one calendar year an individual is a resident of State A under that State's tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.~~” [para. 10]~~

11. ~~“~~The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, e.g. where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.~~” [para. 11]~~

12. ~~“~~Subparagraph ~~(~~a) means, therefore, that in the application of the ~~c~~**C**onvention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.~~” [para. 12]~~

13. ~~“~~As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.).~~” [para. 13]~~

14. ~~“~~If the individual has a permanent home in both Contracting States, paragraph 2 gives preference to the State with which the personal and economic relations of the individual are closer, this being understood as the centre of vital interests. In the cases where the residence cannot be determined by reference to this rule, paragraph 2 provides as subsidiary criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Article 25.~~” [para. 14]~~

15. ~~“~~If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.~~” [para. 15]~~

16. “Subparagraph (b) establishes a secondary criterion for two quite distinct and different situations:

(a) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;

(b) the case where the individual has a permanent home available to him in neither Contracting State.

Preference is given to the Contracting State where the individual has an habitual abode.~~” [para. 16]~~

17. “In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.~~” [para. 17]~~

18. “The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.~~” [para. 18]~~

19. “In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has a~~n~~ habitual abode, subparagraph ~~(~~b) does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.~~” [para. 19]~~

20. “Where, in the two situations referred to in subparagraph ~~(~~b) the individual has a habitual abode in both Contracting States or in neither, preference is given to the State of which he is a national. If, in these cases still, the individual is a national of both Contracting States or of neither of them~~, the~~ subparagraph ~~(~~d) assigns to the competent authorities the duty of resolving the difficulty by mutual agreement according to the procedure established in Article 25.~~” [para. 20]~~

Paragraph 3

8. Paragraph 3, which reproduces Article 4, paragraph 3, of the OECD Model Convention, deals with companies and other bodies of persons, irrespective of whether they are legal persons. The OECD Commentary indicates that “It may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State, but it is, of course,

possible if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc. also, special rules as to the preference must be established". [para. 21] According to the OECD Commentary, "It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed". [para. 22] It may be mentioned that, as in the case of the OECD Model Convention, the word "only" has been added in 1999 to the tie-breaker test for determining the residence of dual residents, other than individuals.

9. The OECD Commentary goes on to state:

> 23. ~~"~~The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the 'place of management' of the enterprise is situated; other conventions attach importance to its 'place of effective management', others again to the 'fiscal domicile of the operator'.~~" [para. 23]~~
>
> [As a result of these considerations, the 'place of effective management' has been adopted as the preference criterion for persons other than individuals **[...]**" [para. 24]]

Comment [MB3]: The issue of keeping, amending or deleting paragraph 24 from the OECD Commentary was discussed during the EGM in June 2011. The participants said that this calls for an open discussion within the Committee.

10. It is 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. **In this respect the OECD Commentary continues:**

> **24.1 Some countries, however, consider that cases of dual residence of persons who are not individuals are relatively rare and should be dealt with on a case-by-case basis. Some countries also consider that such a case-by-case approach is the best way to deal with the difficulties in determining the place of effective management of a legal person that may arise from the use of new communication technologies. These countries are free to leave the question of the residence of these persons to be settled by the competent authorities, which can be done by replacing the paragraph by the following provision:**
>
>> **3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavor to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this Convention except to the extent and in such manner as may be agreed upon by the competent authorities of**

the Contracting States.

Competent authorities having to apply such a provision to determine the residence of a legal person for purposes of the Convention would be expected to take account of various factors, such as where the meetings of its board of directors or equivalent body are usually held, where the chief executive officer and other senior executives usually carry on their activities, where the senior day-to-day management of the person is carried on, where the person's headquarters are located, which country's laws govern the legal status of the person, where its accounting records are kept, whether determining that the legal person is a resident of one of the Contracting States but not of the other for the purpose of the Convention would carry the risk of an improper use of the provisions of the Convention etc. Countries that consider that the competent authorities should not be given the discretion to solve such cases of dual residence without an indication of the factors to be used for that purpose may want to supplement the provision to refer to these or other factors that they consider relevant. Also, since the application of the provision would normally be requested by the person concerned through the mechanism provided for under paragraph 1 of Article 25, the request should be made within three years from the first notification to that person that its taxation is not in accordance with the Convention since it is considered to be a resident of both Contracting States. Since the facts on which a decision will be based may change over time, the competent authorities that reach a decision under that provision should clarify which period of time is covered by that decision.

11. A particular issue, as regards a bilateral treaty between State A and State B, can arise in relation to a company which is under paragraph 1 of ~~a~~**A**rticle 4, a resident of State A, and which is in receipt of, say, interest income, not directly, but instead, through a permanent establishment which it has in a third country, State C. Applying the Model treaty, as it stands, has the effect that such a company can claim the benefit of the terms on, say, withholding tax on interest in the treaty between State A and State B, in respect of interest that is paid to its permanent establishment in State C. This is one example of what is known as a "triangular case". Some concern has been expressed that treaties can be open to abuse where, in the example given, State C is a tax haven and State A exempts the profits of permanent establishments of its resident enterprises. The situation is discussed in depth in the OECD study on the subject: reprinted as "Triangular Cases" in Volume II of the OECD Model Convention. States which wish to protect themselves against potential abuse can take advantage of the possible solutions suggested there, by adopting additional treaty provisions.

NOTE BY THE SECRETARIAT: THE COMMENTARY ON ARTICLE 5 IS IN MARK-UP FROM THE VERSIONS PRESENTED AT THE EXPERT GROUP MEETING IN NEW YORK IN JUNE 2011 AND THE VERSION PRESENTED AT THE ANNUAL SESSION IN 2010 (CF. DOCUMENTS *E/C. 18/2010/5 and E/C. 18/2010/6*).

THE CURRENT VERSION REFLECTS NEW COMMENTARY ON ARTICLE 5, AS ADOPTED BY THE COMMITTEE DURING THE THIRD ANNUAL SESSION IN 2007 AND THE SIXTH ANNUAL SESSION IN 2010.

Article 5

PERMANENT ESTABLISHMENT

A. GENERAL CONSIDERATIONS

1. Article 5 of the United Nations Model ~~Double Taxation~~ Convention ~~between Developed and Developing Countries (hereinafter referred to as the "UN Model")~~ is based on Article 5 of the OECD Model ~~Tax~~ Convention ~~(hereinafter referred to as the "OECD Model")~~ but contains several significant differences. In essence these are that under the U**nited** N**ations** Model **Convention**:

– there is a six months test for a building or construction site constituting a permanent establishment, rather than the ~~12~~**twelve**-month test under the OECD Model **Convention**, and it expressly extends to assembly projects, as well as supervisory activities in connection with building sites and construction, assembly or installation projects (para. 3 of the U**nited** N**ations** Model **Convention** Article);

– the furnishing of services by an enterprise through employees or other personnel results in a permanent establishment where such activities continue for a total of more than 183 days in any ~~12~~**twelve**-month period commencing or ending in the fiscal year concerned (para. 3(b));

– Article 14 (Independent Personal Services) has been retained, whereas in the OECD Model **Convention**, Article 14 has been deleted, and Article 5 addresses cases that were previously considered under the "fixed base" test of that Article. As noted below (in para. 15.1 and thereafter), while the U**nited** N**ations** Model **Convention** has retained Article 14, the present Commentary provides guidance for those countries not wishing to have such an article in their bilateral tax agreements;

– in the paragraph 4 list of what is deemed *not* to constitute a permanent establishment (often referred to as the list of "preparatory and auxiliary activities") "delivery" is not mentioned in the United Nations Model Convention, but is mentioned in the OECD Model Convention. Therefore a delivery activity might result in a permanent establishment under the United Nations Model Convention, without doing so under the OECD Model Convention;

– the actions of a "dependent agent" may constitute a permanent establishment, even without having and habitually exercising the authority to conclude contracts in the name of the enterprise, where that person habitually maintains a stock of goods or merchandise and regularly makes deliveries from the stock (para. 5 (b));

– there is a special provision specifying when a permanent establishment is created in the case of an insurance business; consequently a permanent establishment is more likely to exist under the United Nations Model Convention approach (para. 6); and

– ~~while~~ an independent agent acting as such will usually not create a permanent establishment for the enterprise making use of the agent because such an agent is effectively operating his own business providing a service, as **compared with** the OECD Model Convention, the United Nations Model Convention indicates that such an agent devoting all or nearly all their time to a particular client and not dealing with the client at an arm's length basis is not treated as having the necessary independence (para. 7).

These differences are considered in more detail below.

2. The concept of "permanent establishment" is used in bilateral tax treaties to determine the right of a State to tax the profits of an enterprise of the other State. Specifically, the profits of an enterprise of one State are taxable in the other State only if the enterprise maintains a permanent establishment in the latter State and only to the extent that the profits are attributable to the permanent establishment. The concept of permanent establishment is found in the early model conventions including the 1928 model conventions of the League of Nations. The United Nations Model Convention reaffirms the concept.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 5

Paragraph 1

3. This paragraph, which reproduces Article 5(1) of the OECD Model Convention, defines the term "permanent establishment", emphasizing its essential nature as a "fixed place of business" with a specific "situs". According to paragraph 2 of the OECD Commentary, this definition contains the following conditions:

– the existence of a "place of business", i.e. a facility such as premises or, in certain instances, machinery or equipment;

- this place of business must be “fixed”, i.e., it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

The OECD Commentary goes on to observe:

> *3.* It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has ~~“~~a “productive character” it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (cf. Commentary on paragraph 4).
>
> *4.* The term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g.~~,~~ for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case~~,~~ for instance~~,~~ where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.
>
> *4.1* As noted above, the mere fact that an enterprise has a certain amount of space at its disposal which is used for business activities is sufficient to constitute a place of business. No formal legal right to use that place is therefore required. Thus, for instance, a permanent establishment could exist where an enterprise illegally occupied a certain location where it carried on its business.
>
> *4.2* Whilst no formal legal right to use a particular place is required for that place to constitute a permanent establishment, the mere presence of an enterprise at a particular location does not necessarily mean that that location is at the disposal of that enterprise. These principles are illustrated by the following examples where representatives of one enterprise are present on the premises of another enterprise. A first example is that of a salesman who regularly visits a

major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g., a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

4.5 A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

4.6 The words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. paragraph 20 below).

5.1 Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbouring locations, there may be difficulties in determining whether there is a single "place of business" (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.

5.2 This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an "office hotel" in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

The OECD Commentary then examines some examples relating to the provision of services. In quoting the following two paragraphs, the Committee notes that Article 5 (3) (b) of the U**nited** N**ations** Model **Convention** provides a specific provision in relation to furnishing of services by an enterprise through employees or personnel engaged for that purpose. In practice, therefore, the points made in paragraphs 5.3 and 5.4 of the OECD ~~Model~~ Commentary (as with other parts of the OECD Commentary to Article 5 (1)) may have less significance for the U**nited** N**ations** Model **Convention** than in their original context.

5.3 By contrast, where there is no commercial coherence, the fact that activities may be carried on within a limited geographic area should not result in that area being considered as a single place of business. For example, where a painter works successively under a series of unrelated contracts for a number of unrelated clients in a large office building so that it cannot be said that there is one single project for repainting the building, the building should not be regarded as a single place of business for the purpose of that work. However, in the different example of a painter who, under a single contract, undertakes work throughout a building for a single client, this constitutes a single project for that painter and the building as a whole can then be regarded as a single place of business for the purpose of that work as it would then constitute a coherent whole commercially and geographically.

5.4 *Conversely*, an area where activities are carried on as part of a single project which constitutes a coherent commercial whole may lack the necessary

> geographic coherence to be considered as a single place of business. For example, where a consultant works at different branches in separate locations pursuant to a single project for training the employees of a bank, each branch should be considered separately. However~~,~~ if the consultant moves from one office to another within the same branch location, he should be considered to remain in the same place of business. The single branch location possesses geographical coherence which is absent where the consultant moves between branches in different locations.
>
> ***5.5*** **Clearly, a permanent establishment may only be considered to be situated in a Contracting State if the relevant place of business is situated in the territory of that State. The question of whether a satellite in geostationary orbit could constitute a permanent establishment for the satellite operator relates in part to how far the territory of a State extends into space. No member country would agree that the location of these satellites can be part of the territory of a Contracting State under the applicable rules of international law and could therefore be considered to be a permanent establishment situated therein. Also, the particular area over which a satellite's signals may be received (the satellite's "footprint") cannot be considered to be at the disposal of the operator of the satellite so as to make that area a place of business of the satellite's operator.**

The OECD Commentary then continues:

> *6.* Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. A place of business may, however, constitute a permanent establishment even though it exists, in practice, only for a very short period of time because the nature of the business is such that it will only be carried on for that short period of time. It is sometimes difficult to determine whether this is the case. Whilst the practices followed by ~~M~~**m**ember countries have not been consistent in so far as time requirements are concerned, experience has shown that permanent establishments normally have not been considered to exist in situations where a business had been carried on in a country through a place of business that was maintained for less than six months (conversely, practice shows that there were many cases where a permanent establishment has been considered to exist where the place of business was maintained for a period longer than six months). One exception has been where the activities were of a recurrent nature; in such cases, each period of time during which the place is used needs to be considered in combination with the number of times during which that place is used (which may extend over a number of years). Another exception has been made where activities constituted a business that was carried on exclusively in that country; in this situation, the business may have short duration because of its nature but since it is wholly carried on in that country, its connection with that country is stronger. For ease of administration, countries may want to consider these practices when they address

disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

The Committee agreed with the approach taken in paragraph 6 of the OECD Commentary, while recognizing that such **exceptional** situations will not often arise in practice, and that special care should therefore be taken when relying on paragraph 6 as applicable in an actual case. The OECD Commentary continues:

6.1 As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

6.2 Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraph 18 on arrangements intended to abuse the 12-month period provided for in paragraph 3 would equally apply to such cases.

6.3 Where a place of business which was, at the outset, designed to be used for such a short period of time that it would not have constituted a permanent establishment but is in fact maintained for such a period that it can no longer be considered as a temporary one, it becomes a fixed place of business and thus — retrospectively — a permanent establishment. A place of business can also constitute a permanent establishment from its inception even though it existed, in practice, for a very short period of time, if as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated.

7. For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in paragraph 3 above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

8. Where tangible property such as facilities, industrial, commercial or scientific (ICS) equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, ICS equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, ICS equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the ICS equipment~~,~~ etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the ICS equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example~~,~~ participation in the decisions regarding the work for which the equipment is used, or if they operate, service, inspect and maintain the equipment under the responsibility and control of the lessor, the activity of the lessor may go beyond the mere leasing of ICS equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of [six] months applies. Other cases have to be determined according to the circumstances.

Comment [IRD4]: The OECD Commentary further includes paragraphs 9 (replaced in 1991) and 9.1 (added in 2010).

10. The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). These personnel include employees and other persons receiving instructions from the enterprise (e.g.~~,~~ dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business **[…]** But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

11. A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as **a** closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessors; in general, the lessors permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business.

Paragraph 2

4. Paragraph 2, which reproduces Article 5(2) of the OECD Model **Convention**, lists examples of places that will often constitute a permanent establishment. However, the provision is not self-standing. While paragraph 2 notes that offices, factories, etc., are common types of permanent establishments, when one is looking at the operations of a particular enterprise, the requirements of paragraph 1 must also be met. Paragraph 2 therefore simply provides an indication that a permanent establishment may well exist; it does not ~~prove~~ **provide** that one necessarily does exist. This is also the stance of the OECD Commentary, where it is assumed that States interpret the terms listed "in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1". Developing countries often wish to broaden the scope of the term "permanent establishment" and some believe that a warehouse should be included among the specific examples. However, the deletion of "delivery" from the excluded activities described in paragraph 4 (a) and (b) means that a "warehouse" used for any purpose is (subject to the conditions in paragraph 1 being fulfilled) a permanent establishment under the general principles of the Article. The OECD Commentary points out in paragraph 13 that the term "place of management" is mentioned separately because it is not necessarily an "office" and that "where the laws of the two Contracting States do not contain the concept of a 'place of management' as distinct from an 'office', there will be no need to refer to the former term in their bilateral convention".

5. In discussing subparagraph (f), which provides that the term "permanent establishment" includes mines, oil or gas wells, quarries or any other place of extraction of natural resources, the OECD Commentary states that "the term 'any other place of extraction of natural resources' should be interpreted broadly" to include, for example, all places of extraction of hydrocarbons whether on or offshore. Because subparagraph (f) does not mention exploration for natural resources, whether on or offshore, paragraph 1 governs whether exploration activities are carried on through a permanent establishment. The OECD Commentary states:

> *15.* **[…]** Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualification of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:
>
> ~~(~~a) shall be deemed not to have a permanent establishment in that other State; or

~~(~~b) shall be deemed to carry on such activities through a permanent establishment in that other State; or

~~(~~c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

The Contracting States may moreover agree to submit the income from such activities to any other rule.

6. As mentioned above, in subparagraph (f) the expression "any other place of extraction of natural resources" should be interpreted broadly. Some have argued that, for this purpose, a fishing vessel could be treated as a place of extraction or exploitation of natural resources since "fish" constitute a natural resource. In their analysis, although it is true that all places or apparatus designated as "permanent establishments" in subparagraphs (a) to (e) in paragraph 2 have a certain degree of permanence or constitute "immovable property", fishing vessels can be considered as a place used for extraction of natural resources, which may not necessarily mean only minerals embedded in the Earth. In this view, fishing vessels can be compared to the movable drilling platform that is used in off-shore drilling operations for gaining access to oil or gas. Where such fishing vessels are used in the territorial waters or the exclusive economic zone of the coastal State, their activities would constitute a permanent establishment, situated in that State. However, others are of the view that such an interpretation was open to objection in that it constituted too broad a reading of the term "permanent establishment" and of the natural language of the subparagraph. Accordingly, in their opinion, any treaty partner countries which sought to advance such a proposition in respect of fishing activities, should make that explicit by adopting it as a new and separate category in the list contained in this Article. Consequently, the interpretation on the nature of this activity has been left to negotiations between Contracting States so that, for example, countries which believe that a fishing vessel can be a permanent establishment might choose to make that explicit in this Article, such as by the approach outlined in paragraph 13 of this Commentary. The interpretation as to the nature of this activity would, therefore, be left to negotiations between Contracting States.

Paragraph 3

7. This paragraph covers a broader range of activities than Article 5(3) of the OECD Model **Convention**, which states, "A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months". In addition to the term "installation project" used in the OECD Model **Convention**, subparagraph 3 (a) of the U**nited** N**ations** Model **Convention** includes an "assembly project" as well as "supervisory activities" in connection with "a building site, a construction, assembly or installation project". Another difference is that while the OECD Model **Convention** uses a time limit of 12 months, the U**nited** N**ations** Model **Convention** reduces the minimum duration to six months. In special cases, this six-month period could be reduced in bilateral negotiations to not less than three months. The Committee notes that there are differing views about whether paragraph 3(a) is a "self-standing" provision (so that no resort to paragraph 1 is required) or whether (in contrast) only building sites and the like that meet the criteria of paragraph 1 would constitute

permanent establishments, subject to there being a specific six-month test. However, the Committee considers that where a building site exists for six months, it will in practice almost invariably also meet the requirements of paragraph 1. In fact, an enterprise having a building site, etc., at its disposal, through which its activities are wholly or partly carried on will also meet the criteria of paragraph 1.

8. Some countries support a more elaborate version of paragraph 3(a), which would extend the provision to encompass a situation “where such 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 activities exceed 10 per cent of the sale price of the machinery or equipment”. Other countries believe that such a provision would not be appropriate, particularly if the machinery were installed by an enterprise other than the one doing the construction work.

9. Article 5(3)(b) deals with the furnishing of services, including consultancy services, the performance of which does not, of itself, create a permanent establishment in the OECD Model **Convention**. Many developing countries believe that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can generate large profits. In the (2011) version of the U**nited** N**ations** Model **Convention**, the Committee has agreed to a slight change in the wording of subparagraph 3(b), which was amended to read: “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 183 days in any ~~12~~**twelve**-month period commencing or ending in the fiscal year concerned”, rather than, “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 ~~12~~**twelve**-month period”, as it formerly read. This was seen as providing greater consistency with the approach taken in Article 14(1)(b).

10. A few developing countries oppose the six-month (or 183 days) thresholds in paragraph 3(a) and (b) altogether. They have two main reasons: first, they maintain that construction, assembly and similar activities could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise; second, and more fundamentally, they simply believe that the period during which foreign personnel remain in the source country is irrelevant to their right to tax the income (as it is in the case of artistes and sportspersons under Article 17). Other developing countries oppose a time limit because it could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory. However, the purpose of bilateral treaties is to promote international trade, investment, and development, and the reason for the time limit (indeed for the permanent establishment threshold more generally) is to encourage businesses to undertake preparatory or ancillary operations in another State that will facilitate a more permanent and substantial commitment later on, without becoming immediately subject to tax in that State.

11. In this connection, the OECD Commentary observes, with changes in parentheses to take account of the different time periods in the two Models:

> *18.* The [six]-month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g.~~,~~ for a row of houses). The [six]-month threshold has given rise to abuses; it has sometimes been found that enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) divided their contracts up into several parts, each covering a period less than [six] months and attributed to a different company, which was, however, owned by the same group. Apart from the fact that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules, countries concerned with this issue can adopt solutions in the framework of bilateral negotiations.

The Committee points out that measures to counteract abuses would apply equally in cases under Article 5 (3) (b). The Commentary of the OECD Model **Convention** continues as follows:

> *19.* A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st [August] because of bad weather conditions or a lack of materials but resumed work on 1st [October], completing the road on 1st [January~~]~~ the following year], his construction project should be regarded as a permanent establishment because [eight] months elapsed between the date he **first** commenced work (1st May) and the date he finally finished (1st [January] of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project~~,~~ subcontracts parts of such a project to other enterprises (subcontractors), the period spent by a subcontractor working on the building site must be considered as being time spent by the general contractor on the building project. The subcontractor himself has a permanent establishment at the site if his activities there last more than [six] months.

The Committee considers that the reference in the penultimate sentence of this paragraph of the OECD Commentary to “parts” of such a project should not be taken to imply that an enterprise subcontracting *all* parts of the project could never have a permanent establishment in the host State.

The Commentary of the OECD Model **Convention** continues as follows:

19.1 In the case of fiscally transparent partnerships, the [six]-month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds [six] months, the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site.

20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipelines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such ~~a~~ case**s** the fact that the work force is not present for [six] months in one particular ~~**place**~~ **location** is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts **for** more than [six] months.

12. Subparagraph (*b*) encompasses service activities only if they "continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned". The words "for the same or a connected project" are included because it is not appropriate 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 95 days' duration and another enterprise with two unrelated projects, each of 95 days' duration, one following the other. However, some countries find the "project" limitation 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 120 or 150 days' duration.

13. If States wish to treat fishing vessels in their territorial waters as constituting a permanent establishment (see para. 6 above), they could add a suitable provision to paragraph 3, which, for example, might apply only to catches over a specified level, or by reference to some other criterion.

14. If a permanent establishment is ~~deemed~~ **considered** to exist under paragraph 3, only profits attributable to the activities carried on through that permanent establishment are taxable in the source country.

15. The following passages of the **OECD** Commentary ~~on the OECD Model~~ are relevant to Article 5 (3) (a) of the U**nited** N**ations** Model **Convention**, although the reference to an "assembly project" in the U**nited** N**ations** Model **Convention** and not in the OECD Model **Convention**, and the six-month period in the U**nited** N**ations** Model **Convention** should, in particular, be borne in mind:

16. This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than ~~12~~ **twelve** months. Any of those items which do not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity. Where, however, such an office or workshop is used for a number of construction projects and the activities performed therein go beyond those mentioned in paragraph 4, it will be considered a permanent establishment if the conditions of the Article are otherwise met even if none of the projects involve a building site or construction or installation project that lasts more than ~~12~~ **twelve** months. In that case, the situation of the workshop or office will therefore be different from that of these sites or projects, none of which will constitute a permanent establishment, and it will be important to ensure that only the profits properly attributable to the functions performed and risks assumed through that office or workshop are attributed to the permanent establishment. This could include profits attributable to functions performed and risks assumed in relation to the various construction sites but only to the extent that these functions and risks are properly attributable to the office.

17. The term "building site or construction or installation project" includes not only the construction of buildings but also the construction of roads, bridges or canals, the renovation (involving more than mere maintenance or redecoration) of buildings, roads, bridges or canals, the laying of pipe**-**lines and excavating and dredging. Additionally, the term "installation project" is not restricted to an installation related to a construction project; it also includes the installation of new equipment, such as a complex machine, in an existing building or outdoors. On-site planning and supervision of the erection of a building are covered by paragraph 3. States wishing to modify the text of the paragraph to provide expressly for that result are free to do so in their bilateral conventions.

Alternative text for countries wishing to delete Article 14

15.1. Some countries have taken the view that Article 14 should be deleted and its coverage introduced into Articles 5 and 7. Countries taking such a view often do so because they perceive that the "fixed base" concept in Article 14 has widely acknowledged uncertainties and that the "permanent establishment" concept can accommodate the taxing rights covered by Article 14. This approach is expressed by the Commentary on Article 5 of the OECD Model **Convention** as follows:

> *1.1* Before 2000, income from professional services and other activities of an independent character was dealt with under a separate Article, i.e. Article 14. The

provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to which of Article 7 or 14 applied. The elimination of Article 14 therefore meant that the definition of permanent establishment became applicable to what previously constituted a fixed base.

15.2 Many countries ~~**that do not hold to**~~ **disagree with** these views~~,~~ **and** do not believe they are sufficient to warrant deletion of Article 14**.**~~, or~~ **Further some countries** consider that differences in meaning exist between the "fixed base" (Article 14) and "permanent establishment" (Article 5) concepts**.**~~, and that because~~ **In view** of these differences, the removal of Article 14 and reliance on Articles 5 and 7 will, or at least may, in practice lead to a reduction of source State taxing rights. Considering the differences of views in this area, differences which could not be bridged by a single provision, the Committee decided that Article 14 would be retained in the U**nited** N**ations** Model **Convention** but that guidance in the form of an alternative provision would be provided in this Commentary for countries wishing to delete Article 14 ~~and address situations currently covered by it under Articles 5 and 7~~.

Comment [MB5]: Decision to delete this passage stem from 2010 Annual Session.

15.3 This alternative differs from that provided for under the OECD Model **Convention**, which reflected in its changes the conclusions of a report on Article 14 released in a 2000 OECD report[14]. That report suggested certain changes to Articles of the OECD Model **Convention** (and bilateral treaties) as well as consequential changes to the Commentaries. Since most countries deleting Article 14 will be doing so for the reasons outlined in the OECD report, and are likely to follow the recommendations in the OECD Model **Convention**, the changes to the Articles proposed in that report, as they now appear in the OECD Model **Convention**, are addressed in the paragraphs below regarding the possible deletion of Article 14. The differences between that approach and the alternative wording provided below, result from relevant differences between Article 14 of the U**nited** N**ations** Model **Convention** and Article 14 as it previously appeared in the OECD Model **Convention**.

15.4 Since the deletion of Article 14 is merely presented as an option that some countries may prefer to follow, the entire discussion on the consequential implications of such an approach is addressed in this Commentary on Article 5, including identifying the possibility, and in most cases the need, to make certain consequential changes reflecting the deletion of Article 14, the need to remove references to "independent personal services" and "fixed base" and the possibility of removing references to "dependent personal services" for the sake of clarity.

[14] Organisation for Economic Cooperation and Development, *Issues in International Taxation Issues Related to Article 14 of the OECD Model Tax Convention: No. 7* (Organisation for Economic Cooperation and Development, 2000)

Changes to Articles 14 and 5

15.5 Article 14 would be deleted. Subparagraph (b) of Article 5 (3) would read as follows:

> "(b) the furnishing of 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 183 days within any twelve-month period commencing or ending in the fiscal year concerned;"

15.6 The changes to the version of this subparagraph in the ~~2001~~**1999** U**nited** N**ations** Model **Convention** are minor, comprising (i) the deletion of the words "including consultancy services", after the words "the furnishing of services", on the basis that the wording was unnecessary and confusing, such services being clearly covered; (ii) the replacement of the six-month test with the 183 days test, as noted in paragraph 9 above; and (iii) the use of a semicolon rather than a period at the end of the subparagraph, with the introduction of subparagraph (c**). In relation to the wording of subparagraph (b), some members of the Committee were of the view, however, that the words "(for the same or a connected project)" should be eliminated as no such requirement exists in article 14.**

Comment [MB6]: Amended text agreed upon during the annual session in 2010.

15.7 A new subparagraph 3 (c) would also be inserted, as follows:

> "(c) for an individual, the performing of services in a Contracting State by that individual, but only if the individual's stay in that State is for a period or periods aggregating more than 183 days within any ~~12~~**twelve-**month period commencing or ending in the fiscal year concerned."

15.8 Subparagraph (c) is intended to ensure that any situation previously covered by Article 14 would now be addressed by Articles 5 and 7. The wording reflects the fact that deletion of Article 14 of the U**nited** N**ations** Model **Convention** would involve deletion of the "days of physical presence" test found in subparagraph 1 (b) of Article 14 of that Model, which had no counterpart in the OECD Model **Convention** when the deletion of Article 14 was agreed for that Model.

15.9 It should be noted that subparagraph (c), in attempting to reflect the operation of the current Article 14 (1) (b), more explicitly indicates that the subparagraph only applies to individuals. In this respect, it follows and makes clearer the interpretation found in paragraph 9 of the Commentary on Article 14, to the effect that Article 14 deals only with individuals. The Committee notes that some countries do not accept that view and should seek to clarify the issue when negotiating Article 14.

15.10 It should also be noted that the last part of Article 14 (1) (b) has not been transposed into Article 5: ("… in that case, only so much of the income as is derived from

Comment [MB7]: Decision to delete text below stem from the 2010 annual session.

his activities performed in that other State may be taxed in that other State"). The reason for this is that Article 7 provides its own attribution rules, which, in most cases, means that only the profits of an enterprise attributable to that permanent establishment (that is, the "physical presence" in subparagraph 3 (c)) may be taxed by the State where the permanent establishment exists. ~~**In the relatively small number of cases**~~Where a "limited force of attraction" rule as provided ~~**for**~~ in Article 7 has been adopted in bilateral treaties, other business activities of a same or similar kind as those effected through the physical presence permanent establishment may be taxed by the State where the permanent establishment exists, which can be justified as treating various forms of permanent establishment in the same way. In the event~~**, likely to be very rare in practice,**~~ of States agreeing to a limited force of attraction rule in Article 7 and also to deletion of Article 14, but not wishing to apply the limited force of attraction rule to cases formerly dealt with by Article 14 (1) (b), it could explicitly be provided that such a rule did not apply to subparagraph (3) (c) cases.

Consequential changes to other Articles

5.11 In paragraph 1 of Article 3, existing subparagraphs (c) to (f) should be renumbered as subparagraphs (d) to (g) and the following new subparagraphs (c) and (h) added:

> "*(c)* the term *"enterprise" applies to the carrying on of any business;*
>
> "*(h)* *the* term *"business" includes the performance of professional services and of other activities of an independent character.*"

15.12 The reasoning for this change is reflected in paragraphs 4 and 10.2 of the OECD Commentary on Article 3 as follows:

> 4. The question whether an activity is performed within an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States. No exhaustive definition of the term "enterprise" has therefore been attempted in this Article. However, it is provided that the term "enterprise" applies to the carrying on of any business. Since the term "business" is expressly defined to include the performance of professional services and of other activities of an independent character, this clarifies that the performance of professional services or other activities of an independent character must be considered to constitute an enterprise, regardless of the meaning of that term under domestic law. States which consider that such clarification is unnecessary are free to omit the definition of the term "enterprise" from their bilateral conventions.
>
> *10.2* The Convention does not contain an exhaustive definition of the term "business", which, under paragraph 2, should generally have the meaning which it has under the domestic law of the State that applies ~~to~~ the Convention. Subparagraph ~~(~~*h*), however, provides expressly that the term includes the performance of professional services and of other activities of an independent character. This provision was added in 2000 at the same time ~~that~~ as Article 14,

which dealt with Independent Personal Services, was deleted from the Convention. This addition, which ensures that the term "business" includes the performance of the activities ~~that~~ **which** were previously covered by Article 14, was intended to prevent that the term "business" be interpreted in a restricted way so as to exclude the performance of professional services, or other activities of an independent character, in States where the domestic law does not consider that the performance of such services or activities can constitute a business. Contracting States for which this is not the case are free to agree bilaterally to omit the definition.

15.13 Paragraph 4 of Article 6 should be amended by removing the reference to independent personal services as follows:

"*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~~."

15.14 Paragraph 4 of Article 10 should be amended as follows:

"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."

15.15 Paragraph 5 of Article 10 should be amended as follows:

"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 insofar as such dividends are paid to a resident of that other State or insofar 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."

15.16 Paragraph 4 of Article 11 should be amended as follows:

"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 such permanent establishment ~~or~~

~~fixed base~~. In such cases, the provisions of article 7 ~~or article 14, as the case may be,~~ shall apply."

15.17 Paragraph 5 of Article 11 should be amended as follows:

"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 a fixed base~~, then such interest shall be deemed to arise in the State in which the permanent establishment ~~or a fixed base~~ is situated."

15.18 Paragraph 4 of Article 12 should be amended as follows:

"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 a fixed base~~, or with (b) business activities referred to in subparagraph (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."

15.19 Paragraph 2 of Article 13 should be amended as follows:

"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."

15.20 Delete Article 14. It would depend on agreement between the countries as to whether the following articles are renumbered, but the usual practice is to renumber those Articles, or to rename an additional article as Article 14.

15.21 Countries may wish to replace the title of Article 15 as follows: "INCOME FROM EMPLOYMENT ~~DEPENDENT PERSONAL SERVICES~~", as provided for in the 2000 and subsequent OECD Model **Convention**s. The basis for this change is that where Article 14 is removed it will usually represent a conscious decision to move away from the concepts of independent and dependent personal services, and an acceptance that Article 15 deals only with employment services, any other provision of services, being dealt with under Article 7 or by specific articles such as Articles 16 or 17.

15.22 Subparagraph 2 (c) of Article 15 should be amended by removing references to the fixed base concept, as follows:

"(c) the remuneration is not borne by a permanent establishment ~~or a fixed base~~ which the employer has in the other State."

15.23 The following amendments should be made to Article 17 so as to remove references to the deleted Article 14 and so as to add references to Article 7:

(a) Modify paragraph 1 of Article 17 to read as follows:

"1. Notwithstanding the provisions of articles ~~14~~ 7 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 sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State."

(b) Modify paragraph 2 of Article 17 to read as follows:

"2. Where income in respect of personal activities exercised by an entertainer or a sportsperson in his capacity as such accrues not to the entertainer or sportsman 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 sportsperson are exercised."

15.24 Paragraph 2 of Article 21 should be amended as follows:

"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."

15.25 Paragraph 2 of Article 22 should be amended as follows:

"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."

Paragraph 4

16. This paragraph reproduces Article 5 (4) of the OECD Model **Convention** with one substantive amendment: the deletion of "delivery" in subparagraphs (a) and (b). In view of the similarities to the OECD Model **Convention** provision and the general relevance of its Commentary, the general principles of Article 5 (4) under both Models are first noted below and then the practical relevance of the deletion of references to "delivery" in the U**nited** N**ations** Model **Convention** is considered.

17. The deletion of the word "delivery" reflects the majority view of the Committee that a "warehouse" used for that purpose should, if ~~at least~~ the requirements of paragraph 1 are met, be a permanent establishment.

Comment [MB8]: Note by a member of the Subcommittee: I think it necessary to have a brief reference to the amendment highlighted in paragraph 16 above. Para. 20 then discusses the reasoning in more detail.

18. The OECD Commentary on paragraph 4 of the OECD Article reads as follows:

> *21.* This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in subparagraph *e*), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover subparagraph *f*) provides that combinations of activities mentioned in subparagraphs *a*) to *e*) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.
>
> *22.* *Subparagraph a*) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Subparagraph *b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. Subparagraph *c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph *d*) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".
>
> *23.* Subparagraph *e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this subparagraph provides a generalised exception to

the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organisations which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognised that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realisation of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

24. It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of subparagraph *e*). A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called “management office” in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a “place of management” within the meaning of subparagraph *a*) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph *e*) of paragraph 4.

25. A permanent establishment could also be constituted if an enterprise maintains a fixed place of business for the delivery of spare parts to customers for machinery supplied to those customers where, in addition, it maintains or repairs such machinery, as this goes beyond the pure delivery mentioned in subparagraph *a*) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph *e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

26. Moreover, subparagraph *e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph *e*).

26.1 Another example is that of facilities such as cables or pipelines that cross the territory of a country. Apart from the fact that income derived by the owner or operator of such facilities from their use by other enterprises is covered by Article 6 where they constitute immovable property under paragraph 2 of Article 6, the question may arise as to whether paragraph 4 applies to them. Where these facilities are used to transport property belonging to other enterprises, subparagraph *a*), which is restricted to delivery of goods or merchandise belonging to the enterprise that uses the facility, will not be applicable as concerns the owner or operator of these facilities. Subparagraph *e*) also will not be applicable as concerns that enterprise since the cable or pipeline is not used solely for the enterprise and its use is not of preparatory or auxiliary character given the nature of the business of that enterprise. The situation is different, however, where an enterprise owns and operates a cable or pipeline that crosses the territory of a country solely for purposes of transporting its own property and such transport is merely incidental to the business of that enterprise, as in the case of an enterprise that is in the business of refining oil and that owns and operates a pipeline that crosses the territory of a country solely to transport its own oil to its refinery located in another country. In such case, subparagraph *a*) would be applicable **[…]**

Comment [MB9]: This paragraph of the OECD Commentary was amended in 2010 to include an additional passage on whether the cable or pipeline could constitute a PE for the customer of the operator of the cable or pipeline.

27. As already mentioned in paragraph 21 above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to subparagraph *f*) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in the subparagraphs *a*) to *e*) of paragraph 4 does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed place of business is merely preparatory or auxiliary a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of the particular circumstances. The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of subparagraph *e*) (cf. paragraphs 24 and 25 above). States which want to allow any combination of the items mentioned in subparagraphs *a*) to *e*), disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words "provided" to "character" in subparagraph *f*).

27.1 Subparagraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not "separated organisationally" where they each perform in **a** Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

28. The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude the contracts necessary for maintaining the institution and who exercises this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.

29. If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation (cf. paragraph 11 above and paragraph 2 of Article 13). Since, for example, the display of merchandise is excepted under subparagraphs *a*) and *b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

30. A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales.

19. Subparagraph (f) was added to Article 5 (4) in 1999. It follows the OECD Model **Convention** and provides that "the maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e)" is not a permanent establishment if "the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".

20. As noted above, the U**nited** N**ations** Model **Convention**, in contrast to the OECD Model **Convention**, does not refer to "delivery" in subparagraphs (a) or (b). The question whether the use of facilities for the "delivery of goods" should give rise to a permanent establishment has been debated extensively. A 1997 study revealed that almost 75 per cent of the tax treaties of developing countries *included* the "delivery of goods" in the list of exceptions in paragraph 4 (a) and (b). Nevertheless, some countries regard the omission of the expression in the U**nited** N**ations** Model **Convention** as an important point of departure from the OECD Model **Convention**, believing that a stock of goods for prompt delivery facilitates sales of the product and thereby the earning of profit in the host country.

21. In reviewing the U**nited** N**ations** Model **Convention**, the Committee decided to retain the existing distinction between the two Models, but it noted that even if the delivery of goods is treated as giving rise to a permanent establishment, it may be that little income could properly be attributed to this activity. Tax authorities might be led into ~~over-~~attributing **too much** income to this activity if they do not give the issue close consideration, which would lead to prolonged litigation and inconsistent application of tax treaties. Therefore, although the reference to "delivery" is absent from the U**nited** N**ations** Model **Convention**, countries may wish to consider both points of view when entering into bilateral tax treaties, for the purpose of determining the practical results of utilizing either approach.

Paragraph 5

22. It is generally accepted that, if a person acts in a State for an enterprise in such a way as to closely tie up the activity of the enterprise with the economic life of that State, the enterprise should be treated as having a permanent establishment in that State — even if it does not have a fixed place of business in that State under paragraph 1. Paragraph 5 achieves this by deeming a permanent establishment to exist if the person is a **so-called** dependent agent who carries out on behalf of the enterprise an activity specified in subparagraph (a) or (b). Subparagraph (a) follows the substance of the OECD Model **Convention** and proceeds on the basis that if a person with the authority to conclude contracts in the name of the enterprise creates for that enterprise a sufficiently close association with a State, then it is appropriate to deem that such an enterprise has a

permanent establishment there. The condition in subparagraph (b), relating to the maintenance of a stock of goods, is discussed below.

23. In relation to subparagraph (a), a dependent agent causes a "permanent establishment" to be deemed to exist only if his authority is used repeatedly and not merely in isolated cases. The OECD Commentary states further:

> *32.1* Also, the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. Lack of active involvement by an enterprise in transactions may be indicative of a grant of authority to an agent. For example, an agent may be considered to possess actual authority to conclude contracts where he solicits and receives (but does not formally finalise) orders which are sent directly to a warehouse from which goods are delivered and where the foreign enterprise routinely approves the transactions.
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> *33*. *The* authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only. Moreover the authority has to be habitually exercised in the other State; whether or not this is the case should be determined on the basis of the commercial realities of the situation. A person who is authorised to negotiate all elements and details of a contract in a way binding on the enterprise can be said to exercise this authority "in that State", even if the contract is signed by another person in the State in which the enterprise is situated or if the first person has not formally been given a power of representation. The mere fact, however, that a person has attended or even participated in negotiations in a State between an enterprise and a client will not be sufficient, by itself, to conclude that the person has exercised in that State an authority to conclude contracts in the name of the enterprise. The fact that a person has attended or even participated in such negotiations could, however, be a relevant factor in determining the exact functions performed by that person on behalf of the enterprise. Since, by virtue of paragraph 4, the maintenance of a fixed place of business solely for purposes listed in that paragraph is deemed not to constitute a permanent establishment, a person whose activities are restricted to such purposes does not create a permanent establishment either.
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> *33.1* The requirement that an agent must "habitually" exercise an authority to conclude contracts reflects the underlying principle in Article 5 that the presence which an enterprise maintains in a Contracting State should be more than merely transitory if the enterprise is to be regarded as maintaining a permanent establishment, and thus a taxable presence, in that State. The extent and frequency

of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.

24. The Committee's view is that where paragraph 33 of the OECD Commentary above refers to "(a) person who is authorised to negotiate all elements and details of a contract", this should be taken to include a person who has negotiated all the *essential* elements of the contract, whether or not that person's involvement in the negotiation also extends to other non-essential aspects.

25. With the addition of paragraph 5 (b), relating to the maintenance of a stock of goods, this paragraph is broader in scope than paragraph 5 of the OECD Model **Convention**. Some countries believe that a narrow formula might encourage an agent who was in fact dependent to represent himself as acting on his own behalf.

26. The former Ad Hoc Group of Experts on International Cooperation in Tax Matters understood that subparagraph 5 (b) was to be interpreted such that if all the sales-related activities take place outside the host State and only delivery, by an agent, takes place there, such a situation would not lead to a permanent establishment.[15] The Group of Experts noted, however, that if sales-related activities (for example, advertising or promotion) are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of such goods or merchandise, a permanent establishment may exist.[16]

Paragraph 6

27. This paragraph **of the United Nations Model Convention** does not correspond to any provision in Article 5 of the OECD Model **Convention** and is included to deal with certain aspects of the insurance business. The OECD Model **Convention** nevertheless discusses the possibility of such a provision in bilateral tax treaties in the following terms:

> *39.* According to the definition of the term "permanent establishment" an insurance company of one State may be taxed in the other State on its insurance business, if it has a fixed place of business within the meaning of paragraph 1 or if it carries on business through a person within the meaning of paragraph 5. Since agencies of foreign insurance companies sometimes do not meet either of the above requirements, it is conceivable that these companies do large-scale business in a State without being taxed in that State on their profits arising from such business. In order to obviate this possibility, various conventions concluded by OECD ~~M~~**m**ember countries include a provision which stipulates that insurance

[15] See para. 25 of the Commentary on Article 5 of the ~~2001~~1999 version of the United Nations Model Convention.
[16] Ibid.

companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

28. Paragraph 6 of the U**nited** N**ations** Model **Convention**, which achieves the aim quoted above, is necessary because insurance agents generally have no authority to conclude contracts; thus, the conditions of paragraph 5 (a) would not be fulfilled. If an insurance agent is independent, however, the profits of the insurance company attributable to his activities are not taxable in the source State because the provisions of Article 5 (7) would be fulfilled and the enterprise would not be deemed to have a permanent establishment.

29. Some countries, however, favour extending the provision to allow taxation even where there is representation by such an independent agent. They take this approach because of the nature of the insurance business, the fact that the risks are situated within the country claiming tax jurisdiction, and the ease 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. Other countries see no reason why the insurance business should be treated differently from activities such as the sale of tangible commodities. They also point to the difficulty of ascertaining the total amount of business done when the insurance is handled by several independent agents within the same country. In view of this difference in approach, the question how to treat independent agents is 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.

Paragraph 7

30. The first sentence of this paragraph reproduces Article 5 (6) of the OECD Model **Convention**, with a few minor drafting changes. The relevant portions of the Commentary on the OECD text are as follows:

> *36.* Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business ... Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph [7] has been inserted in the Article for the sake of clarity and emphasis.

37. A *person* will come within the scope of paragraph [7], i.e.~~,~~ he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:

~~(~~a) he is independent of the enterprise both legally and economically, and
~~(~~b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person’s commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents.

38.1 In relation to the test of legal dependence, it should be noted that the control which a parent company exercises over its subsidiary in its capacity as shareholder is not relevant in a consideration of the dependence or otherwise of the subsidiary in its capacity as an agent for the parent. This is consistent with the rule in paragraph 7 of Article 5. But, as paragraph 41 of the Commentary indicates, the subsidiary may be considered a dependent agent of its parent by application of the same tests which are applied to unrelated companies.

38.2 The following considerations should be borne in mind when determining whether an agent may be considered to be independent.

38.3 An independent agent will typically be responsible to his principal for the results of his work but not subject to significant control with respect to the manner in which that work is carried out. He will not be subject to detailed instructions from the principal as to the conduct of the work. The fact that the principal is relying on the special skill and knowledge of the agent is an indication of independence.

38.4 Limitations on the scale of business which may be conducted by the agent clearly affect the scope of the agent’s authority. However such limitations are not relevant to dependency which is determined by consideration of the extent to which the agent exercises freedom in the conduct of business on behalf of the principal within the scope of the authority conferred by the agreement.

38.5 It may be a feature of the operation of an agreement that an agent will provide substantial information to a principal in connection with the business conducted under the agreement. This is not in itself a sufficient criterion for determination that the agent is dependent unless the information is provided in the course of seeking approval from the principal for the manner in which the business is to be conducted. The provision of information which is simply intended to ensure the smooth running of the agreement and continued good relations with the principal is not a sign of dependence.

38.6 Another factor to be considered in determining independent status is the number of principals represented by the agent. Independent status is less likely if the activities of the agent are performed wholly or almost wholly on behalf of only one enterprise over the lifetime of the business or a long period of time. However, this fact is not by itself determinative. All the facts and circumstances must be taken into account to determine whether the agent's activities constitute an autonomous business conducted by him in which he bears risk and receives reward through the use of his entrepreneurial skills and knowledge. Where an agent acts for a number of principals in the ordinary course of his business and none of these is predominant in terms of the business carried on by the agent legal dependence may exist if the principals act in concert to control the acts of the agent in the course of his business on their behalf.

38.7 Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

38.8 In deciding whether or not particular activities fall within or outside the ordinary course of business of an agent, one would examine the business activities customarily carried out within the agent's trade as a broker, commission agent or other independent agent rather than the other business activities carried out by that agent. Whilst the comparison normally should be made with the activities customary to the agent's trade, other complementary tests may in certain circumstances be used concurrently or alternatively, for example where the agent's activities do not relate to a common trade.

31. In the 1980 edition of the U**nited** N**ations** Model **Convention**,[17] the second sentence of paragraph 7 read: "However, when the activities of such an agent are devoted wholly or almost wholly on behalf of the enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph."

32. It was subsequently recognized that this sentence had given rise to anomalous situations. The concern was that if the number of enterprises for which an independent agent was working fell to one, the agent would, without further examination, be treated as

[17] United Nations publication, Sales No. E.80.XVI.3 and corrigendum.

dependent. In the 1999 revision of the Model, the wording was therefore amended as follows:

> 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 as an agent of an independent status within the meaning of this paragraph.

33. The revised version makes clear that the essential criterion for *automatically* treating an agent as not being of "an independent status" is the absence of the arm's-length relationship. The mere fact that the number of enterprises for which the independent agent acts has fallen to one does not of itself change his status from independent to dependent, though it might serve as an indicator of the absence of the independence of that agent.

Paragraph 8

34. The present paragraph reproduces Article 5 (7) of the OECD Model **Convention**. The Commentary on the OECD text is as follows:

> *40.* It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.
>
> *41.* A *parent* company may, however, be found, under the rules of paragraphs 1 or 5 of the Article, to have a permanent establishment in a State where a subsidiary has a place of business. Thus, any space or premises belonging to the subsidiary that is at the disposal of the parent company ... and that constitutes a fixed place of business through which the parent carries on its own business will constitute a permanent establishment of the parent under paragraph 1, subject to paragraphs 3 and 4 of the Article (see for instance, the example in paragraph 4.3 above). Also, under paragraph 5, a parent will be deemed to have a permanent establishment in a State in respect of any activities that its subsidiary undertakes for it if the subsidiary has, and habitually exercises, in that State an authority to conclude contracts in the name of the parent ..., unless these activities are limited to those referred to in paragraph 4 of the Article or unless the subsidiary acts in the ordinary course of its business as an independent agent to which paragraph 6 of the Article applies.

> *41.1* The same principles apply to any company forming part of a multinational group so that such a company may be found to have a permanent establishment in a State where it has at its disposal ... and uses premises belonging to another company of the group, or if the former company is deemed to have a permanent establishment under paragraph 5 of the Article ... The determination of the existence of a permanent establishment under the rules of paragraphs 1 or 5 of the Article must, however, be done separately for each company of the group. Thus, the existence in one State of a permanent establishment of one company of the group will not have any relevance as to whether another company of the group has itself a permanent establishment in that State.

35. The Committee notes that determining whether or not a permanent establishment exists on a separate entity basis may entail vulnerability to abusive arrangements. Depending on the domestic law of States, safeguards against purely artificial structures may be found through application of a rule according to which substance overrides form. The Commentary of the OECD Model **Convention** also states the following:

> *42.* Whilst premises belonging to a company that is a member of a multinational group can be put at the disposal of another company of the group and may, subject to the other conditions of Article 5, constitute a permanent establishment of that other company if the business of that other company is carried on through that place, it is important to distinguish that case from the frequent situation where a company that is a member of a multinational group provides services (e.g. management services) to another company of the group as part of its own business carried on in premises that are not those of that other company and using its own personnel. In that case, the place where those services are provided is not at the disposal of the latter company and it is not the business of that company that is carried on through that place. That place cannot, therefore, be considered to be a permanent establishment of the company to which the services are provided. Indeed, the fact that a company's own activities at a given location may provide an economic benefit to the business of another company does not mean that the latter company carries on its business through that location: clearly, a company that merely purchases parts produced or services supplied by another company in a different country would not have a permanent establishment because of that, even though it may benefit from the manufacturing of these parts or the supplying of these services.

36. The Commentary of the OECD Model **Convention** has been amended to include the following section on "electronic commerce":

Electronic commerce

> *42.1* There has been some discussion as to whether the mere use in electronic commerce operations of computer equipment in a country could constitute a permanent establishment. That question raises a number of issues in relation to the provisions of the Article.

42.2 Whilst a location where automated equipment is operated by an enterprise may constitute a permanent establishment in the country where it is situated (see below), a distinction needs to be made between computer equipment, which may be set up at a location so as to constitute a permanent establishment under certain circumstances, and the data and software which is used by, or stored on, that equipment. For instance, an Internet web site, which is a combination of software and electronic data, does not in itself constitute tangible property. It therefore does not have a location that can constitute a "place of business" as there is no "facility such as premises or, in certain instances, machinery or equipment" (see paragraph 2 above) as far as the software and data constituting that web site is concerned. On the other hand, the server on which the web site is stored and through which it is accessible is a piece of equipment having a physical location and such location may thus constitute a "fixed place of business" of the enterprise that operates that server.

42.3 The distinction between a web site and the server on which the web site is stored and used is important since the enterprise that operates the server may be different from the enterprise that carries on business through the web site. For example, it is common for the web site through which an enterprise carries on its business to be hosted on the server of an Internet Service Provider (ISP). Although the fees paid to the ISP under such arrangements may be based on the amount of disk space used to store the software and data required by the web site, these contracts typically do not result in the server and its location being at the disposal of the enterprise (see paragraph 4 above), even if the enterprise has been able to determine that its web site should be hosted on a particular server at a particular location. In such a case, the enterprise does not even have a physical presence at that location since the web site is not tangible. In these cases, the enterprise cannot be considered to have acquired a place of business by virtue of that hosting arrangement. However, if the enterprise carrying on business through a web site has the server at its own disposal, for example it owns (or leases) and operates the server on which the web site is stored and used, the place where that server is located could constitute a permanent establishment of the enterprise if the other requirements of the Article are met.

42.4 Computer equipment at a given location may only constitute a permanent establishment if it meets the requirement of being fixed. In the case of a server, what is relevant is not the possibility of the server being moved, but whether it is in fact moved. In order to constitute a fixed place of business, a server will need to be located at a certain place for a sufficient period of time so as to become fixed within the meaning of paragraph 1.

42.5 Another issue is whether the business of an enterprise may be said to be wholly or partly carried on at a location where the enterprise has equipment such as a server at its disposal. The question of whether the business of an enterprise is wholly or partly carried on through such equipment needs to be examined on a case-by-case basis, having regard to whether it can be said that, because of such equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:

– providing a communications link — much like a telephone line — between suppliers and customers;
– advertising of goods or services;
– relaying information through a mirror server for security and efficiency purposes;
– gathering market data for the enterprise;
– supplying information.

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A different example is that of an enterprise (sometimes referred to as an “e-tailer”) that carries on the business of selling products through the Internet. In that case, the enterprise is not in the business of operating servers and the mere fact that it may do so at a given location is not enough to conclude that activities performed at that location are more than preparatory and auxiliary. What needs to be done in such a case is to examine the nature of the activities performed at that location in light of the business carried on by the enterprise. If these activities are merely preparatory or auxiliary to the business of selling products on the Internet (for example, the location is used to operate a server that hosts a web site which, as is often the case, is used exclusively for advertising, displaying a catalogue of products or providing information to potential customers), paragraph 4 will apply and the location will not constitute a permanent establishment. If, however, the typical functions related to a sale are performed at that location (for example, the conclusion of the contract with the customer, the processing of the payment and the delivery of the products are performed automatically through the equipment located there), these activities cannot be considered to be merely preparatory or auxiliary.

42.10 A last issue is whether paragraph 5 may apply to deem an ISP to constitute a permanent establishment. As already noted, it is common for ISPs to provide the service of hosting the web sites of other enterprises on their own servers. The issue may then arise as to whether paragraph 5 may apply to deem such ISPs to constitute permanent establishments of the enterprises that carry on electronic commerce through web sites operated through the servers owned and operated by these ISPs. Whilst this could be the case in very unusual circumstances, paragraph 5 will generally not be applicable because the ISPs will not constitute an agent of the enterprises to which the web sites belong, because they will not have authority to conclude contracts in the name of these enterprises and will not regularly conclude such contracts or because they will constitute independent agents acting in the ordinary course of their business, as evidenced by the fact that they host the web sites of many different enterprises. It is also clear that since the web site through which an enterprise carries on its business is not itself a "person" as defined in Article 3, paragraph 5 cannot apply to deem a permanent establishment to exist by virtue of the web site being an agent of the enterprise for purposes of that paragraph.

37. The Committee of Experts notes that the OECD Commentary, in paragraph 42.3, draws a distinction between a contract with an Internet Service Provider and one with a place of business at the disposal of the enterprise. In this regard, the Committee recognizes that some businesses could seek to avoid creating a permanent establishment by managing the contractual terms in cases where the circumstances would justify the conclusion that a permanent establishment exists. ~~In such cases, a rule placing substance over form should apply.~~ **Such abuses may fall under the application of legislative or judicial anti-avoidance rules.**

Comment [MB10]: Suggested new wording comes from the Expert Group Meeting held in June 2011 (language borrowed from OECD Commentary on Article 5, see paragraph 18).

A member of the Subcommittee has subsequently noted that this may confuse some readers without a specific inclusion of ref. to substance over form (which is a more direct reference).

Commentary on chapter III

TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

A. GENERAL CONSIDERATIONS

1. Article 6 of the United Nations Model Convention reproduces Article 6 of the OECD Model Convention **with the exception of the phrase "and to income from immovable property used for the performance of independent personal services" which appears at the end of paragraph 4 of the United Nations Model Convention. This phrase is included in the United Nations Model Convention as a result of the retention of Article 14 dealing with Independent Personal Services**.

2. In taxing income from immovable property, the object should be the taxation of profits rather than of gross income; the expenses incurred in earning income from **immovable [**real**]** property or from agriculture or forestry should therefore be taken into account. This objective should not, however, preclude the use of a withholding tax on rents from **immovable [**real**]** property, based on gross income; in such cases the rate should take into account the fact that expenses have been incurred. On the other hand, if a withholding tax on gross rents is used, it will be just as satisfactory if the owner of the real **immovable [**real**]** property can elect to have the income from the property taxed on a net basis under the regular income tax. Article 6 is not intended to prevent a country which taxes income from agriculture or other immovable property on an estimated or similar basis from continuing to use that method.

3. Some ~~members from developing~~ countries were of the view that the distribution of dividends by a company referred to in ~~a~~**A**rticle 13, paragraph 4, should be treated as income from immovable property and, therefore, as covered by ~~a~~**A**rticle 6. However, this view was not shared by most other members.

4. It was noted that in some countries, a person may receive income (typically rental income) from immovable property in circumstances where that person instead of **directly** owning the immovable property owns shares of a company owning that property and that **the ownership of** ~~such~~ **those** shares entitle**s** that person to the use or enjoyment of the property. Contracting States are free to expand the scope of the article to cover ~~such income~~ **the deemed income from that use or enjoyment**. They may also expand the scope of article 22 to allow source taxation of shares of such companies.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 6

Paragraph 1

5. This paragraph grants the right to tax income from immovable property (including

income from agriculture or forestry) to the State of source, that is, the State where the property in question is situated. In the words of the Commentary on the OECD Model Convention, this provision is based on "the fact that there is always a very close economic connection between the source of this income and the State of source".

6. The OECD Commentary observes: "Although income from agriculture or forestry is included in Article 6, Contracting States are free to agree in their bilateral conventions to treat such income under Article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting States. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such income." [para. 1]

Paragraph 2

7. This paragraph, which gives the term "immovable property" the meaning that it has under the law of the Contracting State in which the property is situated, is intended to alleviate difficulties of interpretation with regard to whether an asset or a right is to be regarded as immovable property. In addition the paragraph lists a number of assets and rights which are in any case to be regarded as covered by the term. On the other hand, the paragraph provides that ships, boats and aircraft shall not be regarded as immovable property.

Like the OECD Model Convention, the United Nations Model Convention contains no special provision concerning income from indebtedness secured by immovable property, a matter which is dealt with under ~~the a~~**A**rticle **11** relating to interest.

Comment [MB11]: Brian Arnold has suggested a more direct wording: "interest from debt secured by immovable property is not covered by Article 6."

Paragraph 3

8. This paragraph provides that the general rule set forth in paragraph 1 shall apply regardless of the form in which immovable property is used.

Paragraph 4

9. ~~The Commentary on the OECD Model Convention observes that t~~**T**his paragraph ~~"makes it clear~~**stipulates** that the provisions of paragraphs 1 and 3 apply also to income from immovable property~~,~~ of industrial, commercial and other enterprises and to income from immovable property used for the performance of independent personal services~~"~~. The OECD Commentary also observes that:

> "**[…]** the right to tax of the State of source has priority over the right to tax of the other State and applies also where~~,~~ in the case of an enterprise ~~or of non-industrial and non-commercial activities,~~ income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the ~~a~~**A**rticle do not prejudge the application of domestic law as regards

the manner in which income from immovable property is to be taxed". [para. 4]

These observations will apply equally in the case of non-industrial and noncommercial activities by reason of the inclusion in paragraph 4 of the United Nations Model Convention on income from immovable property used for the performance of independent personal services.

Article 7

BUSINESS PROFITS

A. GENERAL CONSIDERATIONS

1. Article 7 of the United Nations Model Convention consists of several provisions of ~~a~~**A**rticle 7 of the **2008** OECD Model Convention, either unchanged or substantially amended, and some new provisions. **The ~~UN~~ Committee of Experts decided at its 2009 annual session not to adopt the OECD approach to Article 7 arising from the OECD's 2008 report Attribution of Profits to Permanent Establishments (the 2008 PE Report). The 2008 PE Report envisions taking into account dealings between different parts of an enterprise – a permanent establishment and its head office. That approach by the OECD is now reflected in the new Article 7 in the ~~OECD's~~ 2010 OECD Model Convention ~~Update~~ and the Commentary on that Article. The ~~UN~~ Committee of Experts decided not to adopt this OECD approach because it was in direct conflict with paragraph 3 of Article 7 of the United Nations Model Convention which generally disallows deductions for amounts "paid" (other than toward reimbursement of actual expenses) by a permanent establishment to its head office. That rule is seen as continuing to be appropriate in the context of the United Nation~~al~~s Model Convention, whatever changes have been made to the OECD Model ~~Tax~~ Convention and Commentaries. It should therefore be noted that all subsequent references to Article 7 of the OECD Model Convention and its Commentar~~ies~~y relate to the 2008 OECD Model ~~Update~~Convention. ~~while~~ Article 7 in the United Nations Model Convention and the ~~OECD~~ 2008 OECD Model ~~Update~~ Convention are largely consistent (except for the specific United Nations additions). Aspects of the 2008 OECD Commentary in places reflect ~~aspects~~ views contained in ~~of~~ the OECD's 2008 PE Report. Where the ~~OECD~~ 2008 OECD Commentary reflects the approach of that Report, reference is instead made to the 2005 OECD ~~Update~~ Convention which is not affected in this way.**

2. There is general acceptance of the arm's length ~~rule~~ **principle** embodied in the OECD Model Convention, under which 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 are normally the profits shown on the books of the establishment. Nevertheless, this ~~rule~~ **principle** permits the authorities of the country in which the permanent establishment is located to rectify the accounts of the enterprise, so as to reflect properly income which 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~~ **principle** to the allocation of profits between the home office and its permanent establishment presupposes for most

countries that the domestic legislation authorizes a determination on the basis of the arm's length principle.

3. The application of the arm's length rule is particularly important in connection with the difficult and complex problem of 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 expenses, wherever incurred, for the purpose 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 expenditure that give rise to special problems. These include interest and royalties etc. paid by the permanent establishment to its head office in return for money lent or patent rights licensed by the latter to the permanent establishment. They further include commission **fees** (except for reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the establishment. In this case, it is considered that the payments should not be allowed as deductions in computing the profits of the permanent establishment. Conversely, such payments made to a permanent establishment by the head office should be excluded from the profits of the permanent establishment. On the other hand, an allocable share of such payments, e.g., interest and royalties, paid by the enterprise to third parties should be allowed. ~~For a further consideration of this matter, a reference may be made to the OECD Commentaries reproduced in paragraph 19.~~ **As noted in paragraph 1 above, this approach is consistent with the approach adopted in interpreting Article 7 in the 2008 OECD Model ~~Update~~ Convention but it varies from the approach adopted by the OECD in its 2008 PE R~~r~~eport ~~Attribution of Income to Permanent Establishments and the OECD's 2010 Model Update.~~**

4. Under the OECD Model Convention, only profits attributable to the permanent establishment may be taxed in the source country. The United Nations Model Convention amplifies this attribution principle by a **limited** 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 some business profits in that country arising from transactions outside the permanent establishment. Where, owing to the force of attraction principle, the profits of an enterprise other than those attributable directly to the permanent establishment may be taxed in the State where the permanent establishment is situated, such profits should be determined in the same way as if they were attributable directly to the permanent establishment.

5. The United Nations Model Convention does not contain paragraph 5 of Article 7 of the **2008** OECD Model Convention, which states, "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise". **When drafting the 1980 United Nations Model Convention** ~~T~~the **former** Group of Experts could not reach a consensus on whether profits should be attributed to a permanent establishment by reason of the mere purchase of goods and therefore decided to include in ~~a~~**A**rticle 7 a note stating that this question should be settled in bilateral negotiations. ~~Several members from developing countries believe that this provision could be included if it were amended to include a statement 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. Other~~

~~members from developing countries felt that the provision should be omitted because, even where purchasing is the sole activity of an enterprise in the source country, a permanent establishment could exist in that country, the purchasing activity may contribute to the overall profit of the enterprise, and some portion of that profit thus may appropriately be taxed by that country. The members from developed countries generally favoured inclusion of OECD paragraph 5, without amendment~~. **In light of the fact that the paragraph was deleted from the OECD Model in 2010, the Committee of Experts agreed that this note was no longer needed.**

~~6. The Commentary on OECD Model Convention contains the following preliminary remarks on Article 7:~~

> ~~"This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits . . . [W]hen an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9". [para. 1]~~

> ~~" . . . The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognized that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organizes itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. However, since such problems may result in unrelieved double taxation or non-taxation of certain profits, it is more important for tax authorities to agree on mutually consistent methods of dealing with these problems, using, where appropriate, the mutual agreement procedure provided for in Article 25, than to adopt unilateral interpretations of basic principles to be adhered to despite~~

~~differences of opinion with other States. In this respect, the methods for solving some of the problems most often encountered are discussed below." [para. 2]~~

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 7

Paragraph 1

~~7~~**6**. This paragraph reproduces Article 7, paragraph 1, of the **2008** OECD Model Convention, with the addition of clauses (b) and (c). ~~In the discussion preceding the adoption by the Group of Experts of this paragraph, several members from developing countries expressed support for the force of attraction rule, although they would limit its application~~ **These clauses mean that the United Nations Model Convention amplifies the corresponding Article in the OECD Model Convention by including a limited force of attraction rule. This allows the country in which the permanent establishment is located to tax not only the profits attributable to that permanent establishment but other profits of the enterprise derived in that country to the extent allowed under the Article. It is noted that this is limited to** business profits covered by Article 7 ~~of the OECD Model Convention~~ and **does** not extend it to income from capital (dividends, interest and royalties) covered by other treaty provisions. ~~They argued that neither sales through independent commission agents nor purchase activities would become taxable to the principal 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~~ **The arguments against a more general force of attraction principle are canvassed in paragraph 10 of the Commentary ~~of~~ on the 2008 OECD ~~Update to the OECD~~ Model Convention. The argument for a force of attraction rule are considered to be** that the force of attraction approach avoids some administrative problems because, under that approach, it is not necessary to determine whether particular activities are related to the permanent establishment or the income involved attributable to it. That ~~was~~ **is** the case especially with respect to transactions conducted directly by the home office within the country, ~~but~~ **that are** similar in nature to those conducted by the permanent establishment. ~~However, after discussion, it was proposed~~ **It was agreed** that the "force of attraction" rule **in Article 7** should be limited **to that last situation** 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, sales of the same or a similar kind may be taxed in that State even if they are not conducted through the permanent establishment; a similar rule applies if the permanent establishment is used for other business activities and the same or similar activities are performed without any connection with the permanent establishment.

~~8~~**7**. **When the United Nations Model Convention was last revised in 1999, however** ~~S~~some members **considered** ~~of the Group of Experts consider~~ that ~~the~~ **this limited** force of attraction rule ~~shall~~ **should** not apply where an enterprise is able to demonstrate that the sales or business activities were carried out for reasons other than obtaining treaty benefits. This recognizes that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment.

~~9~~**8**. The **Committee considers that the following part of the** Commentary on **paragraph 1 of Article 7 of** the ~~corresponding provision of the~~ **2008** OECD Model Convention **is applicable to the corresponding paragraph of Article 7**~~contains the following~~:

> ~~"This paragraph is concerned with two questions. First, it restates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It . . . has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights." [para. 3]~~
>
> ~~"The second and more important point [stated in the second sentence] is that . . . when an enterprise carries on business through a permanent establishment in another State that State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment; in other words that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment. This is a question on which there may be differences of view. Some countries have taken the view that when a foreign enterprise has set up a permanent establishment within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory. But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other articles." [para. 5]~~
>
> ~~"On this matter, naturally, there is room for differences of view, and since it is an important question it may be useful to set out the arguments for each point of view." [para. 6]~~
>
> ~~"Apart from the background question of fiscal jurisdiction, the main argument commonly put forward against the solution advocated above is that there is a risk that it might facilitate avoidance of tax. This solution, the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed and arranged by the permanent establishment, it might be difficult in practice to prove that was the~~

~~case. If the rates of tax are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the solution advocated above is that it might conceivably provide the enterprise with a means of ensuring that result." [para. 7]~~

~~"Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of the proposed solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organization of modern business is highly complex. In OECD Member countries, there are a considerable number of companies, each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course reasons based on, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention." [para. 8]~~

~~"It is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched, but it is necessary in considering this point to preserve a sense of proportion and to bear in mind what is said above. It is not, of course, sought in any way to sanction any such malpractice, or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It is fully recognized that Contracting States should be free to use all methods at their disposal to fight fiscal evasion." [para. 9]~~

~~"For the reasons given above, it is thought that the argument that the solution advocated might lead to increased avoidance of tax by foreign enterprises should not be given undue weight. Much more importance is attached to the desirability of interfering as little as possible with existing business organizations and of refraining from inflicting demands for information on foreign enterprises which are unnecessarily onerous." [para. 10]~~

"When referring to the part of the profits of an enterprise that is attributable to a permanent establishment, the second sentence of paragraph 1 refers directly to paragraph 2, which provides the directive for determining what profits should be attributed to a permanent establishment. As paragraph 2 is part of the context in which the sentence must be read, that sentence should not be interpreted in a way that could contradict paragraph 2, e.g. by interpreting it as restricting the amount of profits that can be attributed to a permanent establishment to the amount of profits of the enterprise as a whole.

Thus, whilst paragraph 1 provides that a Contracting State may only tax the profits of an enterprise of the other Contracting State to the extent that they are attributable to a permanent establishment situated in the first State, it is paragraph 2 that determines the meaning of the phrase 'profits attributable to a permanent establishment'. In other words, the directive of paragraph 2 may result in profits being attributed to a permanent establishment even though the enterprise as a whole has never made profits: conversely, that directive may result in no profits being attributed to a permanent establishment even th~~r~~ough the enterprise as a whole has made profits"[para. 11].

"Clearly however, the Contracting State of the enterprise has an interest in the directive of paragraph 2 being correctly applied by the State where the permanent establishment is located. Since that directive applies to both Contracting States, the State of the enterprise must, in accordance with Article 23, eliminate double taxation on the profits properly attributable to the permanent establishment. In other words, if the State where the permanent establishment is located attempts to tax profits that are not attributable to the permanent establishment under Article 7, this may result in double taxation of profits that should properly be taxed only in the State of the enterprise" [para. 12].

"The purpose of paragraph 1 is to provide limits to the right of one Contracting State to tax the business profits of enterprises [that are residents] of the other Contracting State. The paragraph does not limit the right of a Contracting State to tax its own residents under controlled foreign companies provisions found in its domestic law even though such tax imposed on these residents may be computed by reference to the part of the profits of an enterprise that is resident of the other Contracting State that is attributable to these residents' participation in that enterprise. Tax so levied by a State on its own residents does not reduce the profits of the enterprise of the other State and may not, therefore, be said to have been levied on such profits (see also paragraph 23 of the Commentary on Article 1 and paragraphs 37 to 39 of the Commentary on Article 10)". [para. 13]

Paragraph 2

9. This paragraph reproduces Article 7, paragraph 2 of the 2008 OECD Model Convention.

~~10. This paragraph 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 determination of the profits properly attributable to a permanent establishment, especially with regard to "turnkey" contracts. Under a turnkey 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 to be 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. Turnkey contracts, however, often involve components other than normal construction activities, including 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 (and 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.~~

~~11. The question thus arose how much of the total profits of the turnkey contract is properly attributable to the permanent establishment and thus taxable in the country in which 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 included items of income dealt with separately in other articles of the Convention and were taxable in that country accordingly.~~

~~12. The Group recognized that the problem 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 acknowledged that the problem might be considered in the course of bilateral negotiations, but it agreed upon no amendment to address it.~~

~~13~~**10**. **When the United Nations Model Convention was revised in 1999,** ~~S~~some members of the **former** Group of Experts were of the view that the last part of paragraph 2 was too narrow, as they consider**ed** that it refers only to transactions between the permanent establishment and the home office, and does not take into account transactions between the permanent establishment and, for example, other permanent establishments of the same enterprise. For this purpose, Contracting States may consider the alternative clarification as under:

> "There shall in each Contracting State be attributed to that permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions."

~~14~~**11**. **Although** the point in controversy relating to the allocation of profits between different permanent establishments as opposed to allocation between a permanent establishment and its head office was not in doubt, it was generally accepted that the concern of the **former** Group of Experts should be clearly ~~brought out~~ **noted**.

~~15~~**12**. As observed in paragraph ~~11~~**14** of the ~~OECD~~ Commentar**y**~~ies~~ **on Article 7 of the 2008 OECD Model Convention**, paragraph 2 as presently worded: "contains the central directive on which the allocation of profits to a permanent establishment ~~was~~ **is** intended to be based."

As stated in the Article, this is of course subject to the provisions of paragraph 3 of the Article. Paragraph 14 of the OECD Commentary continues:

> "The ~~This~~ paragraph incorporates the view that was generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment

~~were~~ **are** those which that permanent establishment would have made if, instead of dealing with ~~its head office~~ **the rest of the enterprise**, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. This corresponds to the "arm's length" principle discussed in the Commentary on ~~a~~**A**rticle 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of business accountancy."

Since the arm's length principle also extends to the ~~allocation~~ **attribution** of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise, the existing paragraph 2 should be construed to ~~specifically~~ make it applicable to such situations. As interpreted, where an enterprise of a Contracting State carries on its business activities in the other Contracting State through a permanent establishment situated therein, it would be necessary to ~~allocate~~ **attribute** to such permanent establishment the profits which it could be in a position to make if it were a distinct enterprise engaged in the same or similar activities under the same or similar conditions and operating at arm's length, and dealing wholly independently with the enterprise of which it is a permanent establishment or the other permanent establishments of that enterprise.

~~16~~**13**. ~~Relevant portions of the OECD Commentary on this paragraph are as follows:~~

~~". . . The arm's length principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may in their bilateral negotiations, agree upon more detailed provisions or amend paragraph 2 to read as follows:~~

~~'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 independent enterprise engaged in the same or similar activities under the same or similar conditions.' " [para. 11]~~

The determination of the profits attributable to a specific permanent establishment is an instance where the Commentary in the ~~OECD's~~ 2008 OECD Model Convention ~~Update~~ refers to the OECD's 2008 PE Report. Given the comments in paragraph 1 above the Committee considers that the following part of the Commentary on paragraph 2 of Article 7 of the 2005 OECD Model Convention is applicable to paragraph 2 of Article 7:

"In the great majority of cases, trading accounts of the permanent establishment – which are commonly available if only because a well-run business organi~~z~~**s**ation is normally concerned to know what is the profitability of its various branches – will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts **[...]** But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce." [para. 12]

"This raises the question as to what extent such accounts should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. In that respect, accounts could not be regarded as prepared symmetrically unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. However, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. This would be the case if, for example, a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal." [para. 12.1]

"In this respect, it should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment [...]" [para. 12.2]

"Even where a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with the arm's length principle [...] Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this principle, and profits have thus been diverted from the permanent establishment to the head office, or vice versa." [para. 13]

"In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied;

such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting from the figure~~s~~ so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market." [para. 14]

"Many States consider that there is a reali~~z~~sation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are reali~~z~~sed. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the reali~~z~~sation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of reali~~z~~sation depends on each country's domestic law." [para. 15]

"Where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, even when these profits are not actually reali~~z~~sed until a subsequent commercial year, there will be inevitably a time lag between the moment when tax is paid abroad and the moment it can be taken into account in the country where the enterprise's head office is located. A serious problem is inherent in the time lag, especially when a permanent establishment transfers fixed assets or—in the event that it is wound up—its entire operating equipment stock, to some other part of the enterprise of which it forms part. In such cases, it is up to the head office country to seek, on a case by case basis, a bilateral solution with the outward country where there is serious risk of overtaxation." [para. 15.1]

"Another significant problem concerning the transfer of assets, such as bad loans, arises in relation to international banking. Debts may be transferred, for supervisory and financing purposes, from branch to head office or from branch to branch within a single bank. Such transfers should not be recogni~~z~~**s**ed where it cannot be reasonably considered that they take place for valid commercial reasons or that they would have taken place between independent enterprises, for instance where they are undertaken solely for tax purposes with the aim of maximi~~z~~**s**ing the tax relief available to the bank. In such cases, the transfers would not have been expected to take place between wholly independent enterprises and therefore would not have affected the amount of profits which such an independent enterprise might have been expected to make in independent dealing with the enterprise of which it is a permanent establishment." [para. 15.2]

"However, there may exist a commercial market for the transfer of such loans from one bank to another and the circumstances of an internal transfer may be similar to those which might **have** be**en** expected to have taken place between independent banks. An instance of such a transfer ~~may~~ **might** be a case where a bank closed down a particular foreign branch and had therefore to transfer the debts concerned either back to its head office or to another branch. Another example might be the opening of a new branch in a given country and the subsequent transfer to it, solely for commercial reasons, of all loans previously granted to residents of that country by the head office or other branches. Any such transfer should be treated (to the extent **that** it is recogni~~z~~**s**ed for tax purposes at all) as taking place at the open market value of the debt at the date of the transfer. Some relief has to be taken into account in computing the profits of the permanent establishment since, between separate entities, the value of the debt at the date of ~~the~~ transfer would have been taken into account in deciding on the price to be charged and principles of sound accounting require that the book value of the asset should be varied to take into account market values. ~~(This question is further discussed in the report of the Committee on Fiscal Affairs entitled 'Attribution of Income to Permanent Establishments'.)~~ [para. 15.3] ~~[Reproduced in Volume II of the OECD Model Convention at page R(13)-1.]~~

"Where loans which have gone bad are transferred, in order that full, but not excessive, relief for such a loss be granted, it is important that the two jurisdictions concerned reach an agreement for a mutually consistent basis for granting relief. In such cases, account should be taken of whether the transfer value, at the date of **the** internal transfer, was the result of mistaken judg**e**ment as to the debtor's solvency or whether the value at that date reflected an appropriate judg**e**ment of the debtor's position at that time. In the former case, it ~~may~~ **might** be appropriate for the country of the transferring branch to limit relief to the actual loss suffered by the bank as a whole and for the receiving country not to tax the subsequent apparent gain. Where, however, the loan was transferred for commercial reasons~~,~~ from one part of the bank to another and did, after a certain time, improve in value, then the transferring branch should normally be given relief on the basis of the actual value at the time of the transfer. The position is somewhat different where the receiving entity is the head office of a bank in a credit country because normally the credit country will tax the bank on its worldwide profits and will therefore give relief by reference to the total loss suffered in respect of the loan between the time the loan was made and the time it was finally disposed of. In such a case, the transferring branch should receive relief for the period during which the loan was in the hands of that branch by reference to the principles above. The country of the head office will then give relief from double taxation by granting a credit for the tax borne by the branch in the host country." [para. 15.4]

Paragraph 3

~~17~~**14**. The first sentence of paragraph 3 of ~~a~~**A**rticle 7 reproduces **with minor drafting differences** the entire text of Article 7, paragraph 3, of the **2008** OECD Model Convention. The rest of the paragraph consists of ~~new~~ **additional** provisions formulated by the **former** Group of Experts **in 1980**. These provisions stem from a proposal by members from developing countries, who felt that it would be helpful to include all the necessary definitions and clarifications in the text, with a view, in particular, 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 the 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 the 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.

~~18~~**15**. The business profits of an enterprise of a Contracting State are exigible to tax in that State alone unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. The profits and gains of the business would be worked out by deducting all expenses ~~relatable~~ **related** to the business activity, other than ~~the~~ capital expenditure**s** which are currently not deductible or expenses of a personal or non-business nature which cannot be attributed to the business of the enterprise. Normally, many countries while considering the question of deductibility of business expenses apply the criteria of such expenditure being wholly, exclusively and necessarily for the purposes of the business. The basic objective in this behalf is to ensure that the expenditure claimed as deduction in determining the taxable profits ~~is that such expenditure~~ is relevant, referable and necessary for carrying out the business operations. There has to exist a nexus between the expenditure and the business activity so that the expenditure incurred is justified by business expediency, smooth running or facilitating character of the expenditure for business operations. After it has been determined that an item is deductible under the foregoing criteria, then it should be considered whether there are specific legislative provisions placing a monetary or other ceiling limits on the allowableness of business expenditure, otherwise **a** claim~~s~~ for deductibility of expenditure will have to be considered in its entirety, without considering the reasonableness of the amount or its impact on the profitability of business operations.

~~19~~**16**. The **Committee considers that the following part of the Commentary on paragraph 3 of Article 7 of the 2008** OECD **Model Convention** ~~Commentary on Article 7, paragraph 3,~~ is ~~relevant~~ **applicable to the first part of the corresponding paragraph of Article 7**:

> "This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recogni~~z~~ses that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment." [para. ~~16~~**27**]

> "It has sometimes been suggested that the need to reconcile paragraphs 2 and 3 created practical difficulties as paragraph 2 required that prices between the permanent establishment and the head office be normally charged on an arm's length basis, giving to the transferring entity the type of profit which it might have been expected to make were it dealing with an independent enterprise, whilst the wording of paragraph 3 suggested that the deduction for expenses incurred for the purposes of permanent establishments should be the actual cost of those expenses, normally without adding any profit element.**"[para. 28]**

> "In fact, whilst the application of paragraph 3 may raise some practical difficulties, especially in relation to the separate enterprise and arm's length principles underlying paragraph 2, there is no difference of principle between the two paragraphs. Paragraph 3 indicates that in determining the profits of a permanent establishment, certain expenses must be allowed as deductions whilst paragraph 2 provides that the profits determined in accordance with the rule contained in paragraph 3 relating to the deduction of expenses must be those that a separate and distinct enterprise engaged in the same or similar activities under the same or similar conditions would have made. Thus, whilst paragraph 3 provides a rule applicable for the determination of the profits of the permanent establishment, paragraph 2 requires that the profits so determined correspond to the profits that a separate and independent enterprise would have made." [para. ~~17~~**29**]

> **"Also,** paragraph **3 only determines which expenses should be attributed to the permanent establishment for purposes of determining the profits attributable to that permanent establishment. It does not deal with the issue of whether those expenses, once attributed, are deductible when computing the taxable income of the permanent establishment since the conditions for the deductibility of expenses are a matter to be determined by domestic law, subject to the rules of Article 24 on Non-discrimination (in particular, paragraphs 3**

and 4 of that Article)". [para 30].

Despite the above comments, the Committee of Experts notes that some countries may wish to point out in the treaty text that they allow only those deductions that are permitted by their domestic laws.

"In applying these principles to the practical determination of the profits of a permanent establishment, the question may arise as to whether a particular cost incurred by an enterprise can truly be considered as an expense incurred for the purposes of the permanent establishment, keeping in mind the separate and independent enterprise principles of paragraph 2. Whilst in general independent enterprises in their dealings with each other will seek to reali~~z~~**s**e a profit and, when transferring property or providing services to each other, will charge such prices as the open market would bear, nevertheless, there are also circumstances where it cannot be considered that a particular property or service would have been obtainable from an independent enterprise or when independent enterprises may agree to share between them the costs of some activity which is pursued in common for their mutual benefit. In these particular circumstances, it may be appropriate to treat any relevant costs incurred by the enterprise as an expense incurred for the permanent establishment. The difficulty arises in making a distinction between these circumstances and the cases where a cost incurred by an enterprise should not be considered as an expense of the permanent establishment and the relevant property or service should be considered, on the basis of the separate and independent enterprises principle, to have been transferred between the head office and the permanent establishment at a price including an element of profit. The question must be whether the internal transfer of property and services, be it temporary or final, is of the same kind as those which the enterprise, in the normal course of **its** business, would have charged to a third party at an arm's length price, i.e.~~,~~ by normally including in the sale price an appropriate profit." [para. ~~17.1~~ **31**]

"On the one hand, the answer to that question will be in the affirmative if the expense is initially incurred in performing a function the direct purpose of which is to make sales of a specific good or service and to reali~~z~~**s**e a profit through a permanent establishment. On the other hand, the answer will be in the negative if, on the basis of the facts and circumstances of the specific case, it appears that the expense is initially incurred in performing a function the essential purpose of which is to rationali~~z~~**s**e the overall costs of the enterprise or to increase in a general way its sales." [para. ~~17.2~~ **32**]

"Where goods are supplied for resale whether in a finished state or as raw materials or semi-finished goods, it will normally be appropriate for the provisions of paragraph 2 to apply and for the supplying part of the enterprise to be allocated a profit, measured by reference to arm's length principles. But there may be exceptions even here. One example might be where goods are not supplied for resale but for temporary use in the trade so that it may be appropriate for the parts of the enterprise which share the use of the material to bear only their share of the cost of such material~~,~~ e.g.~~,~~ in the case of machinery, the depreciation costs that relate to its use by each of these parts. **It should of course be remembered that the mere purchase of goods does not constitute a permanent establishment (subparagraph 4 *d*) of Article 5) so that no question of attribution of profits**

arises in such circumstances. " [para. ~~17.3~~**33**]

"In the case of intangible rights, the rules concerning the relations between enterprises of the same group (e.g.~~,~~ payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate **'ownership'** of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any particular part of the enterprise and in practical terms it will often be difficult to allocate the costs of creation exclusively to one part of the enterprise. It may therefore be preferable for the costs of creation of intangible rights to be regarded as attributable to all parts of the enterprise which will make use of them and as incurred on behalf of the various parts of the enterprise to which they are relevant accordingly. In such circumstances it would be appropriate to allocate **between the various parts of the enterprise** the actual costs of the creation **or acquisition** of such intangible rights **as well as the costs subsequently incurred with respect to these intangible rights,** ~~between the various parts of the enterprise~~ without any mark-up for profit or royalty. In so doing, tax authorities must be aware of the fact that the possible adverse consequences deriving from any research and development activity (e.g.~~,~~ the responsibility related to the products and damages to the environment) shall also be allocated to the various parts of the enterprise, therefore giving rise, where appropriate, to a compensatory charge." [para. ~~17.4~~**34**]

"The area of services is the one in which difficulties may arise in determining whether in a particular case a service should be charged between the various parts of a single enterprise at its actual cost or at that cost plus a mark-up to represent a profit to the part of the enterprise providing the service. The trade of the enterprise, or part of it, may consist of the provision of such services and there may be a standard charge for their provision. In such a case it will usually be appropriate to charge a service at the same rate as is charged to the outside customer." [para. ~~17.5~~**35**]

"Where the main activity of a permanent establishment is to provide specific services to the enterprise to which it belongs and where these services provide a real advantage to the enterprise and their costs represent a significant part of the expenses of the enterprise, the host country may require that a profit margin be included in the amount of the costs. As far as possible, the host country should then try to avoid schematic solutions and rely on the value of these services in the given circumstances of each case." [para. ~~17.6~~**36**]

"However, more commonly the provision of services is merely part of the general management activity of the company taken as a whole as where, for example, the enterprise conducts a common system of training and employees of each part of the enterprise benefit from it. In such a case it would usually be appropriate to treat the cost of providing the service as being part of the general administrative expenses of the enterprise as a whole which should be allocated on an actual cost basis to the various parts of the enterprise to the extent that the costs are incurred for the purposes of that part of the enterprise, without any mark-up to represent profit to another part of the enterprise." [para. ~~17.7~~**37**]

[*quoted para. 18 of the 1999 UN Model has been renumbered to quoted para. 41 below]

~~"If debts incurred by the head office of an enterprise were used solely to finance its activity or~~ clearly ~~and exclusively the activity of a particular permanent establishment, the problem would be reduced to one of thin capitalizsation of the actual user of such loans. In fact, loans contracted by an enterprise's head office usually serve its own needs only to a certain extent, the rest of the money borrowed providing basic capital for its permanent establishments." [para. 18.1]~~

[*quoted para. 18.2 of the 1999 UN Model has been renumbered to quoted para. 44 below]

~~"Consequently, . . . it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organization and the functions performed. For that reason, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special problems of banks mentioned below." [para. 18.3] (This question is further discussed in the reports of the Committee entitled "Attributiones of Income to Permanent Establishments" and "Thin Capitalization".[13])~~

~~"It is, however, recognizsed that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g., a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is closely related to the ordinary business of such enterprises . . ." [para. 19]~~

[*quoted para. 21 and 22 of the 1999 UN Model have been renumbered to quoted para. ~~38~~ and 39 below]

[*quoted ~~para~~. 23 of the 1999 UN Model have been renumbered to quoted para. 40]

~~"It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a 'separate enterprise' footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, e.g., by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be~~

~~[13] These two reports are reproduced in Volume II of the OECD Model Convention at pages R(13)-1 and R(4)-1, respectively.~~

~~impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed, notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits." [para. 24~~]

"The treatment of services performed in the course of the general management of an enterprise raises the ~~Another~~ question ~~[is]~~ whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skil**l**ful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company ~~has~~ **had** been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some notional figure for "profits of management". In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management." [para. ~~21~~**38**]

"It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the ~~a~~**A**rticle is designed to prevent this. Nevertheless~~,~~ it follows from what is said in paragraph ~~21~~**38** above that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office." [para. ~~22~~**39**]

"It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated." [para. ~~23~~40]

"~~Special considerations apply to payments~~ **The treatment of interest charges raises** particular **issues. First, there might be amounts** which, under the name of interest, are ~~made to~~ **charged by** a head office ~~by~~ **to** its permanent establishment with respect to **internal "**loans**"** ~~made~~ by the former to the latter. ~~In that case, the main issue is not so much whether a debtor/creditor relationship should be recognized within the same legal entity as whether an arm's length interest rate should be charged.~~ **Except for financial enterprises such as banks, it is generally agreed that such internal "interest" need not be recognised.** This is because:

- ~~f~~**F**rom the legal standpoint, the transfer of capital against payment of interest and an undertaking to repay in full at the due date is really a formal act incompatible with the true legal nature of a permanent establishment**.**
- ~~f~~**F**rom the economic standpoint, internal debts and receivables may prove to be non existent, since if an enterprise is solely or predominantly equity funded it ought not to be allowed to deduct interest charges that i~~s~~**t** has manifestly not had to pay. Whil**est**, admittedly, symmetrical charges and returns will not distort the enterprise's overall profits, partial results may well be arbitrarily changed." [para. ~~18~~**41**]

"For these reasons, the ban on deductions for internal debts and receivables should continue to apply generally, subject to the special situation of banks, as mentioned below." [para. 42]

"A different issue, however, is that of the deduction of interest on debts actually incurred by the enterprise. Such debts may relate in whole or in part to the activities of the permanent establishment; indeed, loans contracted by an enterprise will serve either the head office, the permanent establishment or both. The question that arises in relation to these debts is how to determine the part of the interest that should be deducted in computing the profits attributable to the permanent establishment." [para. 43]

"The approach ~~previously~~ suggested ~~in this Commentary~~**… before 1994**, namely the direct and indirect apportionment of actual debt charges, did not prove to be a practical solution, notably since it was unlikely to be applied in a uniform manner. Also, it is well known that the indirect apportionment of total interest payment charges, or of the part of interest that remains after certain direct allocations, comes up against practical difficulties. It is also well known that direct apportionment of total interest expense may not accurately reflect the cost of financing the permanent establishment because the taxpayer may be able to control where loans are booked and adjustment~~s~~ may need to be made to reflect economic reality**, in particular the fact that an independent enterprise would normally be expected to have a certain level of "free" capital.**" [para. ~~18.2~~**44**].

~~20. Some countries may wish to point out that they allow only those deductions that~~

~~are permitted by their domestic laws.~~

Comment [MB12]: During the EGM In June 2011, I noted a will from certain participants to keep this paragraph, but include "…point out **in the treaty text**…

NOTE BY THE SECRETARIAT: THREE ALTERNATIVE VERSIONS TO REFLECT OECD PARAGRAPH 45 (2008) HAVE BEEN INCLUDED BELOW. *OPTION A* IS A VERY REDUCED QUOTE FROM OECD PARAGRAPH 45. *OPTION B* IS THE FULL OECD PARAGRAPH 45 AND *OPTION C* IS A SEPARATE UN PARAGRAPH.

OPTION A

"Consequently … it would be preferable to look for a practical solution that would take into account a capital structure appropriate to both the organization and the functions performed …" [para. 45]

OPTION B

"Consequently, the majority of member countries consider that it would be preferable to look for a practicable solution that would take into account a capital structure appropriate to both the organization and the functions performed. This appropriate capital structure will take account of the fact that in order to carry out its activities, the permanent establishment requires a certain amount of funding made up of "free" capital and interest bearing debt. The objective is therefore to attribute an arm's length amount of interest to the permanent establishment after attributing an appropriate amount of "free" capital in order to support the functions, assets and risks of the permanent establishment. Under the arm's length principle a permanent establishment should have sufficient capital to support the functions it undertakes, the assets it economically owns and the risks it assumes. In the financial sector regulations stipulate minimum levels of regulatory capital to provide a cushion in the event that some of the risks inherent in the business crystallise into financial loss. Capital provides a similar cushion against crystallisation of risk in non-financial sectors."[para. 45]

OPTION C

Comment [IRD13]: This is already dealt with in quoting para 30 of the OECD Commentary in relation to our para 16 above?

Consequently, the Committee of Experts considers it preferable to look for a practical solution. This would take into account a capital structure appropriate to both the organization and the functions performed. This practical solution should also take into account the desirability of limiting deductions ~~so a~~ to protect the ability of source countries to tax the profits generated by the permanent establishment. For that reason the ban on deductions for internal debts and receivables should continue to apply generally subject to the special considerations necessary in the banking sector.

~~21. The question of making a specific provision in article 7, similar to that in paragraph 5 of Article 7 of the OECD Model Convention, regarding non-attribution of profits to a permanent~~

~~establishment for "mere purchase" by that permanent establishment of goods or merchandise for the enterprise has been engaging the attention of the Group of Experts for some time. It has been considered that since under article 5 an office or facility maintained by an enterprise in a Contracting State in the other Contracting State for mere purchase of goods or merchandise does not constitute a permanent establishment, there would be very few cases where an enterprise having a permanent establishment dealing with other business would also have a purchasing facility for the enterprise. However, it has not been considered necessary to make any change in the existing provisions and the matter may be looked into during bilateral negotiations~~.

Paragraph 4

~~22~~**17**. This paragraph reproduces Article 7, paragraph 4, of the **2008** OECD Model Convention. The **Committee considers that the following part of the** ~~OECD~~ Commentary on ~~the~~ paragraph **4 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7**~~is as follows~~:

> "It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the Article. It is emphasized, however, that in general the profits to be attributed to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where, exceptionally, it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear." [para. ~~25~~**52**]
>
> "The essential character of a method [for apportioning] total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits **[**...**]** [T]he criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers

allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say *in va*cuo that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high-cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. **[...]** [T]he general aim of any method [for apportioning] total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and **that** it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result." [para. ~~27~~**54**

"The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws." [para. ~~28~~**55**]

Paragraph 5

~~23~~**1** This paragraph reproduces Article 7, paragraph 6, of the **2008** OECD Model Convention. **The Committee considers that the following part of the Commentary on paragraph 6 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7:**~~ In the words of the OECD Commentary, the paragraph~~

"**This paragraph** is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favourable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is dealing with the permanent establishment; **for** ~~[~~this~~]~~ **reason,** paragraph **6** ~~[thus]~~ gives an assurance of continuous and consistent tax treatment." [para. ~~31~~**58**]

Paragraph 6

~~24~~**19**. This paragraph reproduces Article 7, paragraph 7, of the **2008** OECD Model Convention. **The Committee considers that the following part of the Commentary on paragraph 7 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7:** ~~The OECD Commentary on that paragraph is as follows:~~

"Although it has not been found necessary in the Convention to define the term 'profits', it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD ~~M~~**m**ember countries." [para. ~~32~~**59**]

"This interpretation of the term 'profits', however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, e.g.~~,~~ dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article." [para. ~~33~~**60**]

"To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, **it should be noted that** some of the special Articles contain specific provisions giving priority to a specific Article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph [4] of Article 12 and paragraph 2 of Article 21)." [para. ~~34~~**61**]

"It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of ~~the~~ **this** ~~present~~ Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this ~~a~~**A**rticle will be applicable to ~~industrial and commercial income~~ **business profits** which does not belong to categories of income covered by the special ~~a~~**A**rticles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph [4] of Article 12 and paragraph 2 of Article 21, fall within this Article . . . It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as ~~industrial and commercial~~ **business** profits, in conformity with the tax laws of the Contracting States." [para. ~~35~~**62**]

"It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term 'profits' with a view to clarifying the distinction between this term and~~,~~ e.g.~~,~~ the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term 'profits' includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connection it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits." [para. ~~36~~**63**]

~~"It should also be noted that, whilst the definition of 'royalties' in paragraph 2 of Article 12 of the 1963 Draft Convention and 1977 Model Convention included payments 'for the use of, or the right to use, industrial, commercial, or scientific equipment', the reference to these payments was subsequently deleted from that definition in order to ensure that income from the leasing of industrial, commercial or scientific equipment, including the income from the leasing of containers, falls under the provisions of Article 7 rather than those of Article 12, a result that the Committee on Fiscal Affairs considers to be appropriate given the nature of such income." [para. 37]~~

~~25~~**20**. ~~With respect to the last quoted paragraph from the OECD Model Convention Commentary, i~~**I**t is important to note that in the ~~revised~~ United Nations Model Convention, payments "for the use of, or the right to use, industrial, commercial or scientific equipment" are treated differently **than under the OECD Model Convention**. They remain within the definition of "royalties" in paragraph 3 of ~~a~~**A**rticle 12 and accordingly by reason of paragraph 6 of ~~a~~**A**rticle 7 continue to fall under the provisions of ~~a~~**A**rticle 12, rather than those of ~~a~~**A**rticle 7.

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

A. GENERAL CONSIDERATIONS

1. Two alternative versions are given for ~~a~~**A**rticle 8 of the United Nations Model Convention, namely ~~a~~**A**rticle 8 (alternative A) and ~~a~~**A**rticle 8 (alternative B). Article 8 (alternative A) reproduces Article 8 of the OECD Model Convention. Article 8 (alternative B) ~~makes major~~ **introduces** substantive changes to Article 8 ~~of the OECD Model Convention~~**(alternative A)**, dealing separately with profits from the operation of aircraft and profits from the operation of ships in paragraphs 1 and 2, respectively. The remaining paragraphs (3, 4 and 5) reproduce paragraphs 2, 3 and 4 of Article 8 ~~of the OECD Model Convention~~**(alternative A)** with a minor adjustment in paragraph 5.

2. With regard to the taxation of profits from the operation of ships in international traffic, ~~several members of the Group from developed~~**many** countries supported the position taken in Article 8 ~~of the OECD Model Convention~~**(alternative A)**. In their view, shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extended; 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~~**Consequently**, that would constitute a serious problem, especially because taxes in ~~the~~ developing countries ~~were often~~**could be** excessively high, and the total profits of shipping enterprises were frequently quite modest.

3. ~~Most members from developing~~ **Other** countries asserted that ~~those countries~~**they**

were not in a position to forgo 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 allocating the profit to the various countries concerned **in the course of the operation of ships in international traffic**.

4. ~~While some members from developed countries found taxation of shipping profits at the source acceptable, a large number of members from developed countries said they preferred the principle of exclusive taxation by the State in which the place of effective management of the enterprise was situated~~. Since no consensus could be reached on a provision concerning the taxation of shipping profits, the ~~Group agreed~~ **use of two alternatives in the Model Convention is proposed and** that the question of such taxation should be left to bilateral negotiations.

5. Although the texts of ~~a~~**A**rticle 8 (alternatives A and B) both refer to the "place of effective management of the enterprise", some countries may wish to refer instead to the "~~country~~ **State** of residence of the enterprise".

6. ~~There~~ **Although there** was a consensus ~~within the Group~~ to recommend ~~a~~**A**rticles 8 (alternatives A and B) as alternatives~~. However~~, some ~~members~~ **countries** who could not agree to ~~a~~**A**rticle 8 (alternative A) also could not agree to ~~a~~**A**rticle 8 (alternative B) because of the phrase "more than casual". They argued that some countries might wish to tax either all shipping profits or all airline profits, and acceptance of ~~a~~**A**rticle 8 (alternative B) might thus lead to **a** revenue loss~~es~~, considering the limited number of shipping companies or airlines whose effective management was situated in those countries. ~~The group agreed that~~ **Again,** in such cases taxation should be left to bilateral negotiations.

7. ~~A member from a developing country suggested that the provisions of article 8 may be extended to cover rail or road transport. Since there were few cases of rail or road transport involving double taxation, Contracting States may, if considered necessary, refer to rail or road transport during bilateral negotiations~~ **Depending on the frequency or volume of cross-border traffic, countries may, during bilateral negotiations, wish to extend the provisions of Article 8 to cover rail or road transport**.

8. Countries may also wish to include fishing, dredging or hauling activities on the high seas as falling within the ambit of this Article. In such cases, the profits derived from those activities may be specifically included in the course of bilateral negotiastions.

~~8~~**9**. Some ~~members from developing~~ countries consider~~ed~~ that the activity of transport carried out in inland waters, by definition, cannot be considered international transport and, by virtue of that, the fiscal or tax power should be attributed exclusively to the source country in which the activities are carried out. Since ~~a~~**A**rticle 8 deals with "Shipping, inland waterways transport and air transport", obviously all three modes of transport dealt with in this ~~a~~**A**rticle involve problems of double taxation. Income derived from inland waterways transport is also subject to double taxation if a river or lake used for commercial transportation flows from more than one country with the headquarters of the establishment in one country and traffic originating in more than one country. Hence, it is possible that inland waterways transport would give rise to problems of double taxation.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 8

(ALTERNATIVES A AND B)

Paragraph 1 of ~~*a*~~***A****rticle* 8 (alternative A)

~~9~~**10**. This paragraph, which reproduces Article 8, paragraph 1, of the OECD Model Convention, has the objective of ensuring that profits from the operation of ships or aircraft in international traffic will be taxed in one State alone. The paragraph's effect is that these profits are wholly exempt from tax at source and are taxed exclusively in the State in which ~~is situated~~ the place of effective management of the enterprise engaged in international traffic **is situated**. **It provides an independent operative rule for these activities and is not qualified by Articles 5 and 7 relating to business profits governed by the permanent establishment rule.** The exemption from tax in the source country 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~~ **a number of** 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 **and would argue in favour of alternative B**.

~~10~~**11**. The Commentary on the OECD Model Convention notes that the place of effective management may be situated in a country different from the country of residence of an enterprise operating ships or aircraft and that "**…** some States therefore prefer to confer the exclusive taxing right on the State of residence". The Commentary suggests that States may, in bilateral negotiations, substitute a rule on the following lines: "Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State." The Commentary continues:

> "Some other States, on the other hand, prefer to use a combination of the residence criterion and the place of effective management criterion by giving the primary right to tax to the State in which the place of effective management is situated while the State of residence eliminates double taxation in accordance with Article 23, so long as the former State is able to tax the total profits of the enterprise, and by giving the primary right to tax to the State of residence when the State of effective management is not able to tax total profits. States wishing to follow that principle are free to substitute a rule on the following lines:
>
> 'Profits of an enterprise of a Contracting State from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the other Contracting State, shall be taxable only in the first-mentioned State. However, where the place of effective management of the enterprise is situated in the other State and that other State imposes tax on the whole of the profits of the enterprise from the operation of ships or aircraft, the profits from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the first-mentioned State, may be taxed in that

other State.' " [para. 3]

12 It is also of importance to have consensus on the nature of the income covered by Article 8 as the operations of shipping and air transport enterprises will often include income from activities directly connected with the operations or ancillary to those operations. In this regard the OECD Model Convention observes:

"The profits covered consist in the first place of the profits **directly** obtained by the enterprise from the ~~carriage~~ **transportation** of passengers or cargo **by ships or aircraft (whether owned, leased or otherwise at the disposal of the enterprise) that it operates in international traffic. However, as international transport has evolved, shipping and air transport enterprises invariably carry on a large variety of activities to permit, facilitate or support their international traffic operations. The paragraph also covers profits from activities directly connected with such operations as well as profits from activities which are not directly connected with the operation of the enterprise's ships or aircraft in international traffic as long as they are ancillary to such operation** ~~With this definition, however, the provision would be unduly restrictive, in view of the development of shipping and air transport, and for practical considerations also. The provision therefore covers other classes of profits as well, i.e., those which by reason of their nature or their close relationship with the profits directly obtained from transport may all be placed in a single category. Some of these classes of profits are mentioned in the following paragraphs~~." [para. 4]

Any activity carried on primarily in connection with the transportation, by the enterprise, of passengers or cargo by ships or aircraft that it operates in international traffic should be considered to be directly connected with such transportation. [para. 4.1]

Activities that the enterprise does not need to carry on for the purposes of its own operation of ships or aircraft in international traffic but which make a minor contribution relative to such operation and are so closely related to such operation that they should not be regarded as a separate business or source of income of the enterprise should be considered to be ancillary to the operation of ships and aircraft in international traffic. [para. 4.2]

13. Applying the principles set out above, the Commentary on the OECD Model Convention deals with a number of activities in relation to the extent to which paragraph 1 will apply when those activities are carried on by an enterprise engaged in the operation of ships or aircraft in international traffic. The Commentary notes as follows:

"Profits obtained by leasing a ship or aircraft on charter fully equipped, ~~manned~~ **crewed** and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. However, Article [12], and not Article 8, applies to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an ~~occasional source of income for~~ **ancillary activity of** an enterprise engaged in the international operation of ships or aircraft." [para. 5]

~~"The principle that the taxing right should be left to one Contracting State~~

~~alone makes it unnecessary to devise detailed rules, e.g. for defining the profits covered, this being rather a question of applying general principles of interpretation." [para. 6]~~

~~"Shipping and air transport enterprises particularly the latter often engage in additional activities more or less closely connected with the direct operation of ships and aircraft. Although it would be out of the question to list here all the auxiliary activities which could properly be brought under the provision, nevertheless a few examples may usefully be given." [para. 7]~~

~~"The provision applies, inter alia, to the following activities:~~

~~(a) the sale of passage tickets on behalf of other enterprises;~~

~~(b) the operation of a bus service connecting a town with its airport;~~

~~(c) advertising and commercial propaganda;~~

~~(d) transportation of goods by truck connecting a depot with a port or airport." [para. 8]~~

~~"If an enterprise engaged in international transport undertakes to see to it that, in connection with such transport, goods are delivered directly to the consignee in the other Contracting State, such inland transportation is considered to fall within the scope of the international operation of ships or aircraft and, therefore, is covered by the provisions of this Article." [para. 9]~~

Profits derived by an enterprise from the transportation of passengers or cargo otherwise than by ships or aircraft that it operates in international traffic are covered by the paragraph to the extent that such transportation is directly connected with the operation, by that enterprise, of ships or aircraft in international traffic or is an ancillary activity. One example would be that of an enterprise engaged in international transport that would have some of its passengers or cargo transported internationally by ships or aircraft operated by other enterprises, e.g. under code-sharing or slot-chartering arrangements or to take advantage of an earlier sailing. Another example would be that of an airline company that operates a bus service connecting a town with its airport primarily to provide access to and from that airport to the passengers of its international flights. [para. 6]

A further example would be that of an enterprise that transports passengers or cargo by ships or aircraft operated in international traffic which undertakes to have those passengers or that cargo picked up in the country where the transport originates or transported or delivered in the country of destination by any mode of inland transportation operated by other enterprises. In such a case, any profits derived by the first enterprise from arranging such transportation by other enterprises are covered by the paragraph even though the profits derived by the other enterprises that provide such inland transportation would not be. [para. 7]

An enterprise will frequently sell tickets on behalf of other transport enterprises at a location that it maintains primarily for purposes of selling tickets for transportation on ships or aircraft that it operates in international traffic. Such sales of tickets on behalf of other enterprises will either be directly connected with voyages aboard ships or aircraft that the enterprise operates

(e.g. sale of a ticket issued by another enterprise for the domestic leg of an international voyage offered by the enterprise) or will be ancillary to its own sales. Profits derived by the first enterprise from selling such tickets are therefore covered by the paragraph. [para. 8]

Advertising that the enterprise may do for other enterprises in magazines offered aboard ships or aircraft that it operates or at its business locations (e.g. ticket offices) is ancillary to its operation of these ships or aircraft and profits generated by such advertising fall within the paragraph. [para. 8.1]

"~~Recently, 'containerization' has come to play an increasing role in the field of~~ **Containers are used extensively in** international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers ~~which is supplementary~~ **are usually either directly connected** or ~~incidental~~ **ancillary** to its ~~international~~ operation of ships or aircraft **in international traffic and in such cases** fall within the scope of ~~this Article~~ **the paragraph**. **The same conclusion would apply with respect to profits derived by such an enterprise from the short-term storage of such containers (e.g. where the enterprise charges a customer for keeping a loaded container in a warehouse pending delivery) or from detention charges for the late return of containers.**" [para. ~~10~~**9**]

"~~On the other hand, the provision does not cover a clearly separate activity such as the keeping of a hotel as a separate business; the profits from such an establishment are in any case easily determinable. In certain cases, however, circumstances are such that the provision must apply even to a hotel business e.g. the keeping of a hotel for no other purpose than to provide transit passengers with night accommodation, the cost of such a service being included in the price of the passage ticket. In such a case, the hotel can be regarded as a kind of waiting room." [para. 11]~~

~~"There is another activity which is excluded from the field of application of the provision, namely a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country." [para. 12]~~

~~"It may be agreed bilaterally that profits from the operation of a vessel engaged in fishing, dredging or hauling activities on the high seas be treated as income falling under this article." [para. 13]~~

An enterprise that has assets or personnel in a foreign country for purposes of operating its ships or aircraft in international traffic may derive income from providing goods or services in that country to other transport enterprises. This would include (for example) the provision of goods and services by engineers, ground and equipment-maintenance staff, cargo handlers, catering staff and customer services personnel. Where the enterprise provides such goods to, or performs services for, other enterprises and such activities are directly connected or ancillary to the enterprise's operation of ships or aircraft in international traffic, the profits from the provision of such goods or services to other enterprises will fall under the paragraph. [para. 10]

For example, enterprises engaged in international transport may enter

into pooling arrangements for the purposes of reducing the costs of maintaining facilities needed for the operation of their ships or aircraft in other countries. For instance, where an airline enterprise agrees, under an International Airlines Technical Pool agreement, to provide spare parts or maintenance services to other airlines landing at a particular location (which allows it to benefit from these services at other locations), activities carried on pursuant to that agreement will be ancillary to the operation of aircraft in international traffic. [para. 10.1]

"Investment income of shipping~~,~~ ~~inland waterways~~ or air transport enterprises (e.g.~~,~~ income from stocks, bonds, shares or loans) is to be subjected to the treatment ordinarily applied to this class of income**, except where the investment that generates the income is made as an integral part of the carrying on of the business of operating the ships or aircraft in international traffic in the Contracting State so that the investment may be considered to be directly connected with such operation. Thus, the paragraph would apply to interest income generated, for example, by the cash required in a Contracting State for the carrying on of that business or by bonds posted as security where this is required by law in order to carry on the business: in such cases, the investment is needed to allow the operation of the ships or aircraft at that location. The paragraph would not apply, however, to interest income derived in the course of the handling of cash-flow or other treasury activities for permanent establishments of the enterprise to which the income is not attributable or for associated enterprises, regardless of whether these are located within or outside that Contracting State, or for the head office (centralisation of treasury and investment activities), nor would it apply to interest income generated by the short-term investment of the profits generated by the local operation of the business where the funds invested are not required for that operation."** [para. 14]

14. Clearly, these principles would not apply in the case of a separate business such as a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country. Profits from this activity would not be covered by paragraph 1.

Paragraph 1 of ~~a~~***A****rticle* 8 (alternative B)

~~11~~**15**. This paragraph reproduces Article 8, paragraph 1, of the OECD Model Convention, with the deletion of the words "ships or". Thus the paragraph does not apply to the taxation of profits from the operation of ships in international traffic but does apply to the taxation of profits from the operation of aircraft in international traffic. Hence the Commentary on ~~article 8 A,~~ paragraph 1~~,~~ **of Article 8 (alternative A)** is relevant in so far as aircraft are concerned.

~~12. However, during the discussion by the Group of Experts, several members from developing countries, although agreeing to the consensus, pointed out, in connection with the taxation of profits from the operation of aircraft in international traffic, 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.~~

Paragraph 2 of ~~a~~**_A_**_rticle_ 8 (alternative B)

~~13~~**16**. This paragraph allows profits from the operation of ships in international traffic to be taxed in the source country if operations in that country are “more than casual”. It **also** provides an independent operative rule for the shipping business and is not qualified by ~~a~~**A**rticles 5 and 7 relating to business profits governed by the permanent establishment rule. It ~~thus~~ covers both regular or frequent shipping visits and irregular or isolated visits, provided the latter were planned 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.

~~14~~**17**. The overall net profits should, in general, be determined by the authorities of the country in which the place of effective management of the enterprise is situated (or 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 that 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, might also 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 was intended to achieve a sharing of revenues that would reflect the managerial and capital inputs originating in the country of residence.

Paragraph 2 of ~~_a_~~**_A_**_rticle_ 8 (alternative A) and *paragraph* 3 of ~~_a_~~**_A_**_rticle_ 8 (alternative B)

~~15~~**18**. Each of these paragraphs reproduces Article 8, paragraph 2, of the OECD Model Convention. The paragraphs apply not only to inland waterways transport between two or more countries but also to inland waterways transport effected by an enterprise of one country between two points in another country. ~~They do not preclude the settlement through bilateral negotiations of~~ **Countries are free to settle** any specific tax problem which may occur with regard to inland waterways transport, particularly between adjacent countries**, through bilateral negotiations**.

~~16~~**19**. **The rules set out in paragraphs 9 to 12 above relating to taxing rights and profits covered will apply equally to this paragraph.**

Enterprises not exclusively engaged in shipping, inland waterways transport and air transport.

20. With regard to enterprises not exclusively engaged in shipping, inland waterways transport or air transport, the Commentary on Article 8, paragraph 2, of the OECD Model Convention observes:

> **"It follows from the wording of paragraphs 1 and 2 that enterprises not exclusively engaged in shipping, inland waterways transport or air transport nevertheless come within the provisions of these paragraphs as regards profits arising to them from the operation of ships, boats or aircraft belonging to them." [para. 18]**
>
> "If such an enterprise has in a foreign country permanent establishments exclusively concerned with the operation of its ships or aircraft, there is no reason to treat such establishments differently from the permanent establishments of enterprises engaged exclusively in shipping, inland waterways transport or air transport." [para. 19]
>
> "Nor does any difficulty arise in applying the provisions of paragraphs 1 and 2 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping, inland waterways transport or air transport. If its goods are carried in its own ships to a permanent establishment belonging to it in a foreign country, ~~...~~ **it is right to say that** none of the profit obtained by the enterprise through acting as its own carrier can properly ~~be attributed to the permanent establishment~~ **be taxed in the State where the permanent establishment is situated**. The same must be true even if the permanent establishment maintains installations for operating the ships or aircraft (e.g.~~,~~ consignment wharves) or incurs other costs in connection with the carriage of the enterprise's goods (e.g.~~,~~ staff costs). ~~In this case, the permanent establishment's expenditure in respect of the operation of the ships, boats or aircraft should be attributed not to the permanent establishment but to the enterprise itself, since none of the profit obtained through the carrying benefits the permanent establishment.~~ [**In this case, even though certain functions related to the operation of ships and aircraft in international traffic may be performed by the permanent establishment, the profits attributable to these functions are taxable exclusively in the State where the place of effective management of the enterprise is situated. Any expenses, or part thereof, incurred in performing such functions must be deducted in computing that part of the profit that is not taxable in the State where the permanent establishment is located and will not, therefore, reduce the part of the profits attributable to the permanent establishment which may be taxed in that State pursuant to Article 7.]" [para. 20]**

"Where **ships or aircraft are operated in international traffic,** the ~~enterprise's~~ **application of the Article to the profits arising from such operation will not be affected by the fact that the** ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise**;** ~~(e.g., ships or aircraft put into service by~~**thus, even if such profits could be attributed to** the permanent establishment **under Article 7, they will only be taxable in the State in which the place of effective management of the enterprise is situated (a result that is confirmed by paragraph 4 of Article 7)** ~~and figuring on its balance sheet), then the effective management for the purposes of paragraphs 1 and 2 must be considered, as regards the operation of the ships or aircraft as being in the Contracting State in which the permanent establishment is situated~~." [para. 21]

Paragraph 3 of ~~*a*~~***A****rticle* 8 (alternative A) and *paragraph* 4 of ~~*a*~~***A****rticle* 8 (alternative B)

~~17~~**21**. Each of these paragraphs, which reproduce Article 8, paragraph 3, of the OECD Model Convention, refers to the case in which the place of effective management of the enterprise concerned is aboard a ship or a boat. As noted in the Commentary on the OECD Model Convention, "In this case tax will only be charged by the State where the home harbour of the ship or boat is situated. It is provided that if the home harbour cannot be determined, tax will be charged only in the Contracting State of which the operator of the ship or boat is a resident." [para. 22]

Paragraph 4 of ~~*a*~~***A****rticle* 8 (alternative A) and *paragraph* 5 of ~~*a*~~***A****rticle* 8 (alternative B)

18. Paragraph 4 of ~~a~~**A**rticle 8 (alternative A) reproduces Article 8, paragraph 4, of the OECD Model Convention. Paragraph 5 of ~~a~~**A**rticle 8 (alternative B) also reproduces the latter paragraph, with one adjustment, namely, the replacement of the phrase "paragraph 1" by the words "paragraphs 1 and 2". As the Commentary on the OECD Model Convention observes:

"Various forms of international co**-**operation exist in shipping or air transport. In this field~~,~~ international co**-**operation is secured through pooling agreements or other conventions of a similar kind which lay down certain rules for apportioning the receipts (or profits) from the joint business." [para. 23]

"In order to clarify the taxation position of the participant in a pool, joint business or in an international operating agency and to cope with any difficulties which may arise~~,~~ the Contracting States may bilaterally add the following, if they find it necessary:

'**[…]** but only to so much of the profits so derived as is attributable to the participant in proportion to its share in the joint operation'." [para. 24]

Article 9

ASSOCIATED ENTERPRISES

A. GENERAL CONSIDERATIONS

1. Article 9 of the United Nations Model Convention reproduces Article 9 of the OECD Model Convention, except for ~~a new~~ paragraph 3. As noted in the OECD Commentaries, "[t]his Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms" [para. 1]. It should be considered in conjunction with ~~a~~**A**rticle 25 on mutual agreement procedure and ~~a~~**A**rticle 26 on exchange of information.

2. The application of the arm's length rule to the allocation of profits between the associated enterprises presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's length principle.

3. With regard to transfer pricing of goods, technology, trademarks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's length terms, the Contracting States will **normally** follow the OECD principles which are set out in the OECD Transfer Pricing Guidelines. These conclusions represent internationally agreed principles ~~and the Group of Experts~~ **it is** recommend**ed** that the Guidelines should be followed for the application of the arm's length principle which underlies the ~~a~~**A**rticle. **[In addition, the Committee of Experts is currently producing a manual on the practical aspects of transfer pricing with a focus on the issues faced by developing countries.]**

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 9

Paragraph 1

4. Paragraph 1 provides that in cases involving associated enterprises, the tax authorities of a Contracting State may for the purpose of calculating tax liabilities rewrite the accounts of the enterprises if as a result of the special relations**hip** between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that **an** adjustment should be sanctioned in such circumstances, and this paragraph calls for little comment. The provision applies only if special conditions have been made or imposed between the two enterprises. ~~"No~~ **Clearly no** re-writing of the accounts ~~of associated enterprises is authorized~~ **with a consequential adjustment should be made** if the transactions between ~~such~~ **the associated** enterprises have taken place on **a** normal open market commercial ~~terms (on an~~**basis, in other words, at** arm's length ~~basis)." [para. 2]~~.

5. ~~The Group of Experts have made an amendment in 1999 of a drafting nature in paragraph 1 bringing the language of the main portion in line with that in the OECD Model Convention. Prior to the amendment, it read:~~

> ~~". . . then any profits which would, but for those conditions, have not so accrued . . ."~~

~~This portion of paragraph 1 has been modified in 1999 as under:~~

> ~~". . . 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 . . ."~~

~~6~~**5**. "As discussed in the Committee on Fiscal Affairs' Report on Thin Capitali~~z~~**s**ation,[14] there is an interplay between tax treaties and domestic rules on thin capitali~~z~~**s**ation relevant to the scope of the ~~a~~**A**rticle**."[para. 3]** As noted in the Commentary on the OECD Model Convention:

> "~~(~~a) ~~t~~**T**he Article does not prevent the application of national rules on thin capitali~~z~~**s**ation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation;
>
> ~~(~~b) ~~t~~**T**he Article is relevant not only in determining whether the rate of interest provided for in a loan contract is an arm's length rate, but also whether a *prima facie* loan can be regarded as a loan or should be regarded as some other kind of payment, in particular a contribution to equity capital;
>
> ~~(~~c) ~~t~~**T**he application of rules designed to deal with thin capitalization should normally not have the effect of increasing the taxable profits of the relevant domestic enterprise to more than the arm's length profit, and **that** this principle should be followed in applying existing tax treaties." [para. 3]

The OECD Commentary continues:

"The question arises as to whether special procedural rules which some countries have adopted for dealing with transactions between related parties are consistent with ~~this~~**the** ~~Model~~**Convention**. For instance, it may be asked whether the reversal of the burden of proof or presumptions of any kind which are sometimes found in domestic laws are consistent with the arm's length principle. A number of countries interpret the Article in such a way that it by no means bars the adjustment of profits under national law under conditions that differ from those of the Article and that it has the function of raising the arm's length principle at treaty level. Also, almost all ~~M~~**m**ember countries consider that additional information requirements which would be more stringent than the normal requirements, or even a reversal of the burden of proof, would not constitute discrimination within the meaning of Article 24. However, in some cases the application of the national law of some countries may result in adjustments to profits at variance with the principles of the Article. Contracting States are enabled by the Article to deal with such situations by means of corresponding adjustments (see below) and under mutual agreement procedures." [para. 4]

Paragraph 2

~~7~~**6**. In the words of the OECD Commentary, "The re**-**writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons), insofar as an

[14] Adopted by the Council of the OECD on 26 November 1986 and reproduced in volume II of the ~~loose-leaf~~ **full-length** version of the OECD Model Tax Convention at page R(4)-1.

enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B." The OECD Commentary observes that "[p]aragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation". [para. 5]

However, according to the OECD Commentary,

" [...] an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph may not be invoked and should not be applied where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it considers that the adjustment made in State A is justified both in principle and as regards the amount." [para. 6]

"The paragraph does not specify the method by which an adjustment is to be made. OECD ~~M~~**m**ember countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of Article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23, in respect of tax paid by its associate enterprise in State A." [para. 7]

"It is not the purpose of the paragraph to deal with what might be called 'secondary adjustments'. Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in paragraph 1~~;~~ and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if arm's length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y)~~;~~ and that in those circumstances there could have been other tax consequences (e.g.~~,~~ the operation of a withholding tax) depending upon the type of income concerned and the provisions of the ~~a~~**A**rticle dealing with such income." [para. 8]

"These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm’s length, depend on the facts of the individual case **[**...**]** [N]othing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.” [para. 9]

“The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B’s commitment should be open-ended—in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment **[**...**]**” [para. 10]

“If there is a dispute between the parties concerned over the amount and character of the appropriate adjustment, the mutual agreement procedure provided for under Article 25 should be implemented; the Commentary on that Article contains a number of considerations applicable to adjustments of the profits of associated enterprises carried out on the basis of the present Article (following, in particular, adjustment of transfer prices) and to the corresponding adjustments which must then be made in pursuance of paragraph 2 thereof **[**...**]**” [para. 11]

~~8~~**7**. ~~Some members of the Group of Experts had noted~~ **The view has been expressed** that a correlative adjustment under paragraph 2 could be very costly to a ~~small~~ **developing** country which may consider not including paragraph 2 in its treaties. ~~Several members of the Group of Experts responded that they believed that~~ **However,** paragraph 2 ~~was~~ **is** an essential aspect of ~~a~~**A**rticle 9~~.~~ **and** ~~F~~**f**ailure to provide **a** correlative adjustment will result in double taxation, which is contrary to the purpose of the Convention. ~~However, a~~**A** country ~~c~~**sh**ould closely examine the primary adjustment under paragraph 1 before deciding what correlative adjustment was appropriate to reflect the primary adjustment. ~~Another member suggested~~ **Some countries take the view** that it may be desirable to eliminate the obligation that a State may have to make a correlative adjustment when the other Contracting State has previously adjusted the transfer prices. ~~He observed that it could~~ **This approach can** be ~~convenient to change~~ **achieved by changing** the word “shall” to “may” ~~and that.~~ Contracting States may, during bilateral negotiations, use the word that is convenient. However, there ~~was~~ **is** no consensus on this point and the language of paragraph 2 remains unchanged.

Paragraph 3

9. ~~The Group of Experts has made an amendment in 1999 to article 9 by inserting a new paragraph 3~~. **The UN Model Convention was amended in 1999 by the insertion of paragraph 3.** Paragraph 2 of ~~a~~**A**rticle 9 requires a country to make an “appropriate adjustment” (a correlative adjustment) to reflect a change in the transfer price made by a country under ~~a~~**A**rticle 9, paragraph 1. The new paragraph 3 provides that the provisions

of paragraph 2 shall not apply where 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 wil**l**ful default. In other words, in case a final order has been passed in a judicial, administrative or other legal proceeding pointing out that in relation to the adjustment of profits under paragraph 1 one of the enterprises is visited with a penalty for fraud, gross negligence or wil**l**ful default, there would be no obligation to make the correlative adjustment under paragraph 2. This approach means that a taxpayer may be subject to non-tax and tax penalties. Member countries may consider such double penalties as too harsh~~. Some members pointed out~~**, but it should be borne in mind** that cases involving **the** levy of such penalties are likely to be exceptional and there would be no application of this provision in a routine manner.

Article 10

DIVIDENDS

A. GENERAL CONSIDERATIONS

1. Article 10 of the United Nations Model Convention reproduces the provisions of Article 10 of the OECD Model Convention with the exception of those of paragraph 2, which contains substantive differences **and paragraphs 4 and 5 which refer to independent personal services from a fixed base.** Article 10 deals with the taxation of dividends received by a resident of a Contracting State from sources in the other Contracting State. Paragraph 1 provides that dividends may be taxed in the country of residence, and paragraph 2 provides that dividends may be taxed in the country of source, but at a limited tax rate. The term “dividends” is defined in paragraph 3 as generally including distributions of corporate profits to shareholders. As the OECD Commentary observes **in paragraph 3**: “From the shareholders’ standpoint, dividends are income from the capital which they have made available to the company as its shareholders.” Paragraph 4 provides that paragraphs 1 and 2 do not apply to dividends that are attributable to a permanent establishment of the recipient in the source country, and paragraph 5 generally precludes a Contracting State from taxing dividends paid by a company resident in the other State unless the shareholder is a resident of the taxing State or the dividends are attributable to a permanent establishment of the recipient in that State.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 10

Paragraph 1

2. This paragraph, which reproduces Article 10, paragraph 1, of the OECD Model Convention, provides that dividends may be taxed in the State of the beneficiary’s residence. It does not, however, provide that dividends may be taxed exclusively in that State and therefore 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 of the **former** Group **of Experts** 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 **former** Group **of Experts** reached a consensus that dividends may be taxed by the State of the beneficiary's residence. 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.

3. According to the Commentary on Article 10, paragraph 1, of the OECD Model Convention,

> "**[...]** The term 'paid' has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom." [para. 7]
>
> "The Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State. It does not, therefore, apply to dividends paid by a company which is a resident of a third State or to dividends paid by a company which is a resident of a Contracting State which are attributable to a permanent establishment which an enterprise of that State has in the other Contracting State **[...].**" [para. 8]

Paragraph 2

4. This paragraph reproduces Article 10, paragraph 2, of the OECD Model Convention with certain changes which will be explained hereunder.

~~5. The Group of Experts has amended the main provision of paragraph 2 in 1999 to bring it in line with that in the OECD Model Convention. Prior to the amendment, it was provided that such dividends could also be taxed in the Contracting State of which the company paying the dividends is a resident, but if the recipient is the beneficial owner of dividends, the tax was to be charged in the specified manner. This provision has been changed to provide that if the beneficial owner of the dividends is a resident of the other Contracting State, the tax would be charged in the specified manner. The same change has been made in paragraph 2 of articles 11 and 12 relating to interest and royalties respectively. The purpose of this amendment is to allow the benefits of these articles (namely, 10, 11 and 12) to a beneficial owner residing in that other Contracting State regardless of the residence of any agent or other intermediary collecting the income on behalf of the beneficial owner, and while continuing to deny this benefit, when the beneficial owner was not a resident of that other Contracting State, even if the intermediary collecting the income was a resident. Although some members of the Group of Experts expressed doubts about the effects of this change on developing countries as also the countries that taxed dividends income on a remittance basis, even on re-examination it was considered that the amendment, as proposed, on the lines of the existing provision in the OECD Model Convention, did not require reconsideration. These remarks apply, mutatis mutandis, to similar amendments made~~

~~to paragraph 2 of articles 11 (interest) and 12 (royalties).~~

~~6~~5. The OECD Model Convention restricts the tax in the source country to 5 per cent in subparagraph (a) for direct investment dividends and 15 per cent in subparagraph (b) for portfolio investment dividends, but the United Nations Model Convention leaves these percentages to be established through bilateral negotiations.

Comment [MB14]: The last two sentences of this paragraph have been moved to the start of the next paragraph.

~~7~~**6.** Also, the minimum ownership necessary for direct investment dividends is reduced in subparagraph (a) from 25 per cent to 10 per cent. However, the 10 per cent threshold which determines the level of shareholding qualifying as a direct investment is illustrative only. **When it last considered this issue, the former** Group of Experts decided to replace "25 per cent" by "10 per cent" in subparagraph (a) as the minimum capital required for direct investment dividend status because in some developing countries non-residents are limited to a 50 per cent share ownership, and 10 per cent is a significant portion of such permitted ownership.

~~8~~7. The **former** Group **of Experts** was unable to reach a consensus on the maximum tax rates to be permitted in the source country. Members from the developing countries, who basically preferred the principle of the taxation of dividends exclusively in the source country, considered that the rates prescribed by the OECD Model Convention would entail too large a loss of revenue for the source country. Also, although they accepted the principle of taxation in the beneficiary's country of residence, they believed that any reduction in withholding taxes in the source country should benefit the foreign investor rather than the treasury of the beneficiary's country of residence, as may happen under the traditional tax-credit method if the reduction lowers the cumulative tax rate of the source country below the rate of the beneficiary's country of residence.

~~9~~8. The **former** Group **of Experts** suggested some considerations that might guide countries in negotiations on the rates for source country taxation of direct investment dividends. If the developed (residence) country uses a credit system, treaty negotiations could appropriately seek a withholding tax rate at source that would, in combination with the basic corporate tax rate of the source country, produce a combined effective rate not exceeding the tax rate in the residence country. The parties' negotiating positions may also be affected by whether the residence country allows credit for taxes spared by the source country under tax incentive programmes. If the developed country uses an exemption system for double taxation relief, it could, in bilateral negotiations, seek a limitation on withholding rates on the grounds that (a) 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, and (b) the exemption and resulting departure from tax neutrality with domestic investment are of benefit to the international investor, and a limitation of the withholding rate at source, which would also benefit the investor, would be in keeping with this aspect of the exemption.

~~10~~9. Both the source country and the country of residence should be able to tax dividends on portfolio investment shares, 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 in some cases. The **former** Group **of Experts** decided not to recommend a maximum rate because source countries may have varying views on the importance of portfolio investment and on the figures to be inserted.

~~11~~**10**. In 1999, it was noted that recent developed/developing country treaty practice indicates a range of direct investment and portfolio investment withholding tax rates. Traditionally, dividend withholding rates in the developed/developing country treaties have been higher than those in treaties between developed countries. Thus, while the OECD direct and portfolio investment rates are 5 per cent and 15 per cent, developed/developing country treaty rates have traditionally ranged between 5 per cent and 15 per cent for direct investment dividends and 15 per cent and 25 per cent for portfolio dividends. Some developing countries have taken the position that short-term loss of revenue occasioned by low withholding rates is justified by the increased foreign investment in the medium and long terms. Thus, several modern developed/developing country treaties contain the OECD Model rates for direct investment, and a few treaties provide for even lower rates.

~~12~~**11**. Also, several special features in developed/developing country treaties have appeared: (a) the tax rates may not be the same for both countries, with higher rates allowed to the developing country; (b) tax rates may not be limited at all; (c) reduced rates may apply only to income from new investment; (d) the lowest rates or exemption may apply only to preferred types of investments (e.g., "industrial undertakings" or "pioneer investments"); and (e) dividends may qualify for reduced rates only if the shares have been held for a specified period. In treaties of countries that have adopted an imputation system of corporation taxation (i.e., integration of company tax into the 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.

~~13~~**12.** Although the rates are fixed either partly or wholly for reasons connected with the general balance of the particular bilateral tax treaty, the following technical factors 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 can credit 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 matching credit is given in the country of residence for tax spared in the country of source;

(d) the achievement from the source country's point of view of a satisfactory balance between raising revenue and attracting foreign investment.

~~14~~**13**. The Commentary on the OECD Model Convention contains the following passages:

"If a partnership is treated as a body corporate under the domestic laws applying to it, the two Contracting States may agree to modify subparagraph ~~(~~a) of paragraph 2 in a way to give the benefits of the reduced rate provided for parent companies also to such partnership." [para. 11]

~~"Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State . . . States which wish to make this more explicit are free to do so during bilateral negotiations . . ." [para. 12]~~

"The requirement of beneficial ownership was introduced in paragraph 2 of Article 10 to clarify the meaning of the words "paid ... to a resident" as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over dividend income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term "beneficial owner" is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance". [para. 12]

Comment [MB15]: New text in paragraph 14 (now 13) of the UN Commentary was agreed at the annual session of 2010 (cf. report from that year chapter III K, Concept of Beneficial Ownership).

"Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies"1 concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties". [para. 12.1]

"Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State". [para. 12.2]

"The tax rates fixed by the Article for the tax in the State of source are maximum rates. The States may agree, in bilateral negotiations, on lower rates or even on taxation exclusively in the State of the beneficiary's residence. The reduction of rates provided for in paragraph 2 refers solely to the taxation of dividends and not to the taxation of the profits of the company paying the dividends." [para. 13]

"Under the domestic laws of many States, pension funds and similar entities are generally exempt from tax on their investment income. In order to achieve neutrality of treatment as regards domestic and foreign investments by these entities, some States provide bilaterally that income, including dividends, derived by such an entity resident of the other State shall be exempt from source taxation. States wishing to do so may agree bilaterally on a provision drafted along the lines of the provision found in paragraph 69 of the Commentary on Article 18." [para. 13.1]

"Similarly, some States refrain from levying tax on dividends paid to other States and some of their wholly-owned entities, at least to the extent that such dividends are derived from activities of a governmental nature. Some States are able to grant such an exemption under their interpretation of the sovereign immunity principle (see paragraphs 6.38 and 6.39 of the Commentary on Article 1); others may do it pursuant to provisions of their domestic law. States wishing to do so may confirm or clarify, in their bilateral conventions, the scope of these exemptions or grant such an exemption in cases where it would not otherwise be available. This may be done by adding to the Article an additional paragraph drafted along the following lines:

Notwithstanding the provisions of paragraph 2, dividends referred to in paragraph 1shall be taxable only in the Contracting State of which the recipient is a resident if the beneficial owner of the dividends is that State or a political subdivision or local authority thereof." [para. 13.2]

"The two Contracting States may also, during bilateral negotiations, agree to [lower the holding percentage required for direct investment dividends]. A lower percentage is, for instance, justified in cases where the state of residence of the parent company, in accordance with its domestic law, grants exemption to such a company for dividends derived from a holding of less than 25 per cent in a non-resident subsidiary." [para. 14]

"In subparagraph ~~(~~a) of paragraph 2, the term 'capital' is used in **[...]** [defining the minimum ownership required for direct investment dividends]. The use of this term in this context implies that, for the purposes of subparagraph ~~(~~a), it should be used in the sense in which it is used for the purposes of distribution to the shareholder (in the particular case, the parent company).

~~(~~a) As a general rule, therefore, the term 'capital' in subparagraph ~~(~~a) should be understood as it is understood in company law. Other elements, in particular the reserves, are not to be taken into account.

~~(~~b) Capital, as understood in company law, should be indicated in terms of par value of all shares which in the majority of cases will be shown as capital in the company's balance sheet.

~~(~~c) No account need be taken of differences due to the different classes of shares issued (ordinary shares, preference shares, plural voting shares, non-voting shares, bearer shares, registered shares etc.), as such differences relate more to the nature of the shareholder's right than to the extent of his ownership of the capital.

~~(~~d) When a loan or other contribution to the company does not, strictly speaking, come as capital under company law but when on the basis of internal law or practice ('thin capitalization', or assimilation of a loan to share capital), the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as 'capital' within the meaning of subparagraph ~~(~~a).

~~(~~e) In the case of bodies which do not have capital within the meaning of company law, capital for the purpose of subparagraph ~~(~~a) is to be taken as meaning the total of all contributions to the body which are taken into account for the purpose of distributing profits.

In bilateral negotiations, Contracting States may depart from the criterion of 'capital' used in subparagraph ~~(~~a) of paragraph 2 and use instead the criterion of 'voting power'." [para. 15]

"Subparagraph ~~(~~a) of paragraph 2 does not require that the company receiving the dividends must have owned at least [10] per cent of the capital for a relatively long time before the date of the distribution. This means that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which paragraph 2 applies, i.e.~~,~~ in most cases the situation existing at the time when the dividends become legally available to the shareholders. The primary reason for this resides in the desire to have a provision which is applicable as broadly as possible. To require the parent company to have possessed the minimum holding for a certain time before the distribution of the profits could involve extensive inquiries. Internal laws of certain OECD ~~M~~**m**ember countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received. In view of this, Contracting States may include a similar condition in their conventions." [para. 16]

"The reduction envisaged in subparagraph ~~(~~a) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than [10] per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph ~~(~~a) a provision along the following lines:

> 'provided that this holding was not acquired primarily for the purpose of taking advantage of this provision'." [para. 17]

"Paragraph 2 lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by infdividual assessment." [para. 18]

"The paragraph does not settle procedural questions. Each State should be able to use the procedure provided in its own laws. It can either forthwith limit its tax to the rates given in the ~~a~~**A**rticle or tax in full and make a refund **. . .** Specific questions arise with triangular cases (see paragraph ~~53~~**71** of the Commentary on Article 24) ~~[e.g., cases in which income arising in a Contracting State and beneficially owned by a resident of the other Contracting State is attributable to a permanent establishment in a third State]."~~ [para. 19]

"It does not specify whether or not the relief in the State of source should be conditional upon the dividends being subject to tax in the State of residence. This question can be settled by bilateral negotiations." [para. 20]

"The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the dividends. This question is dealt with in Articles 23 A and 23 B." [para. 21]

"Attention is drawn generally to the following case: the beneficial owner of the dividends arising in a Contracting State is a company resident of the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the dividends the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this ~~a~~**A**rticle, in order to define the treatment applicable to such companies." [para. 22]

Paragraph 3

~~15~~**14** This paragraph reproduces Article 10, paragraph 3, of the OECD Model Convention, the Commentary on which reads as follows:

"In view of the great differences between the laws of OECD ~~M~~**m**ember countries, it is impossible to define 'dividends' fully and exhaustively. Consequently, the definition merely mentions examples which are to be found in the majority of the ~~M~~**m**ember countries' laws and which, in any case, are not treated differently in them. The enumeration is followed up by a general formula. In the course of the revision of the 1963 Draft Convention, a thorough study has been undertaken to find a solution ~~which~~ **that** does not refer to domestic laws. This study has led to the conclusion that, in view of the still remaining dissimilarities between ~~M~~**m**ember countries in the field of company law and taxation law, it did not appear to be possible to work out a definition of the concept of dividends that would be independent of domestic laws. It is open to the Contracting States, through bilateral negotiations, to make allowance for peculiarities of their laws and to agree to bring under the definition of 'dividends' other payments by companies falling under the ~~a~~**A**rticle." [para. 23]

"The notion of dividends basically concerns distributions by companies within the meaning of subparagraph ~~(~~b) of paragraph 1 of Article 3. Therefore the definition relates, in the first instance, to distributions of profits the title to which is constituted by shares~~,~~ that is holdings in a company limited by shares (joint stock company). The definition assimilates to shares all securities issued by companies which carry a right to participate in the companies' profits without being debt claims; such are, for example, 'jouissance' shares or 'jouissance' rights, founders' shares or other rights participating in profits. In bilateral conventions, of course, this enumeration may be adapted to the legal situation in the Contracting States concerned. This may be necessary, in particular, as regards income from 'jouissance' shares and founders' shares. On the other hand, debt-claims participating in profits do not come into this category **[**...**]** ; likewise interest on convertible debentures is not a dividend." [para. 24]

"Article 10 deals not only with dividends as such but also with interest on loans in so far as the lender effectively shares the risks run by the company, i.e.~~,~~ when repayment depends largely on the success or otherwise of the enterprise's business. Articles 10 and 11 do not therefore prevent the treatment of this type of interest as dividends under the national rules on thin capitali~~z~~**s**ation applied in the borrower's country. The question whether the contributor of the loan shares the risks run by the enterprise must be determined in each individual case in the light of all the circumstances, as for example the following:

— the loan very heavily outweighs any other contribution to the enterprise's capital (or was taken out to replace a substantial portion of capital which has been lost) and is substantially unmatched by redeemable assets;

— the creditor will share in any profits of the company;

— the repayment of the loan is subordinated to claims of other creditors or to the payment of dividends;

— the level or payment of interest would depend on the profits of the company;

— the loan contract contains no ~~final~~ **fixed** provisions for repayment by a definite date." [para. 25]

"The laws of many of the States put participations in a ~~S~~**société** à responsabilité limitée (limited liability company) on the same footing as shares. Likewise, distributions of profits by cooperative societies are generally regarded as dividends." [para. 26]

"Distributions of profits by partnerships are not dividends within the meaning of the definition, unless the partnerships are subject, in the State where their place of effective management is situated, to a fiscal treatment substantially similar to that applied to companies limited by shares (for instance, in Belgium, Portugal and Spain, also in France as regards distributions to ~~'~~commanditaires~~'~~ in the ~~'~~sociétés *en* commandite simple~~'~~). On the other hand, clarification in bilateral conventions may be necessary in cases where the taxation law of a Contracting State gives the owner of holdings in a company a right to opt, under certain conditions, for being taxed as a partner of a partnership, or, vice versa, gives the partner of a partnership the right to opt for taxation as the owner of holdings in a company." [para. 27]

"Payments regarded as dividends may include not only distributions of profits decided by annual general meetings of shareholders, but also other benefits in money or money's worth, such as bonus shares, bonuses, profits on a liquidation and disguised distributions of profits. The reliefs provided in the ~~a~~**A**rticle apply so long as the State of which the paying company is a resident taxes such benefits as dividends. It is immaterial whether any such benefits are paid out of current profits made by the company or are derived, for example, from reserves, i.e.~~,~~ profits of previous financial years. Normally, distributions by a company which have the effect of reducing the membership rights, for instance, payments constituting a reimbursement of capital in any form whatever, are not regarded as dividends." [para. 28]

"The benefits to which a holding in a company confer entitlement are, as a general rule, available solely to the shareholders themselves. Should, however, certain of such benefits be made available to persons who are not shareholders within the meaning of company law, they may constitute dividends if:

— the legal relations between such persons and the company are assimilated to a holding in a company ('concealed holdings') and

— the persons receiving such benefits are closely connected with a shareholder; this is the case, for example, where the recipient is a relative of the shareholder or is a company belonging to the same group as the company owning the shares." [para. 29]

"When the shareholder and the person receiving such benefits are residents of two different States with which the State of source has concluded conventions, differences of views may arise as to which of these conventions is applicable. A similar problem may arise when the State of source has concluded a convention with one of the States but not with the other. This, however, is a conflict which may affect other types of income and the solution to it can be found only through an arrangement under the mutual agreement procedure." [para. 30]

Paragraph 4

~~16~~**15**. This paragraph, which makes paragraphs 1 and 2 inapplicable to dividends on shares that are effectively connected with a permanent establishment or fixed base of the recipient in the source country, reproduces Article 10, paragraph 4, of the OECD Model Convention **except the United Nations Model Convention refers to a company performing independent personal services from a fixed base**. The OECD Commentary notes that paragraph 4 does not adopt a force of attraction rule, allowing dividends to be taxed as business profits if the recipient has a permanent establishment or fixed base in the source country, regardless of whether the shareholding is connected with the permanent establishment. Rather, the paragraph only permits dividends to be taxed as business profits "if they are paid in respect of holdings forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment". [para. 31]

The OECD Commentary also notes:

> **"It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a shareholding be "effectively connected" to such a location requires that the shareholding be genuinely connected to that business." [para. 32]**

Paragraph 5

~~17~~**16**. This paragraph, which bars a Contracting State from taxing dividends paid by a company resident in the other State merely because the company derives income or profits in the taxing State, reproduces Article 10, paragraph 5, of the OECD Model Convention~~,~~ **except for** the **reference in the United Nations Model Convention to "fixed base". The OECD** Commentary ~~on which~~ reads as follows:

> "The Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other State. Certain States, however, tax not only dividends paid by companies resident therein but even distributions by non-resident companies of profits arising within their territory. Each State, of course, is entitled to tax profits arising in its territory which are made by non-resident companies, to the extent provided in the Convention (in particular in Article 7). The shareholders of such companies should not be taxed as well at any rate, unless they are residents of the State and so naturally subject to its fiscal sovereignty." [para. 33]
>
> "Paragraph 5 rules out the extraterritorial taxation of dividends, i.e.~~,~~ the practice by which States tax dividends distributed by a non-resident company solely because the corporate profits from which the distributions are made originated in their territory (for example, reali~~z~~**s**ed through a permanent establishment situated therein). There is, of course, no question of extraterritorial taxation when the country of source of the corporate profits taxes the dividends because they are paid to a shareholder who is a resident of that State or to a permanent establishment **[**or fixed base**]** situated in that State." [para. 34]
>
> "Moreover, it can be argued that such a provision does not aim at, or cannot result in, preventing a State from subjecting the dividends to a withholding tax when distributed by foreign companies if they are cashed in its territory. Indeed, in such a case, the criterion for tax liability is the fact of the payment of the dividends, and not the origin of the corporate profits allotted for distribution. But if the person cashing the dividends in a Contracting State is a resident of the other Contracting State (of which the distributing company is a resident), he may under Article 21 obtain exemption from, or refund of, the withholding tax of the first-mentioned State. Similarly, if the beneficiary of the dividends is a resident of a third State which had concluded a double taxation convention with the State where the dividends are cashed, he may, under Article 21 of that convention, obtain exemption from, or refund of, the withholding tax of the last-mentioned State." [para. 35]

"Paragraph 5 further provides that non-resident companies are not to be subjected to special taxes on undistributed profits." [para. 36]

"It might be argued that where the taxpayer's country of residence, pursuant to its ~~counteracting measures (such as sub-part F~~ **controlled foreign companies** legislation ~~in the United States),~~**or other rules with similar effect** seeks to tax profits which have not been distributed**,** it is acting contrary to the provisions of paragraph 5. However **it should be noted that** the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under ~~a counteracting~~ **such** legislation **or rules**. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder." [para. 37]

"The application of ~~counteracting~~ **such** legislation **or rules** may, however, ~~pose some difficulties.~~**complicate the application of Article 23.** If the income ~~is~~**were** attributed to the taxpayer then each item of the income would have to be treated under the relevant provisions of the Convention (business profits, interest, royalties). If the amount is treated as a deemed dividend then it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 or as 'other income' within the meaning of Article 21. Under some ~~counteracting measures~~ **of these legislation or rules** the taxable amount is treated as a dividend with the result that an exemption provided for by a tax convention, e.g.~~,~~ an affiliation exemption~~,~~ is also extended to it~~(for instance, in Germany)~~. It is doubtful whether the Convention requires this to be done. If the country of residence considers that this is not the case~~,~~ it may face the allegation that it is obstructing the normal operation of the affiliation exemption by taxing the dividend (in the form of 'deemed dividend') in advance." [para. 38]

"Where dividends are actually distributed by the base company, the provisions of a bilateral convention regarding dividends have to be applied in the normal way because there is dividend income within the meaning of the convention. Thus, the country of the base company may subject the dividend to a withholding tax. The country of residence of the shareholder will apply the normal methods for the elimination of double taxation (i.e.~~,~~ tax credit or tax exemption is granted). This implies that the withholding tax on the dividend should be credited in the shareholder's country of residence, even if the distributed profit (the dividend) has been taxed years before under ~~counteracting~~**controlled foreign companies** legislation **or other rules with similar effect.** However, the obligation to give credit in that case remains doubtful. Generally the dividend as such is exempted from tax (as it was already taxed under the ~~counteracting~~**relevant** legislation~~)~~ **or rules** and one might argue that there is no basis for a tax credit. On the other hand, the purpose of the treaty would be frustrated if the crediting of taxes could be avoided by simply anticipating the dividend taxation under counteracting legislation. The general principle set out above would suggest that the credit should be granted, though the details may depend on the technicalities of the ~~counteracting measures~~**relevant legislation or rules** and the system for crediting foreign taxes against domestic tax, as well as on the particularities of the case (e.g., time lapsed since the taxation of the 'deemed dividend'). However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot fully be safeguarded by tax authorities." [para. 39]

~~18~~**17.** It may be relevant to point out that certain countries' laws seek to avoid or mitigate economic double taxation, that is, the simultaneous taxation of the company's profits at the level of the company and of dividends at the level of the shareholder. For a detailed consideration of this matter, it may be instructive to refer to paragraphs 40 to 67 in the Commentaries on Article 10 of the OECD Model Convention.

Branch profits taxes

~~19~~**18.** The inclusion of a branch profits tax provision in a revised United Nations Model Convention was discussed at the 1987 and 1991 meetings of the **former** Group of Experts. The issue was further discussed in the 1997 meeting (Eighth Meeting) of the **former** Group of Experts and it was considered that because only a few countries had **a** branch tax, the paragraph might be better placed in the commentaries and not in the main text. It would be left to the Contracting States, if they so desire, during the course of bilateral negotiations to incorporate the provisions relating to the branch profits tax in their bilateral tax treaties. Developing countries were generally not opposed to the principle of branch profits taxation, even if they did not impose a branch profits tax. ~~One member from a developed country stated that imposition of a branch profits tax would conflict with his country's policy of taxing business profits once.~~

~~20~~**19.** Some members, while citing the justification of branch profits taxation as a means of achieving rough parity in source country taxation whether business in that country is conducted through a subsidiary corporation or a branch, maintained that the principle should be followed logically throughout the Convention. Thus, in this view, contrary to paragraph 3 of ~~a~~**A**rticle 7 of the United Nations Model Convention, all expenses of the permanent establishment must be deductible as if the permanent establishment were a distinct and separate enterprise dealing wholly independently with the head office.

~~21~~**20**. Another member from a developed country noted that his country imposed the tax in two separate parts: (i) a tax analogous to a dividend withholding tax was imposed on the "dividend equivalent amount" of a branch that was approximately the amount that would likely have been distributed as dividends if the branch were a subsidiary; and (ii) a second tax, analogous to a withholding tax on interest paid by a subsidiary resident in that country to its foreign parent, was imposed on the excess of the amount of interest deducted by the branch in computing its taxable income 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.

~~22~~**21**. If one or both of the Contracting States impose branch profits taxes, they may include in the Convention a provision such as the following:

"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 ~~a~~**A**rticle 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."

~~23~~**22.** The suggested provision does not recommend a maximum branch profits rate. 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 **former** 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 branch profits tax rate was the 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 ~~a~~**A**rticle 10, rather than in ~~a~~**A**rticle 7, because the tax is intended to be analogous to a tax on dividends.

~~24~~**23**. The provision allows the branch profits tax to be imposed only on profits taxable under ~~a~~**A**rticle 7, paragraph 1, on account of the permanent establishment. Many treaties further limit the tax base to such profits "after deducting therefrom income tax and other taxes on income imposed thereon in that other State". Other treaties do not contain this clause because the concept is included under domestic law.

~~25~~**24**. At the **former** Group~~'s~~ **of Experts** 1991 meeting, attention was drawn to the fact that a branch profits tax provision could potentially conflict with a treaty's non-discrimination clause. Since a branch profits tax is usually a second level of tax on profits of foreign corporations that is not imposed on domestic corporations carrying on the same activities, it could be viewed, as a technical matter, as prohibited by ~~a~~**A**rticle 24 (Non-discrimination). However, countries imposing the tax do so as an analogue to the dividend withholding tax paid on dividends from a subsidiary to its foreign parent, and they therefore consider it appropriate to include in the non-discrimination ~~a~~**A**rticle an explicit exception allowing imposition of the branch tax. The non-discrimination ~~a~~**A**rticle in several treaties with branch profits tax provisions contains the following paragraph:

"Nothing in this ~~a~~**A**rticle shall be construed as preventing either Contracting State from imposing a tax as described in paragraph ___ [branch profits tax provision] of ~~a~~**A**rticle 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 ~~a~~**A**rticle 24 (Non-discrimination).

~~26~~**25**. Some members of the **former** Group of Experts pointed out that there are many artificial devices entered into by persons to take advantage of the provisions of ~~a~~**A**rticle 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 ~~a~~**A**rticle 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 ~~a~~**A**rticle by means of that creation or assignment.”

Article 11

INTEREST

A. GENERAL CONSIDERATIONS

1. Article 11 of the United Nations Model Convention reproduces the provisions of Article 11 of the OECD Model Convention with the exception of paragraphs 2 and 4, in which substantive changes have been made **and with respect to paragraph 4 and 5 which refer to independent personal services from a fixed base**.

2. 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 which have granted loans or to institutional investors which hold bonds or debentures. Interest may also be paid on loans between associated enterprises.

3. At the domestic level, interest is usually deductible in calculating profits. Any tax on interest is paid by the beneficiary unless a special contract provides that it should be paid by the payer of the interest. Contrary to what occurs in the case of dividends, interest is not liable to taxation in the hands of both the beneficiary and the payer. If the latter is obliged to withhold a certain portion of the interest as a tax, the amount withheld represents an advance on the tax to which the beneficiary will be liable on his aggregate income or profits for the fiscal year, and the beneficiary can deduct this amount from the tax due from him and obtain reimbursement of any sum by which the amount withheld exceeds the tax finally payable. This mechanism prevents the beneficiary from being taxed twice on the same interest.

4. At the international level, when the beneficiary of the interest is a resident of one State and the payer of the interest is a resident of another, the interest 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, increase the financial burden on the payer.

5. The Commentary on the OECD Model Convention notes that although this double taxation could be eliminated by barring the source country or the residence country from taxing the interest,

> “A formula reserving the exclusive taxation of interest to one State, whether the State of the beneficiary’s residence or the State of source, could not be sure of receiving general approval. Therefore a compromise solution was adopted. It provides that interest may be taxed in the State of residence**,** but leaves to the State of source the right to impose a tax if its laws so provide, it being implicit in this right that the State of source is free to give up all taxation on interest paid to non-residents. Its exercise of this right will however be limited by a ceiling which its tax cannot exceed . . . The

sacrifice that the latter would accept in such conditions will be matched by a relief to be given by the State of residence, in order to take into account the tax levied in the State of source (~~cf~~ **see**. Article 23 A or 23 B)." [para. 3]

"Certain countries do not allow interest paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the interest is paid by a resident of a Contracting State to a resident of the other State is dealt with in paragraph 4 of Article 24." [para. 4]

COMMENTARY ON THE PARAGRAPHS OF ARTICLE 11

Paragraph 1

6. This paragraph reproduces Article 11, paragraph 1, of the OECD Model Convention, the Commentary on which reads as follows:

"Paragraph 1 lays down the principle that interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in the latter. In doing so, it does not stipulate an exclusive right to tax in favour of the State of residence. The term 'paid' has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom." [para. 5]

"The Article deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to interest arising in a third State or to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State . . ." [para. 6]

Paragraph 2

7. This paragraph reproduces Article 11, paragraph 2, of the OECD Model Convention with one substantive change. The OECD Model Convention provides that the tax in the country of source "shall not exceed 10 per cent of the gross amount of the interest", but the United Nations Model Convention leaves this percentage to be established through bilateral negotiations.

~~8. The Group of Experts has amended the main provision of paragraph 2 to bring it in line with that in the OECD Model Convention. Prior to the amendment, it was provided that such interest could also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the recipient is the beneficial owner of the interest the tax was to be charged in the specified manner. This provision has been changed to provide that if the beneficial owner of the interest is a resident of the other Contracting State, the tax would be charged in the specified manner. The purpose of the amendment is to allow the benefit of this article to a beneficial owner residing in that other Contracting State regardless of the residence of any agent or other intermediary collecting the income on behalf of the beneficial owner, and while continuing to deny this benefit when the beneficial owner was~~

~~not a resident of the Contracting State, even if the intermediary collecting the income was a resident.~~

~~9~~**8**. **When this Article was last considered by the former Group of Experts,** Members from developing countries took the view 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 country to prevent double taxation of that income through exemption, credit or other relief measures. These members reason that interest should be taxed where it was earned, that is, where the capital was put to use. Some members from developed countries felt that the home country of the investor should have the exclusive right to tax interest, since 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 pointed 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.

~~10~~**9**. 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. Since the **former** Group **of Experts** was unable to reach a consensus on an alternative ceiling, the matter was left to bilateral negotiations.

~~11~~**10**. The decision not to recommend a maximum withholding rate can be justified under current treaty practice. The withholding rates for interest adopted in developed/developing country tax treaties range more widely than those for dividends—between complete exemption and 25 per cent. However, some developing countries have reduced the interest withholding rate to attract foreign investment; several of them have adopted rates at or below the OECD rate of 10 per cent.

~~12~~**11**. A precise level of withholding tax for a source country should take into account several 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 main direction of interest flows (e.g., from developing to developed countries).

~~13~~**12**. In negotiations on bilateral treaties with a general positive rate for interest withholding, a lower ceiling or even exemption has sometimes been agreed upon for interest in one or more of the following categories:

(a) Interest paid to Governments or government agencies;

(b) Interest guaranteed by Governments or government agencies; (c) Interest paid to central banks;

(d) Interest paid to banks or other financial institutions;

(e) Interest on long-term loans;

(f) Interest on loans to financing special equipment or public works; or

(g) Interest on other government-approved types of investment (e.g., export finance).

With respect to bank loans and loans from financial institutions, a major justification for the reduced rate is the high costs associated with these loans, particularly the lender's cost of funds. The withholding tax, because it is a gross basis tax, has a high effective tax rate. If the effective rate is higher than the general tax rate in the lender's country of residence, the borrower is often required to bear the tax through a gross-up feature in the loan agreement. In that case, the withholding tax amounts to an additional tax on residents of the source State. One way to deal with this is to allow the lender to elect to treat such income as business profits under ~~a~~**A**rticle 7, but this approach raises computation and administrative issues for banks and tax administrators.

~~14~~**13**. A similar justification exists for reduced rates on interest from credit sales. The supplier in such cases often merely passes on to the customer, without additional charge, the price he has had to pay to a bank or export finance agency to finance the credit. For a person selling equipment on credit, the interest is more an element of the sales price than income from invested capital.

~~15~~**14**. In addition, long-term credits correspond to investments that should be profitable enough to be repaid in installments over a period. In the latter case, interest must be paid out of earnings at the same time as installments of credit are repaid out of capital. Consequently, any excessive fiscal burden on such interest must be passed on to the book value of the capital goods purchased on credit, with the result that the fiscal charge levied on the interest might, in the last analysis, diminish the amount of tax payable on the profits made by the user of the capital goods.

~~16~~**15**. At the **former** Group~~'s~~ **of Experts** 1991 meeting, some members argued that interest income received by government agencies should be exempted from source country taxation because exemption would facilitate the financing of development projects, especially in developing countries, by eliminating tax considerations from negotiations over interest rates. Some members from developing countries asserted that the financing of such projects would be enhanced even further if the interest income was also exempt from tax in the lender's country of residence.

~~17~~**16**. The predominant treaty practice is to exempt governmental interest from source country tax, but there is a wide range of practice on the details. In some instances interest income is exempted if paid by a government or paid to a government; in other instances only interest paid to a government is exempt. Also, the definition of "government" varies to include, e.g., local authorities, agencies, instrumentalities, central banks, and financial institutions owned by the government.

~~18~~**17**. The **former** Group **of Experts** ~~has~~ observed that long-term credits often call for special guarantees because of the difficulty of long-term political, economic and monetary forecasting. Moreover, most developed countries, in order to ensure full employment in their capital goods industries or public works enterprises, have adopted various measures to encourage long-term credits, including credit insurance or interest-rate reductions by government agencies. These measures may take the form of direct loans by government agencies tied to loans by private banks or private credit facilities or interest terms more favourable than those obtainable on the money market. These measures are not likely to persist if the preferences are effectively cancelled out or reduced by excessive taxation in the debtor's country. Thus, not only should interest on loans made by a government be exempted, but an argument exists for exempting interest on long-term loans made by private banks where such loans are guaranteed or refinanced by a government or a government agency.

~~19~~**18**. The Commentary on the OECD Model Convention contains the following passages:

> ~~"Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State . . . States which wish to make this more explicit are free to do so during bilateral negotiations." [para. 8]~~
>
> **"The requirement of beneficial ownership was introduced in paragraph 2 of Article 11 to clarify the meaning of the words 'paid to a resident' as they are used in paragraph 1 of the Article. It makes plain that the State of source is not obliged to give up taxing rights over interest income merely because that income was immediately received by a resident of a State with which the State of source had concluded a convention. The term 'beneficial owner' is not used in a narrow technical sense, rather, it should be understood in its context and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance." [para. 9]**
>
> **"Relief or exemption in respect of an item of income is granted by the State of source to a resident of the other Contracting State to avoid in whole or in part the double taxation that would otherwise arise from the concurrent taxation of that income by the State of residence. Where an item of income is received by a resident of a Contracting State acting in the capacity of agent or nominee it would be inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption merely on account of the status of the immediate recipient of the income as a resident of the other Contracting State. The immediate recipient of the income in this situation qualifies as a resident but no potential double taxation arises as a consequence of that status since the recipient is not treated as the owner of the income for tax purposes in the State of residence. It would be equally inconsistent with the object and purpose of the Convention for the State of source to grant relief or exemption where a resident of a Contracting State, otherwise than through an agency or nominee relationship, simply acts as a conduit for another person who in fact receives the benefit of the income concerned. For these reasons, the report from the Committee on Fiscal Affairs entitled 'Double Taxation Conventions and the Use of Conduit Companies'[18] concludes that a conduit company cannot normally be regarded as the beneficial owner if, though the formal owner, it has, as a practical matter, very**

Comment [MB16]: Paragraphs 9 to 11 of the revised OECD Commentary were adopted at the sixth annual session of the Committee in 2010 (cf. chapter III K of the Report from last year).

[18] Reproduced in Volume II of the full-length version of the OECD Model Tax Convention at page R(6)-1.

narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties. [para. 10]

"Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all member countries). States which wish to make this more explicit are free to do so during bilateral negotiations." [para. 11]

"The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment. Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law . . ." ~~[para. 9]~~ **[para. 12]**

"It does not specify whether or not the relief in the State of source should be conditional upon the interest being subject to tax in the State of residence. This question can be settled by bilateral negotiations." ~~[para. 10]~~ **[para. 13]**

"The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the interest. This question is dealt with in Articles 23 A and 23 B." ~~[para. 11]~~ **[para. 14]**

~~"Attention is drawn generally to the following case: the beneficial owner of interest arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether, in the case of such a company, it is justifiable to allow in the State of source of the interest the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this article, in order to define the treatment applicable to such companies." [para. 12]~~

~~"It should, however, be pointed out that the solution adopted, given the combined effect of the right to tax accorded to the State of source and the allowance to be made for the tax levied there against that due in the State of residence, could, in certain cases, result in maintaining partial double taxation and lead to adverse economic consequences. In fact, when the beneficiary of the interest has himself had to borrow in order to finance the operation which earns him interest, the profit he will realize by way of interest will be much smaller than the nominal amount of interest he receives; if the interest he pays and that which he receives balance, there will be no profit at all. In such a case, the allowance to be made under paragraph 2 of Article 23 A, or paragraph 1 of Article 23 B, raises a difficult and sometimes insoluble problem in view of the fact that the tax levied in the State where the interest arises is calculated on the gross amount thereof, whereas the same interest is reflected in the beneficiary's business results at its net amount only. The result of this is that part, or sometimes even the whole amount, of the tax levied in the State where the interest~~

~~arises cannot be allowed as a credit in the beneficiary's State of residence and so constitutes an excess charge for the beneficiary, who, to that extent, suffers double taxation. Moreover, the latter, in order to avoid the disadvantage just mentioned, will tend to increase the rate of interest he charges his debtor, whose financial burden would then be increased to a corresponding extent. Thus in certain cases the practice of taxation at the source can constitute an obstacle to international trade." [para. 13]~~

Comment [MB17]: New OECD paragraph 13 included above.

~~"The disadvantages just mentioned arise in business, particularly with the sale on credit of equipment, other commercial credit sales, and loans granted by banks. The supplier in such cases very often merely passes on to the customer, without any additional charge, the price he will himself have had to pay to a bank or an export finance agency to finance the credit; similarly, the banker generally finances the loan which he grants with funds lent to his bank and, in particular, funds accepted by him on deposit. In the case especially of the person selling equipment on credit, the interest is more an element of the selling price than income from invested capital." [para. 14]~~

Comment [MB18]: New OECD paragraph 14 included above.

~~"If two Contracting States, in order to eliminate all risks of double taxation, should desire to avoid the imposition of a tax in the State of source on interest arising from the abovementioned categories of debts, their common intention can be expressed by an additional paragraph which would follow paragraph 2 of the Article, and which might be in the following terms:~~

~~3. Notwithstanding the provisions of paragraph 2, any such interest as is mentioned in paragraph 1 shall be taxable only in the Contracting State of which the recipient is a resident, if such recipient is the beneficial owner of the interest and if such interest is paid:~~

~~(a) in connection with the sale on credit of any industrial, commercial or scientific equipment,~~

~~(b) in connection with the sale on credit of any merchandise by one enterprise to another enterprise, or~~

~~(c) on any loan of whatever kind granted by a bank." [para. 15]~~

Comment [MB19]: Deleted in the OECD Commentary.

~~"As regards, more particularly, the types of credit sale referred to in subparagraph (a) of the text suggested above, they comprise not only sales of complete units, but also sales of separate components thereof. Furthermore, as regards credit sales of the types referred to in subparagraphs (a) and (b) of the suggested text, it is immaterial whether the interest is stipulated separately and as additional to the sale price, or is included from the outset in the price payable by instalments." [para. 16]~~

Comment [MB20]: Renumbered and amended as paragraph 7.9 in the OECD Commentary.

~~"Contracting States may add to the categories of interest enumerated . . . above other categories in regard to which the imposition of a tax in the State of source might appear to them to be undesirable. They may also agree that the exclusion of a right to tax in the State of source shall be limited to certain of the categories of interest mentioned." [para. 17]~~

Comment [MB21]: Renumbered and amended as paragraph 7.12 in the OECD Commentary.

Paragraph 3

~~20~~**19**. This paragraph reproduces Article 11, paragraph 3, of the OECD Model Convention, the Commentary on which reads as follows:

> "Paragraph 3 specifies the meaning to be attached to the term 'interest' for the application of the taxation treatment defined by the ~~a~~**A**rticle. The term designates, in general, income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits. The term 'debt claims of every kind' obviously embraces cash deposits and security in the form of money, as well as government securities, and bonds and debentures, although the three latter are specially mentioned because of their importance and of certain peculiarities that they may present. It is recogni~~z~~**s**ed, on the one hand, that mortgage interest comes within the category of income from movable capital (*revenus de capitaux mobiliers*), even though certain countries assimilate it to income from immovable property. On the other hand, debt claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest." [para. 18]
>
> "Interest on participating bonds should not normally be considered as a dividend, and neither should interest on convertible bonds until such time as the bonds are actually converted into shares. However, the interest on such bonds should be considered as a dividend if the loan effectively shares the risks run by the debtor company . . . In situations of presumed thin capitali~~z~~**s**ation, it is sometimes difficult to distinguish between dividends and interest and in order to avoid any possibility of overlap between the categories of income dealt with ~~in~~ **under** Article 10 and Article 11 respectively, it should be noted that the term 'interest' as used in Article 11 does not include items of income which are dealt with in Article 10." [para. 19]
>
> "As regards, more particularly, government securities, and bonds and debentures, the text specifies that premiums or prizes attaching thereto constitute interest. Generally speaking, what constitutes interest yielded by a loan security, and may properly be taxed as such in the State of source, is all that the institution issuing the loan pays over and above the amount paid by the subscriber, that is to say, the interest accruing plus any premium paid at redemption or at issue. It follows that when a bond or debenture has been issued at a premium, the excess of the amount paid by the subscriber over that repaid to him may constitute negative interest which should be deducted from the interest that is taxable. On the other hand, any profit or loss which a holder of such a security reali~~z~~**s**es by the sale thereof to another person does not enter into the concept of interest. Such profit or loss may, depending on the case, constitute either a business profit or a loss, a capital gain or a loss, or income falling under Article 21." [para. 20]
>
> "Moreover, the definition of interest in the first sentence of paragraph 3 is, in principle, exhaustive. It has seemed preferable not to include a subsidiary reference to domestic laws in the text; this is justified by the following considerations:
>
> (a) the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws;
>
> (b) the formula employed offers greater security from the legal point of

view and ensures that conventions would be unaffected by future changes in any country's domestic laws;

(c) in the Model Convention references to domestic laws should as far as possible be avoided.

It nevertheless remains understood that in a bilateral convention two Contracting States may widen the formula employed so as to include in it any income which is taxed as interest under either of their domestic laws but which is not covered by the definition and in these circumstances may find it preferable to make reference to their domestic laws." [para. 21]

"The definition of interest in the first sentence of paragraph 3 does not normally apply to payments made under certain kinds of non-traditional financial instruments where there is no underlying debt (for example, interest rate swaps). However, the definition will apply to the extent that a loan is considered to exist under a "substance over form" rule, an~~d~~ "abuse of rights" principle, or any similar doctrine. [para 21.1]

~~20~~19.1. Furthermore, in a number of countries, certain non-traditional financial arrangements are assimilated to debt relations under domestic tax law, although their legal form is not a loan. The definition of interest in paragraph 3 applies to payments made under such arrangements.

Comment [MB22]: New Commentary agreed in 2008 to address Islamic financial instruments. Certain changes have been done to ensure that the correct version of the amended Commentary is included. Cf. document from June 2009 on changes to commentary on article 11…: http://www.un.org/esa/ffd/tax/RevisionToArt11.pdf

~~20~~19.2. The ~~above~~ definition applies, for instance, to Islamic financial instruments where the economic reality of the contract underlying the instrument is a loan (even if the legal form thereof is not). This may be the case, for example, of *murabaha, istisna'a*, certain forms of *mudaraba* and *musharaka* (i.e., profit-sharing deposits and diminishing *musharaka*) and *ijara*[19] (where assimilated to finance lease), as well as *sukuk* based on such instruments.

~~20~~19.3. Countries that do not deal specifically in their domestic law with the above-mentioned instruments and generally follow an economic-substance-based approach for tax purposes may, nevertheless, apply the definition of interest to payments made under those instruments. Alternatively, such countries, as well as those following a purely legal approach for tax purposes, may wish to refer expressly to such instruments in the definition of interest in the treaty. This may be done by inserting the following after the first sentence:

> **"The term also includes income from arrangements such as Islamic financial instruments where the substance of the underlying contract can be assimilated to a loan".**

~~20~~19.4. It is clear that the ~~above~~ definition does not apply to Islamic financial instruments the economic substance of which cannot be considered as a loan.

[19] For more details regarding these instruments, see the *Manual for Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* ~~([secretariat note: relevant reference will be provided upon preparation of revised version of the Manual)~~.

~~20~~19.5 The OECD Commentary then continues:

"The second sentence of paragraph 3 excludes from the definition of interest penalty charges for late payment but Contracting States are free to omit this sentence and treat **penalty** charges as interest in their bilateral conventions. Penalty charges, which may be payable under the contract, or by customs or by virtue of a judgement, consist either of payments calculated or else of fixed sums; in certain cases they may combine both forms of payment. Even if they are determined *pro rata temporis* they constitute not so much income from capital as a special form of compensation for the loss suffered by the creditor through the debtor's delay in meeting his obligations. Moreover, considerations of legal security and practical convenience make it advisable to place all penalty charges of this kind, in whatever form they be paid, on the same footing for the purposes of their taxation treatment. On the other hand, two Contracting States may exclude from the application of Article 11 any kinds of interest which they intend to be treated as dividends." [para. 22]

"Finally, the question arises whether annuities ought to be assimilated to interest; it is considered that they ought not to be. On the one hand, annuities granted in consideration of past employment are referred to in Article 18 and are subject to the rules governing pensions. On the other hand, although it is true that instalments of purchased annuities include an interest element on the purchase capital as well as return of capital, such instalments thus constituting "*fruits civils*" which accrue from day to day, it would be difficult for many countries to make a distinction between the element representing income from capital and the element representing a return of capital in order merely to tax the income element under the same category as income from movable capital. Taxation laws often contain special provisions classifying annuities in the category of salaries, wages and pensions, and taxing them accordingly." [para. 23]

Paragraph 4

~~21~~**20**. This paragraph, which provides that paragraphs 1 and 2 do not apply to some interest if the recipient has a permanent establishment or fixed base in the source country, reproduces Article 11, paragraph 4, of the OECD Model Convention, with **two** modification**s**. **First, the United Nations Model Convention refers to a fixed base as well as a permanent establishment. Secondly, the** OECD version only applies if the obligation on which the interest is paid is effectively connected with the permanent establishment or fixed base. Since the United Nations Model Convention, unlike the OECD Model Convention, adopts a limited force of attraction rule in ~~a~~**A**rticle 7, defining the income that may be taxed as business profits, a conforming change is made in ~~a~~**A**rticle 11, paragraph 4, of the United Nations Model Convention. This modification makes paragraphs 1 and 2 of ~~a~~**A**rticle 11 inapplicable if the debt claim is effectively connected with the permanent establishment or fixed base or with business activities in the source country of the same or similar kind as those effected through the permanent establishment.

Paragraph 5

~~22~~**21**. This paragraph reproduces Article 11, paragraph 5, of the OECD Model Convention, which specifies that interest is from sources in the residence country of the payer**, except that the United Nations version refers to a fixed base as well as a permanent establishment**. The first sentence of paragraph 5 was amended in 1999 **in line with the OECD Model Convention**. However, in the course of discussion, the **former** Group **of Experts** agreed that countries might substitute a rule that would identify the source of interest as the State in which the loan giving rise to the interest was used. Where, in bilateral negotiations, the two parties differed on the appropriate rule, a possible solution would be a rule which, in general, would accept the place of residence of the payer as the source of interest; but where the loan was used in the State having a "place of use" rule, the interest would be deemed to arise in that State. The OECD Commentary on Article 11, paragraph 5, reads as follows:

> "This paragraph lays down the principle that the State of source of the interest is the State of which the payer of the interest is a resident. It provides, however, for an exception to this rule in the case of interest-bearing loans which have an obvious economic link with a permanent establishment owned in the other Contracting State by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, the paragraph determines that the source of the interest is in the Contracting State in which the permanent establishment is situated, leaving aside the place of residence of the owner of the permanent establishment, even when he resides in a third State." [para. 26]
>
> "In the absence of an economic link between the loan on which the interest arises and the permanent establishment, the State where the latter is situated cannot on that account be regarded as the State where the interest arises; it is not entitled to tax such interest, not even within the limits of a 'taxable quota' proportional to the importance of the permanent establishment. Such a practice would be incompatible with paragraph 5. Moreover, any departure from the rule fixed in the first sentence of paragraph 5 is justified only where the economic link between the loan and the permanent establishment is sufficiently clear-cut. In this connection, a number of possible cases may be distinguished:
>
> ~~(~~a) The management of the permanent establishment has contracted a loan which it uses for the specific requirements of the permanent establishment; it shows it among its liabilities and pays the interest thereon directly to the creditor.
>
> ~~(~~b) The head office of the enterprise has contracted a loan the proceeds of which are used solely for the purposes of a permanent establishment situated in another country. The interest is serviced by the head office but is ultimately borne by the permanent establishment.
>
> ~~(~~c) The loan is contracted by the head office of the enterprise and its proceeds are used for several permanent establishments situated in different countries.
>
> In cases ~~(~~a) and ~~(~~b) the conditions laid down in the second sentence of paragraph 5 are fulfilled, and the State where the permanent establishment is situated is to be

Comment [MB23]: Suggested wording during the EGM in June.

regarded as the State where the interest arises. Case ~~(~~c), however, falls outside the provisions of paragraph 5, the text of which precludes the attribution of more than one source to the same loan. Such a solution, moreover, would give rise to considerable administrative complications and make it impossible for lenders to calculate in advance the taxation that interest would attract. It is, however, open to two Contracting States to restrict the application of the final provision in paragraph 5 to case ~~(~~a) or to extend it to case ~~(~~c).” [para. 27]

“Paragraph 5 provides no solution for the case, which it excludes from its provisions, where both the beneficiary and the payer are indeed residents of the Contracting States, but the loan was borrowed for the requirements of a permanent establishment owned by the payer in a third State and the interest is borne by that establishment. As paragraph 5 now stands, therefore, only its first sentence will apply in such a case. The interest will be deemed to arise in the Contracting State of which the payer is a resident and not in the third State in whose territory is situated the permanent establishment for the account of which the loan was effected and by which the interest is payable. Thus the interest will be taxed both in the Contracting State of which the payer is a resident and in the Contracting State of which the beneficiary is a resident. But, although double taxation will be avoided between these two States by the arrangements provided in the ~~a~~**A**rticle, it will not be avoided between them and the third State if the latter taxes the interest on the loan at the source when it is borne by the permanent establishment in its territory.” [para. 28]

It has been decided not to deal with that case in the Convention. The Contracting State of the payer's residence does not, therefore, have to relinquish its tax at the source in favour of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne. If this were not the case and the third State did not subject the interest borne by the permanent establishment to source taxation, there could be attempts to avoid source taxation in the Contracting State through the use of a permanent establishment situated in such a third State. States for which this is not a concern and that wish to address the issue described in the paragraph above may do so by agreeing to use, in their bilateral convention, the alternative formulation of paragraph 5 suggested in paragraph 30 below. The risk of double taxation just referred to could also be avoided through a multilateral convention. Also, if in the case described in paragraph 28, the State of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States together with, where appropriate, the State of the beneficiary's residence, from concerting measures to avoid the double taxation that would result from such claims using, where necessary, the mutual agreement procedure (as envisaged in paragraph 3 of Article 25).” [para. 29]

~~“It has not, however, been considered possible to refer to such a case in a bilateral convention and provide for it a solution consisting, for example, in obliging~~

~~the Contracting State of the payer's residence to relinquish its tax at the source in favour of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne. The risk of double taxation just referred to can only be fully avoided through a bilateral convention containing a similar provision to that in paragraph 5, between the Contracting State of which the payer of the interest is a resident and the third State in which the permanent establishment paying the interest is situated, or through a multilateral convention containing such a provision." [para. 29]~~

"As mentioned in paragraph 29, any such double taxation could be avoided either through a multilateral convention or if the State of the beneficiary's residence and the State of the payer's residence agreed to word the second sentence of paragraph 5 in the following way, which would have the effect of ensuring that paragraphs 1 and 2 of the Article did not apply to the interest, which would then typically fall under Article 7 or 21:

~~"Moreover, in the case not settled in paragraph 5 where whichever of the two Contracting States is that of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne together claim the right to tax the interest at the source, there would be nothing to prevent those two States – together with, where appropriate, the State of the beneficiary's residence – from concerting measures to avoid the double taxation that would result from such claims. The proper remedy, it must be said again, would be the establishment between these different States of bilateral conventions, or a multilateral convention, containing a provision similar to that in paragraph 5. Another solution would be for two Contracting States to word the second sentence of paragraph 5 in the following way:~~

Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a State other than that of which he is a resident 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. " [para. 30]

"If two Contracting States agree in bilateral negotiations to reserve to the State where the beneficiary of the income resides the exclusive right to tax such income, then ipso facto there is no value in inserting in the convention which fixes their relations that provision in paragraph 5 which defines the State of source of such income. But it is equally obvious that double taxation would not be fully avoided in such a case if the payer of the interest owned, in a third State which charged its tax at the source on the interest, a permanent establishment for the account of which the loan had been borrowed and which bore the interest payable on it. The case would then be just the same as is contemplated **[**...**]** above." [para. 31]

Paragraph 6

~~23~~**22**. This paragraph reproduces Article 11, paragraph 6, of the OECD Model Convention, the Commentary on which reads as follows:

> "The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of interest in cases 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 paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the ~~a~~**A**rticle apply only to that last-mentioned amount and that the excess part of the interest shall remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention." [para. 32]
>
> "It is clear from the text that for this clause to apply the interest held excessive must be due to a special relationship between the payer and the beneficial owner or between ~~either~~ **both** of them and some other person. There may be cited as examples cases where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9." [para. 33]
>
> "On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest." [para. 34]
>
> "With regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under paragraph 6 of Article 11 it would be necessary to ~~substitute other words for~~ **as a minimum to remove** the **limiting** phrase 'having regard to the debt-claim for which it is paid'. **If greater clarity of intent is felt appropriate, a phrase such as "for whatever reason" might be added after "exceeds". Either of these alternative versions would apply where some or all of an interest payment is excessive because the amount of the loan or the terms relating to it (including the rate of interest) are not what would have been agreed upon in the absence of the special relationship**. Nevertheless, this paragraph can affect not only the recipient but also the payer of ~~the~~ excessive interest and if the law of the State of source permits, the excess amount can be disallowed as a deduction, due regard being had to other applicable provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the interest, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 6, as long as they do not

alter its general purport." [para. 35]

"Should the principles and rules of their respective laws oblige the two Contracting States to apply different ~~a~~**A**rticles of the Convention for the purpose of taxing the excess, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty." [para. 36]

~~24~~**23**. ~~Some~~ **When this issue was last considered, some** members of the **former** Group of Experts pointed out that there are many artificial devices entered into by persons to take advantage of the provisions of ~~a~~**A**rticle 11 through, inter alia, creation or assignment of debt claims in respect of which interest is charged. 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 ~~a~~**A**rticle 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 debt claim in respect of which the interest is paid to take advantage of this ~~a~~**A**rticle by means of that creation or assignment."