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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.

Article 12

ROYALTIES

A. GENERAL CONSIDERATIONS

1. Article 12 of the United Nations Model Convention reproduces Article 12 of the OECD Model Convention, with the following exceptions: first, substantive differences appear in paragraphs 1 and 3; second, paragraphs 2 and 5 do not appear in the OECD Model Convention with the result that the paragraph numbers in the United Nations Model Convention differ from those in the OECD Model Convention; and third, a drafting adjustment is made in paragraph 4.

2. When the user of a patent or similar property is resident in one country and pays royalties to the owner ~~thereof~~ **of the property** who is resident in another country, the amount paid by the user is generally subject to withholding tax in his country, the source country. The source country tax is on the gross payments, with no allowance for any related expenses incurred by the owner. Without recognition of expenses, the owner's after-tax profit may in some cases be only a small percentage of gross royalties. Consequently, the owner may take the withholding tax in the source country into account in fixing the amount of the royalty, so that the user and the source country will pay more for the use of the patent or similar property than they would if the withholding tax levied by the source country were lower and took into account the expenses incurred by the owner. A manufacturing enterprise or an inventor may have spent substantial sums on the development of the property generating the royalties, because the work of research and testing involves considerable capital outlays and does not always yield successful results. The problem of determining the appropriate tax rate to be applied by the source country to gross royalty payments is therefore complex, especially since the user may make a lump sum payment for the use of the patent or similar property, in addition to regular royalty payments.

3. The Commentary on Article 12 of the OECD Model Convention includes the following preliminary remarks:

> "In principle, royalties in respect of licences to use patents and similar property and similar payments are income to the recipient from a letting. The letting may be granted in connection with an ~~industrial and commercial~~ enterprise (e.g.~~,~~ the use of literary copyright granted by a publisher~~)~~ or ~~an independent profession (e.g.,~~ **the** use of a patent granted by the inventor) or quite independently of any activity of the grantor (e.g.~~,~~ use of a patent granted by the inventor's heirs)." [para. 1]
>
> "Certain countries do not allow royalties 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 royalties are 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. 2]

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 12

Paragraphs 1 and 2

4. Paragraph 1 drops the word "only" from the corresponding provision of the OECD Model Convention, which provides that "royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State". Paragraph 2 is an addition flowing logically from the premise underlying paragraph 1, which is that royalties ~~should~~ **may** be taxable in the source country as well as the residence country. ~~A member from a~~**A** developed country has observed that by providing for taxing rights in respect of royalties to be shared between the

State of residence and the State of source, the United Nations Model Convention departs from the principle of exclusive residence State's right to tax provided in the OECD Model Convention. In this context, it should be noted that several member States of OECD have recorded reservations about the approval of exclusive residence State taxation.

~~5. The Group of Experts has amended the provisions of paragraph 2 of article 12 in 1999 to bring it in line with the provisions of paragraph 2 of articles 10 and 11. Prior to the amendment, it was provided that such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, the tax will be charged in the specified manner. The purpose of this amendment is to allow the benefit of this article to the beneficial owner residing in the treaty country regardless of the residence of any agent or other intermediary collecting the income on behalf of the beneficial owner, while continuing to deny this benefit when the beneficial owner was not a resident of the treaty country, even if the intermediary collecting the income was a resident. In this connection, a reference is made to paragraph 5 of the Commentary on article 10.~~

~~6~~**5. The Commentary on the OECD Model Convention contains the following relevant passages:**

Comment [MB1]: The text under the amended paragraph 6 (which reproduces paragraphs 4, 4.1 and 4.2 of the OECD Commentary) was agreed upon at the sixth annual session in 2010.

"The requirement of beneficial ownership was introduced in paragraph 1 of Article 12 to clarify how the Article applies in relation to payments made to intermediaries. It makes plain that the State of source is not obliged to give up taxing rights over royalty 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. 4]

"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'[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. 4.1]

"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, in those cases where 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

[1] Reproduced in Volume II of the loose-leaf version of the OECD Model Tax Convention, at page R(6)-1.

negotiations. [para. 4.2]

6. During discussion by the **former** Group of Experts in 1999, members from developing countries argued that, in order to facilitate the conclusion of tax treaties between those countries and developed countries, the primary right to tax royalties should be given to the country where the income arose, that is, the source country. Patents and processes might be licensed to developing countries after they had been fully exploited elsewhere and, according to these members, after the expenses incurred in connection with their development had already been largely recouped.

7. Members from developed countries responded that it would be unrealistic to assume that enterprises selected the oldest patents for licensing to developing countries. Normally, an enterprise would license its patents to foreign subsidiaries and therefore select the most up-to-date inventions, in the hope of expanding existing markets or opening up new ones. Patents are not merchandise but instruments for promoting industrial production. Several members from developed countries held as a matter of principle that the country of residence of the owner of a patent or similar property should have the exclusive or primary right to tax royalties paid thereon.

8. Since the **former** Group **of Experts** reached no consensus on a particular rate for the withholding tax to be charged on royalties on a gross basis, the rate should be established through bilateral negotiations. The following considerations might be taken into account in negotiations:

First, the country of source should recognize both current expenses allocable to the royalty and expenditure incurred in the development of the property whose use gave rise to the royalty. It should be considered that the costs of developing the property are also allocable to profits derived from other royalties or activities, past or future, associated with these expenditures and that expenditure not directly incurred in the development of that property might nevertheless have contributed significantly to that development;

Second, if an expense ratio is agreed upon in fixing a gross rate in the source country, the country of the recipient, if following a credit method, should also use that expense ratio in applying its credit, whenever feasible. Therefore, that matter should be considered under ~~a~~**A**rticle 23 A or 23 B.

9. Other factors might influence the determination of the withholding tax on gross royalties, including the developing countries' need to earn revenue and conserve foreign exchange; the fact that royalty payments flow almost entirely from developing countries to developed countries; the extent of assistance that developed countries should, for a variety of reasons, extend to developing countries; and the special importance of providing such assistance in the context of royalty payments; the desirability of preventing a shift of the tax burden to the licensees in the licensing arrangement; the ability that taxation at source confers on a developing country to make selective judgements by which, through reduced taxation or exemption, it could encourage those licensing arrangements if they were considered desirable for its development; the lessening of the risks of tax evasion resulting from taxation at the source; the fact that the country of the licensor supplies the facilities and activities necessary for the development of the patent and thus undertakes the risks associated with the patent; the desirability of obtaining and encouraging a flow of technology to developing countries; the desirability of expanding the field of activity of the licensor in the utilization of his research; the benefits that developed countries obtain from world development in general; the relative importance of revenue sacrifice; the relation of the royalty decision to other decisions in the negotiations.

10. Income from film rentals should not be treated as industrial and commercial profits but should be dealt with in the context of royalties. The tax would thus be levied on a gross basis but expenses would be taken into account in fixing the withholding rate. With regard to expenses, there are factors that could be regarded as peculiarly relevant to film rentals. As a general rule, the expenses of film producers might be much higher and the profits lower than in the case of industrial royalties. On the other

hand, because a considerable part of film expenses represents high salaries paid to actors and other participants who were taxed solely by the country of residence, and not by the source country, these expenses might not justify any great reduction of the withholding tax at source. However, it could be said that the amounts involved were nevertheless real costs for the producer and should be taken into account, while at the same time all countries involved should join in efforts to make sure that such income did not escape tax. Further, while the write-off of expenses in the country of residence did not mean that the expenses should not be taken into account at source, at some point old films could present a different expense situation.

11. Some members of the **former** Group **of Experts** ~~believe~~ **expressed** that because copyright royalties represent cultural efforts, they should be exempted from taxation by the source country. Other members, however, argue**d** that tax would be levied by the residence country, and the reduction at source would not benefit the author. Other members favour exempting copyright royalties at the source, not necessarily for cultural reasons, but because the country of residence is in a better position to evaluate the expenses and personal circumstances of the creator of the royalties, including the period over which the books or other copyrighted items had been created; a reduction of the source country tax could be supported in some cases by the fact that the tax was too high to be absorbed by the tax credit of the residence country. However, source countries might not be willing to accept that approach to the problem. Furthermore, if the person dealing with the source country might be the publisher and not the author, arguments supporting the exemption of the author's income because of his personal situation obviously do not apply to the publisher.

Paragraph 3

12. This paragraph reproduces Article 12, paragraph 2, of the OECD Model Convention, but does not incorporate the 1992 amendment thereto which eliminates equipment rental from this ~~a~~**A**rticle, and paragraph 3 of ~~a~~**A**rticle 12 includes payments for tapes and royalties which are not included in the corresponding provision of the OECD Model Convention. The following portions of the OECD Commentary are relevant (the bracketed paragraphs being portions of the Commentary that ~~on the 1977 OECD Model Convention that are omitted from or altered in the present OECD Commentary~~**highlight differences between the U**nited **N**ations Model Convention **and** the OECD **Model Convention**):

> "Paragraph 2 contains a definition of the term 'royalties'. These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of intellectual property specified in the text and ~~industrial and commercial property specified in the text and~~ information concerning industrial, commercial or scientific experience. The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been, or are required to be, registered in a public register. The definition covers both payments made under a licen**sc**e and compensation which a person would be obliged to pay for fraudulently copying or infringing the right~~. . . . [T]he word 'payment', used in the definition, 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. As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, [equipment renting and] the provision of information~~" [para 8]
>
> **As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other Articles of the Convention, as regards, in particular, [equipment renting and] the provision of information." [para. 8.4]**
>
> Comment [MB2]: Corresponds to last sentences from former OECD paragraph 8.
>
> "Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as ~~industrial and~~

~~commercial~~ **business** profits and, in consequence, subjected to the provisions of Articles 7 and 9." [para. 10]

In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 ~~alludes~~ **is referring** to the concept of "know-how". Various specialist bodies and authors have formulated definitions of know-how ~~which do not differ intrinsically. One such definition, given by the 'Association des Bureaux pour la Protection de la Propriété Industrielle' (ANBPPI), states that 'know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique'.~~. **The words "payments […] for information concerning industrial, commercial or scientific experience" are used in the context of the transfer of certain information that has not been patented and does not generally fall within other categories of intellectual property rights. It generally corresponds to undivulged information of an industrial, commercial or scientific nature arising from previous experience, which has practical application in the operation of an enterprise and from the disclosure of which an economic benefit can be derived. Since the definition relates to information concerning previous experience, the Article does not apply to payments for new information obtained as a result of performing services at the request of the payer.**" [para 11]

"In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof." **[para 11.1]**

Comment [MB3]: OECD paragraph 11.1 was formerly part of OECD paragraph 11.

This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. ~~Thus, payments obtained as consideration for after sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for an opinion given by an engineer, advocate or an accountant, do not constitute royalties within the meaning of paragraph 2. Such payments~~**Payments made under the latter contracts** generally fall under Article 7 **or in the case of the UN Model** Article 14. [**para 11.2**]"

Comment [MB4]: Parts of OECD paragraph 11.2 was part of former paragraph 11.

"The need to distinguish these two types of payments, i.e. payments for the supply of know-how and payments for the provision of services, sometimes gives rise to practical difficulties. The following criteria are relevant for the purpose of making that distinction:

- **Contracts for the supply of know-how concern information of the kind described in paragraph 11 that already exists or concern the supply of that type of information after its development or creation and include specific provisions concerning the confidentiality of that information.**
- **In the case of contracts for the provision of services, the supplier undertakes to perform services which may require the use, by that supplier, of special knowledge, skill and expertise but not the transfer of such special knowledge, skill or expertise to the other party.**
- **In most cases involving the supply of know-how, there would generally be very little more which needs to be done by the supplier under the contract other than to supply existing information or reproduce existing material. On the other hand, a contract for the performance of services would, in the majority of cases, involve a**

very much greater level of expenditure by the supplier in order to perform his contractual obligations. For instance, the supplier, depending on the nature of the services to be rendered, may have to incur salaries and wages for employees engaged in researching, designing, testing, drawing and other associated activities or payments to sub-contractors for the performance of similar services". [para 11.3]

"Examples of payments which should therefore not be considered to be received as consideration for the provision of know-how but, rather, for the provision of services, include:

- **payments obtained as consideration for after-sales service,**
- **payments for services rendered by a seller to the purchaser under a warranty,**
- **payments for pure technical assistance,**
- **payments for a list of potential customers, when such a list is developed specifically for the payer out of generally available information (a payment for the confidential list of customers to which the payee has provided a particular product or service would, however, constitute a payment for know-how as it would relate to the commercial experience of the payee in dealing with these customers),**
- **payments for an opinion given by an engineer, an advocate or an accountant, and**
- **payments for advice provided electronically, for electronic communications with technicians or for accessing, through computer networks, a trouble-shooting database such as a database that provides users of software with nonconfidential information in response to frequently asked questions or common problems that arise frequently". [para. 11.4]**

"In the particular case of a contract involving the provision, by the supplier, of information concerning computer programming, as a general rule the payment will only be considered to be made in consideration for the provision of such information so as to constitute know-how where it is made to acquire information constituting ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques, where this information is provided under the condition that the customer not disclose it without authorisation and where it is subject to any available trade secret protection". [para. 11.5]

"In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then ~~it seems possible to apply to the whole amount of the consideration~~the treatment applicable to the principal **part should generally be applied to the whole amount of the consideration**". [**para 11.6**]

Comment [MB5]: Most of paragraph 11.6 was part of former paragraph 11.

~~"Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. Software may be described as a program, or series of programs, containing~~

~~instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing, on a magnetic tape or disk, or on a laser disk. It may be standardized with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware. The rights in computer software are a form of intellectual property. Research into the practices of OECD Member countries has established that all but one protect software rights either explicitly or implicitly under copyright law. Transfers of rights occur in many different ways ranging from the alienation of the entire rights to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment." [para. 12]~~

Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. In 1992, the Commentary was amended to describe the principles by which such classification should be made. Paragraphs 12 to 17 were further amended in 2000 to refine the analysis by which business profits are distinguished from royalties in computer software transactions. In most cases, the revised analysis will not result in a different outcome". [para 12]

"Software may be described as a program, or series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing or electronically, on a magnetic tape or disk, or on a laser disk or CD-Rom. It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware". [para. 12.1]

"The character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer programs are a form of intellectual property. Research into the practices of OECD member countries has established that all but one protects rights in computer programs either explicitly or implicitly under copyright law. Although the term "computer software" is commonly used to describe both the program — in which the intellectual property rights (copyright) subsist — and the medium on which it is embodied, the copyright law of most OECD member countries recognises a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program. Transfers of rights in relation to software occur in many different ways ranging from the alienation of the entire rights in the copyright in a program to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be regarded as royalties and other types of payment. The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software". [para. 12.2]

~~"Three situations are considered. The first is of payments made where less than the full rights in software are transferred. In a partial transfer of rights the consideration is likely to represent a royalty only in very limited circumstances. One such case is where the transferor is the author of the software (or has acquired from the author his rights of distribution and reproduction) and he has placed part of his rights at the disposal of a third party to enable the latter to develop or exploit the software itself commercially, for example by development and distribution of it . . . [E]ven where a software payment is properly to be regarded as a royalty there are difficulties in applying the copyright provisions of the Article to software royalties since paragraph [3] requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt but treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of copyrights or refers specifically to software." [para. 13]~~

The transferee's rights will in most cases consist of partial rights or complete rights in the underlying copyright (see paragraphs 13.1 and 15 below), or they may be (or be equivalent to) partial or complete rights in a copy of the program (the "program copy"), whether or not such copy is embodied in a material medium or provided electronically (see paragraphs 14 to 14.2 below). In unusual cases, the transaction may represent a transfer of "know-how" or secret formula (paragraph 14.3)". [para. 13]

"Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payments are for the right to use the copyright in the program (i.e. to exploit the rights that would otherwise be the sole prerogative of the copyright holder). It should be noted that where a software payment is properly to be regarded as a royalty there may be difficulties in applying the copyright provisions of the Article to software payments since paragraph 2 requires that software be classified as a literary, artistic or scientific work. None of these categories seems entirely apt. The copyright laws of many countries deal with this problem by specifically classifying software as a literary or scientific work. For other countries treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of the copyrights or refers specifically to software". [para 13.1]

~~"In other cases, the acquisition of the software will generally be for the personal or business use of the purchaser. The payment will then fall to be dealt with as commercial income in accordance with Articles 7 or 14. It is of no relevance that the software is protected by copyright or that there may be restrictions on the use to which the purchaser can put it." [para. 14]~~

In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in

relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as commercial income in accordance with Article 7". [para. 14]

"The method of transferring the computer program to the transferee is not relevant. For example, it does not matter whether the transferee acquires a computer disk containing a copy of the program or directly receives a copy on the hard disk of her computer via a modem connection. It is also of no relevance that there may be restrictions on the use to which the transferee can put the software". [para. 14.1]

"The ease of reproducing computer programs has resulted in distribution arrangements in which the transferee obtains rights to make multiple copies of the program for operation only within its own business. Such arrangements are commonly referred to as "site licences", "enterprise licenses", or "network licences". Although these arrangements permit the making of multiple copies of the program, such rights are generally limited to those necessary for the purpose of enabling the operation of the program on the licensee's computers or network, and reproduction for any other purpose is not permitted under the license. Payments under such arrangements will in most cases be dealt with as business profits in accordance with Article 7". [para. 14.2]

"Another type of transaction involving the transfer of computer software is the more unusual case where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. In these cases, the payments may be characterised as royalties to the extent that they represent consideration for the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience which cannot be separately copyrighted. This contrasts with the ordinary case in which a program copy is acquired for operation by the end user". [para. 14.3]

"Arrangements between a software copyright holder and a distribution intermediary frequently will grant to the distribution intermediary the right to distribute copies of the program without the right to reproduce that program. In these transactions, the rights acquired in relation to the copyright are limited to those necessary for the commercial intermediary to distribute copies of the software program. In such transactions, distributors are paying only for the acquisition of the software copies and not to exploit any right in the software copyrights. Thus, in a transaction where a distributor makes payments to acquire and distribute software copies (without the right to reproduce the software), the rights in relation to these acts of distribution should be disregarded in analysing the character of the transaction for tax purposes. Payments in these types of transactions would be dealt with as business profits in accordance with Article 7. This would be the case regardless of whether the copies being distributed are delivered on tangible media or are distributed electronically (without the distributor

having the right to reproduce the software), or whether the software is subject to minor customisation for the purposes of its installation". [para. 14.4]

"~~The second situation is where the payments are made as consideration for the alienation of rights attached to the software. It is clear that where~~**Where** consideration is paid for the transfer of the full ownership **of the rights in the copyright**, the payment cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there ~~are extensive but partial alienation~~ **is a transfer** of rights involving:

— exclusive right of use **of the copyright** during a specific period or in a limited geographical area;

— additional consideration related to usage;

— consideration in the form of a substantial lump sum payment". [para. 15]

"Each case will depend on its particular facts but in general **if the payment is in consideration for the transfer of rights that constitute a distinct and specific property (which is more likely in the case of geographically-limited than time-limited rights),** such payments are likely to be ~~commercial income~~ **business profits** within Article 7 **(**or 14 **in the case of the UN Model)** or a capital gain~~s matter~~ within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated ~~in full or in part~~, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in instalments or, in the view of most countries, by the fact that the payments are related to a contingency". [para 16]

"~~The third situation is where software~~**Software** payments ~~are~~ **may be** made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods set out in paragraph 11 above for dealing with similar problems in relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part". [para. 17]

"The principles expressed above as regards software payments are also applicable as regards transactions concerning other types of digital products such as images, sounds or text. The development of electronic commerce has multiplied the number of such transactions. In deciding whether or not payments arising in these transactions constitute royalties, the main question to be addressed is the identification of that for which the payment is essentially made". [para. 17.1]

"Under the relevant legislation of some countries, transactions which permit the customer to electronically download digital products may give rise to use of copyright by the customer, e.g. because a right to make one or more copies of the digital content is granted under the contract. Where the consideration is essentially for something other than for the use of, or right to use, rights in the copyright (such as to acquire other types of contractual rights, data or services), and the use of copyright is limited to such rights as are required to enable downloading, storage and operation on the customer's computer, network or other storage, performance or display device, such use of copyright should not affect the analysis of the character of the payment for purposes of applying the definition of 'royalties'". [para. 17.2]

"This is the case for transactions that permit the customer (which may be an enterprise) to electronically download digital products (such as software, images, sounds or text) for that customer's own use or enjoyment. In these transactions, the payment is

essentially for the acquisition of data transmitted in the form of a digital signal and therefore does not constitute royalties but falls within Article 7 or Article 13, as the case may be. To the extent that the act of copying the digital signal onto the customer's hard disk or other non-temporary media involves the use of a copyright by the customer under the relevant law and contractual arrangements, such copying is merely the means by which the digital signal is captured and stored. This use of copyright is not important for classification purposes because it does not correspond to what the payment is essentially in consideration for (i.e. to acquire data transmitted in the form of a digital signal), which is the determining factor for the purposes of the definition of royalties. There also would be no basis to classify such transactions as "royalties" if, under the relevant law and contractual arrangements, the creation of a copy is regarded as a use of copyright by the provider rather than by the customer". [para. 17.3]

"By contrast, transactions where the essential consideration for the payment is the granting of the right to use a copyright in a digital product that is electronically downloaded for that purpose will give rise to royalties. This would be the case, for example, of a book publisher who would pay to acquire the right to reproduce a copyrighted picture that it would electronically download for the purposes of including it on the cover of a book that it is producing. In this transaction, the essential consideration for the payment is the acquisition of rights to use the copyright in the digital product, i.e. the right to reproduce and distribute the picture, and not merely for the acquisition of the digital content". [para. 17.4]

"The suggestions made above regarding mixed contracts could also be applied in regard to certain performances by artists and, in particular, in regard to an orchestral concert given by a conductor or a recital given by a musician. The fee for the musical performance, together with that paid for any simultaneous radio broadcasting thereof, seems to fall to be treated under Article 17. Where, whether under the same contract or under a separate one, the musical performance is recorded and the artist has stipulated that he be paid royalties on the sale or public playing of the records, then so much of the payment received by him as consists of such royalties falls to be treated under Article 12 w**here, however, the copyright in a sound recording, because of either the relevant copyright law or the terms of contract, belongs to a person with whom the artist has contractually agreed to provide his services (i.e. a musical performance during the recording), or to a third party, the payments made under such a contract fall under Articles 7 [or Article 14 of the UN Model] (e.g. if the performance takes place outside the State of source of the payment) or 17 rather than under this Article, even if these payments are contingent on the sale of the recordings."** [para. 18]

"It is further pointed out that variable or fixed payments for the working of mineral deposits, sources or other natural resources are governed by Article 6 and do not, therefore, fall within the present Article." ~~[If two Contracting States should have difficulty from the legal standpoint in applying this distinction in regard to consideration for the use of, or the right to use, equipment, they could add to the text of paragraph 2, after the words 'industrial, commercial or scientific equipment', the words 'not constituting immovable property referred to in Article 6'.]"~~ [para. 19]

~~13. Reference is made to the revision of the Commentary on Article 12 concerning software payments that has been approved by the OECD Fiscal Affairs Committee which would replace the Commentary quoted above.~~

~~14~~**13**. Paragraph 2 of Article 12 of the OECD Model Convention (corresponding to paragraph 3 of ~~a~~**A**rticle 12 of the United Nations Model Convention) was amended by deleting the words "or the use of, or the right to use, industrial, commercial or scientific equipment" by the Report entitled "The

Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. However, a number of OECD member countries have entered reservations on this point.

~~15~~**14**. **When** ~~T~~**t**he **former** Group **of Experts** considered **this issue it** ~~**considered**~~ **addressed** the problems of distinguishing royalties from types of income properly subject to other articles of the Convention. A member from a developed country asserted that the problem was that the "royalties" definition makes an imperfect distinction between revenues that constituted royalties in the strict sense and payments received for brain-work and technical services, such as surveys of any kind (engineering, geological research etc.). The member also mentioned the problem of distinguishing between royalties akin to income from capital and payments received for services. Given the broad definition of "information concerning industrial, commercial or scientific experience", some countries tend to regard the provision of brain-work and technical services as the provision of "information concerning industrial, commercial or scientific experience" and to regard payment for it as royalties.

~~16~~**15**. In order to avoid those difficulties, this member proposed that the definition of royalties be restricted by excluding payments received for "information concerning industrial, commercial or scientific experience". The member also suggested that a protocol should be annexed to the treaty making it clear that such payments should be deemed to be profits of an enterprise to which ~~a~~**A**rticle 7 would apply and that payments received for studies or surveys of a scientific or technical nature, such as geological surveys, or for consultant or supervisory services, should also be deemed to be business profits subject to ~~a~~**A**rticle 7. The effect of these provisions would be that the source country could not tax such payments unless the enterprise had a permanent establishment in that country and that taxes should only be imposed on the net income element of such payments attributable to that permanent establishment.

~~17~~**16**. Some members from developing countries interpreted the phrase "information concerning industrial, commercial or scientific experience" to mean specialized knowledge, having intrinsic property value relating to industrial, commercial, or managerial processes, conveyed in the form of instructions, advice, teaching or formulas, plans or models, permitting the use or application of experience gathered on a particular subject. They also pointed out that the definition of the term royalties could be broadened through bilateral negotiations to include gains derived from the alienation of any such right or property that were contingent on the productivity, use or disposition thereof. The **former** Group **of Experts** agreed that literary copyrights could be interpreted to include copyrights relating to international news.

Paragraph 4

~~18~~**17**. This paragraph reproduces with modifications Article 12, paragraph 3, of the OECD Model Convention, which states that paragraph 1 does not apply to royalties beneficially owned by a person having a permanent establishment or ~~permanent~~ **a fixed** base in the source country if the right or property from which the royalties derive is effectively connected with the permanent establishment or fixed base. The **former** Group **of Experts** decided to modify paragraph 3 of the OECD Model Convention by introducing a limited force of attraction principle. In addition to royalties excluded from the application of paragraph 1 by paragraph 3 of the OECD Article, paragraph 4 of the United Nations Model Convention excludes royalties which are received in connection with business activities described in subparagraph (c) of paragraph 1 of ~~a~~**A**rticle 7 (business activities of the same or similar kind as those of a permanent establishment in the source country), even if the business activities are not carried on through a permanent establishment or a fixed base. The United Nations Model Convention also modifies the paragraph to refer to paragraph 2 as well as paragraph 1.

Paragraph 5

~~19~~**18**. **This** paragraph, which provides that royalties are considered income from sources in the residence country of the payer of the royalties, is an innovation of the United Nations Model Convention, not found in Article 12 of the OECD Model Convention.

~~20~~**19**. As in the case of interest, some members suggested that some countries may wish to substitute a rule that would identify the source of a royalty as the State in which the property or right giving rise to the royalty (the patent etc.) is used. Where, in bilateral negotiations, the two parties differ on the appropriate rule, a possible solution would be a rule which, in general, would accept the payer's place of residence as the source of royalty; but where the right or property for which the royalty was paid was used in the State having a place of use rule, the royalty would be deemed to arise in that State.

Paragraph 6

~~21~~**20**. This paragraph reproduces Article 12, paragraph 4, 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 royalties 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 royalties 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 Article apply only to that last-mentioned amount and that the excess part of the royalty shall remain taxable according to the laws of the two Contracting States~~,~~ due regard being had to the other provisions of the Convention**. The paragraph permits only the adjustment of the amount of royalties and not the reclassification of the royalties in such a way as to give it a different character, e.g. a contribution to equity capital. For such an adjustment to be possible under paragraph 4 of Article 12 it would be necessary as a minimum to remove the limiting phrase "having regard to the use, right or information for which they are paid". If greater clarity of intent is felt appropriate, a phrase such as "for whatever reason" might be added after "exceeds"." [para. 22]**
>
> "It is clear from the text that for this clause to apply the payment held excessive must be due to a special relationship between the payer and the beneficial owner or between both of them and some other person. There may be cited as examples cases where royalties are 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. 23]
>
> "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 royalty." [para. 24]
>
> "With regard to the taxation treatment to be applied to the excess part of the royalty, 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 purpose of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases required, to the excess part of the royalties there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 4, as long as they do not alter its general purport." [para. 25]
>
> "Should the principles and rules of their respective laws oblige the two Contracting States to apply different Articles 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. 26]

~~22~~**21**. **When this issue was last considered by the former Group of Experts, s**ome members ~~of the Group of Experts~~ pointed out that there are very artificial devices entered into by persons to take advantage of the provisions of ~~a~~**A**rticle 12 through, inter alia, creation or assignment of agreements for the use, right or information with respect to intangible assets for which royalties are charged. While substance over form rules, abuse of rights principles 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:

> "The provisions of this ~~a~~**A**rticle shall not apply if it was the main purpose, or one of the main purposes, of any persons concerned with the creation or the assignment of the rights in respect of which the royalties are paid to take advantage of this ~~a~~**A**rticle by means of that creation or assignment."

Article 13

CAPITAL GAINS

A. GENERAL CONSIDERATIONS

1. Article 13 of the United Nations Model Convention consists of the first three paragraphs of Article 13 of the OECD Model Convention.~~, followed by two new paragraphs (paragraphs 4 and 5) and by the text of Article 13, paragraph 4~~**5**~~, of the OECD Model Convention renumbered as paragraph 6 and adjusted to take into account the insertion of the two new paragraphs.~~ **Paragraph 4 broadly corresponds with paragraph 4 of the OECD Model Convention and paragraph 5 is a distinct provision in the UN Model. Paragraph 6 is the same as paragraph 5 of the OECD Model Convention but adjusted to take into account the insertion of the additional paragraph.**

2. The text of this ~~a~~**A**rticle resulted from a compromise which the **former** Group **of Experts** felt would be most acceptable to both developed and developing countries. Some members from developed countries advocated the use of Article 13 of the OECD Model Convention, which (1) allows the source country to tax capital gains from the alienation of immovable property and from movable property that is a part of a permanent establishment or pertains to a fixed base for performing independent personal services, (2) permits gains from the alienation of ships and aircraft to be taxed only in the State of effective management of the relevant enterprises, and (3) reserves to the residence country the right to tax gains on other forms of alienable property. Most members from developing countries advocated the right of the source country to levy a tax in situations in which the OECD reserves that right to the country of residence.

3. Concerning the taxation of capital gains in both developed and developing countries, the following remarks from the preliminary remarks in the Commentary on Article 13 of the OECD Model Convention are pertinent:

> ***1.*** ~~"~~A comparison of the tax laws of the OECD ~~M~~**m**ember countries shows that the taxation of capital gains varies considerably from country to country:
>
> — in some countries capital gains are not deemed to be taxable income;
>
> — in other countries capital gains accrued to an enterprise are taxed, but capital gains made by an individual outside the course of his trade or business are not taxed;
>
> — even where capital gains made by an individual outside the course of his trade or business are taxed, such taxation often applies only in specified cases, e.g., profits from the sale of immovable property or speculative gains (where an asset was bought to be resold).~~" [para. 1]~~
>
> ***2.*** ~~"~~Moreover, the taxes on capital gains vary from country to country. In some OECD ~~M~~**m**ember countries, capital gains are taxed as ordinary income and therefore added to the income from other sources. This applies especially to the capital gains made by the alienation of

assets of an enterprise. In a number of OECD ~~M~~member countries, however, capital gains are subjected to special taxes, such as taxes on profits from the alienation of immovable property, or general capital gains taxes, or taxes on capital appreciation (increment taxes). Such taxes are levied on each capital gain or on the sum of the capital gains accrued during a year, mostly at special rates, which do not take into account the other income (or losses) of the taxpayer. It does not seem necessary to describe all those taxes.~~” [para. 2]~~

3. ~~“~~The Article does not deal with the above-mentioned questions. It is left to the domestic law of each Contracting State to decide whether capital gains should be taxed and, if they are taxable, how they are to be taxed. The Article can in no way be construed as giving a State the right to tax capital gains if such right is not provided for in its domestic law. The Article does not specify to what kind of tax it applies. It is understood that the Article must apply to all kinds of taxes levied by a Contracting State on capital gains. The wording of Article 2 is large enough to achieve this aim and to include also special taxes on capital gains.~~” [para. 3]~~

4. The OECD Commentary on Article 13 contains the following general remarks:

4. ~~“~~It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom. The right to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such gain is a capital gain or a business profit. Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the ~~a~~Article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question.~~” [para. 4]~~

5. ~~“~~The Article does not give a detailed definition of capital gains. This is not necessary for the reasons mentioned above. The words ‘alienation of property’ are used to cover in particular capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.~~” [para. 5]~~

6. ~~“~~Most States taxing capital gains do so when an alienation of capital assets takes place. Some of them, however, tax only so-called reali~~z~~sed capital gains. Under certain circumstances, though there is an alienation no reali~~z~~sed capital gain is recogni~~z~~sed for tax purposes (e.g., when the alienation proceeds are used for acquiring new assets). Whether or not there is a reali~~z~~sation has to be determined according to the applicable domestic tax law. No particular problems arise when the State which has the right to tax does not exercise it at the time the alienation takes place.~~” [para. 6]~~

7. ~~“~~As a rule, appreciation in value not associated with the alienation of a capital asset is not taxed, since, as long as the owner still holds the asset in question, the capital gain exists only on paper. There are, however, tax laws under which capital appreciation and revaluation of business assets are taxed even if there is no alienation.~~” [para. 7]~~

8. ~~“~~Special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated. This may be the case if the value of a capital asset has increased in such a manner that the owner proceeds to the revaluation of this asset in his books. Such revaluation of assets in the books may also occur in the case of a depreciation of the national currency. A number of States levy special taxes on such book profits, amounts put into reserve, an increase in the paid-up capital and other revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset. These taxes on capital appreciation (increment taxes) are covered by the Convention according to Article 2.~~” [para. 8]~~

9. ~~“~~Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the Article or to lay down special rules. The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment **[**or pertaining to a fixed base**]**, the prior right to tax belongs to the State where such property is situated. Special attention must be drawn, however, to the cases dealt with in paragraphs 13 to 17 below.~~” [para. 9]~~

10. “In some States the transfer of an asset from a permanent establishment situated in the territory of such State to a permanent establishment or the head office of the same enterprise situated in another State is assimilated to an alienation of property. The Article does not prevent these States from taxing profits or gains deemed to arise in connection with such a transfer, provided, however, that such taxation is in accordance with Article 7.~~” [para. 10]~~

11. “The Article does not distinguish as to the origin of the capital gain. Therefore all capital gains, those accruing over a long term, parallel to a steady improvement in economic conditions, as well as those accruing in a very short period (speculative gains)~~,~~ are covered. Also capital gains which are due to depreciation of the national currency are covered. It is, of course, left to each State to decide whether or not such gains should be taxed.~~” [para. 11]~~

12. “The Article does not specify how to compute a capital gain, this being left to the domestic law applicable. As a rule, capital gains are calculated by deducting the cost from the selling price. To arrive at cost all expenses incidental to the purchase and all expenditure for improvements are added to the purchase price. In some cases the cost after deduction of the depreciation allowances already given is taken into account. Some tax laws prescribe another base instead of cost, e.g., the value previously reported by the alienator of the asset for capital tax purposes.~~” [para. 12]~~

13. “Special problems may arise when the basis for the taxation of capital gains is not uniform in the two Contracting States. The capital gain from the alienation of an asset computed in one State according to the rules mentioned in paragraph 12 above, may not necessarily coincide with the capital gain computed in the other State under the accounting rules used there. This may occur when one State has the right to tax capital gains because it is the State of situs while the other State has the right to tax because the enterprise is a resident of that other State.~~” [para. 13]~~

14. “The following example may illustrate this problem: an enterprise of State A bought immovable property situated in State B. The enterprise may have entered depreciation allowances in the books kept in State A. If such immovable property is sold at a price which is above cost, a capital gain may be reali~~z~~**s**ed and, in addition, the depreciation allowances granted earlier may be recovered. State B, in which the immovable property is situated and where no books are kept, does not have to take into account, when taxing the income from the immovable property, the depreciation allowances booked in State A. Neither can State B substitute the value of the immovable property shown in the books kept in State A for the cost at the time of the alienation. State B cannot, therefore, tax the depreciation allowances reali~~z~~**s**ed in addition to the capital gain as mentioned in paragraph 12 above.~~” [para. 14]~~

15. “On the other hand, State A~~,~~ of which the alienator is a resident, cannot be obliged in all cases to exempt such book profits fully from its taxes under paragraph 1 of the Article and Article 23 A (there will be hardly any problems for States applying the tax credit method). To the extent that such book profits are due to the reali~~z~~**s**ation of the depreciation allowances previously claimed in State A and which had reduced the income or profits taxable in such State A, that State cannot be prevented from taxing such book profits **[**…**]**~~” [para. 15]~~

16. ~~"~~Further problems may arise in connection with profits due to changes of the rate of exchange between the currencies of State A and State B. After the devaluation of the currency of State A, enterprises of such State A may, or may have to, increase the book value of the assets situated outside the territory of State A. Apart from any devaluation of the currency of a State, the usual fluctuations of the rate of exchange may give rise to so-called currency gains or losses. Take for example an enterprise of State A having bought and sold immovable property situated in State B. If the cost and the selling price, both expressed in the currency of State B, are equal, there will be no capital gain in State B. When the value of the currency of State B has risen between the purchase and the sale of the asset in relation to the currency of State A, in the currency of that State a profit will accrue to such enterprise. If the value of the currency of State B has fallen in the meantime, the alienator will sustain a loss which will not be recogni~~z~~**s**ed in State B. Such currency gains or losses may also arise in connection with claims and debts contracted in a foreign currency. If the balance sheet of a permanent establishment situated in State B of an enterprise of State A shows claims and debts expressed in the currency of State B, the books of the permanent establishment do not show any gain or loss when repayments are made. Changes of the rate of exchange may be reflected, however, in the accounts of the head office. If the value of the currency of State B has risen (fallen) between the time the claim has originated and its repayment, the enterprise, as a whole will realize a gain (sustain a loss). This is true also with respect to debts if between the time they have originated and their repayment, the currency of State B has fallen (risen) in value.~~" [para. 16]~~

17. ~~"~~The provisions of the ~~a~~**A**rticle do not settle all questions regarding the taxation of such currency gains. Such gains are in most cases not connected with an alienation of the asset; they may often not even be determined in the State on which the right to tax capital gains is conferred by the Article. Accordingly, the question, as a rule, is not whether the State in which a permanent establishment is situated has a right to tax, but whether the State of which the taxpayer is a resident must, if applying the exemption method, refrain from taxing such currency gains which, in many cases, cannot be shown but in the books kept in the head office. The answer to that latter question depends not only on the Article but also on Article 7 and on Article 23 A. If in a given case differing opinions of two States should result in an actual double taxation, the case should be settled under the mutual agreement procedure provided for by Article 25.~~" [para. 17]~~

18. ~~"~~Moreover~~,~~ the question arises which Article should apply when there is paid for property sold an annuity during the lifetime of the alienator and not a fixed price. Are such annuity payments, as far as they exceed costs, to be dealt with as a gain from the alienation of the property or as 'income not dealt with' according to Article 21? Both opinions may be supported by arguments of equivalent weight, and it seems difficult to give one rule on the matter. In addition such problems are rare in practice, so it therefore seems unnecessary to establish a rule for insertion in the Convention. It may be left to Contracting States~~,~~ who may be involved in such a question~~,~~ to adopt a solution in the mutual agreement procedure provided for by Article 25.~~" [para. 18]~~

19. ~~"~~The Article is not intended to apply to prizes in a lottery or to premiums and prizes attaching to bonds or debentures.~~" [para. 19]~~

20. ~~"~~The Article deals first with the gains which may be taxed in the State where the alienated property is situated. For all other capital gains, paragraph [6] gives the right to tax to the State of which the alienator is a resident.~~" [para. 20]~~

21. ~~"~~As capital gains are not taxed by all States, it may be considered reasonable to avoid only actual double taxation of capital gains. Therefore, Contracting States are free to supplement their bilateral convention in such a way that a State has to for**e**go its right to tax conferred on it by the domestic laws only if the other State on which the right to tax is conferred by the Convention makes use thereof. In such a case, paragraph [6] of the Article should be supplemented accordingly. Besides, a modification of Article 23 A as suggested in **[**…**]** the Commentary on Article 23 A is needed.~~” [para. 21]~~

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 13

Paragraph 1

5. This paragraph reproduces Article 13, paragraph 1, of the OECD Model Convention, the Commentary on which is as follows:

22. ~~“~~Paragraph 1 states that gains from the alienation of immovable property may be taxed in the State in which it is situated. This rule corresponds to the provisions of Article 6 and of paragraph 1 of Article 22. It applies also to immovable property forming part of the assets of an enterprise **[**or used for performing independent personal services**].** For the definition of immovable property paragraph 1 refers to Article 6. Paragraph 1 of Article 13 deals only with gains which a resident of a Contracting State derives from the alienation of immovable property situated in the other Contracting State. It does not, therefore, apply to gains derived from the alienation of immovable property situated in the Contracting State of which the alienator is a resident in the meaning of Article 4 or situated in a third State; the provisions of paragraph **5 [paragraph 6 of the United Nations text]** ~~1 of Article 21~~ shall apply to such gains **(and not, as was mentioned in this Commentary before 2002, those of paragraph 1 of Article 21**.~~” [para. 22]~~

23. ~~“~~**The rules of paragraph 1 are supplemented by those of paragraph 4, which applies to gains from the alienation of all or part of the shares in a company holding immovable property [...]**~~Certain tax laws assimilate the alienation of all or part of the shares in a company, the exclusive or main aim of which is to hold immovable property, to the alienation of such immovable property. In itself paragraph 1 does not allow that practice: a special provision in the bilateral convention can alone provide for such an assimilation. Contracting States are of course free either to include in their bilateral conventions such special provision; or to confirm expressly that the alienation of shares cannot be assimilated to the alienation of the immovable property”. [para. 23]~~

Paragraph 2

6. This paragraph reproduces Article 13, paragraph 2, of the OECD Model Convention, the Commentary on which reads as follows:

24. ~~“~~Paragraph 2 deals with movable property forming part of the business property of a permanent establishment of an enterprise **[**or pertaining to a fixed base used for performing independent personal services**]**. The term ‘movable property’ means all property other than immovable property which is dealt with in paragraph 1. It includes also incorporeal property, such as goodwill, licences, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment **[**or fixed base**]** is situated, which corresponds to the rules for business profits **[**and for income from independent personal services**]** (Article**[**s**]** 7 **[**and 14**]**)~~” [para. 24]~~

25. “The paragraph makes clear that its rules apply when movable property of a permanent establishment **[**or fixed base**]** is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) **[**or the fixed base as such**]** is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment. The rules of Article 7 should then apply mutatis mutandis without express reference thereto. For the transfer of an asset from a permanent establishment in one State to a permanent establishment (or the head office) in another State, ~~cf.~~ **see** paragraph 10 above.~~” [para. 25]~~

26. “On the other hand, paragraph 2 may not always be applicable to capital gains from the alienation of a participation in an enterprise. The provision applies only to property which was owned by the alienator, either wholly or jointly with another person. Under the laws of some countries, capital assets of a partnership are considered to be owned by the partners. Under some other laws, however, partnerships and other associations are treated as body corporate for tax purposes, distinct from their partners (members), which means that participation**s** in such entities are dealt with in the same way as shares in a company. Capital gains from the alienation of such participation**s,** like capital gains from the alienation of shares, are therefore taxable only in the State of residence of the alienator. Contracting States may agree bilaterally on special rules governing the taxation of capital gains from the alienation of a participation in a partnership.~~” [para. 26]~~

27. “Certain States consider that all capital gains arising from sources in their territory should be subject to their taxes according to their domestic laws, if the alienator has a permanent establishment within their territory. Paragraph 2 is not based on such a conception which is sometimes referred to as ‘the force of attraction of the permanent establishment’. The paragraph merely provides that gains from the alienation of movable property forming part of the business property of a permanent establishment **[**or of movable property pertaining to a fixed base used for performing independent personal services**]** may be taxed in the State where the permanent establishment **[**or the fixed base**]** is situated. The gains from the alienation of all other movable property are taxable only in the State of residence of the alienator as provided in paragraph **45** [paragraph 6 of the United Nations text]. The foregoing explanations accord with those in the Commentary on Article 7.~~” [para. 27]~~

Paragraph 3

7. This paragraph reproduces Article 13, paragraph 3, of the OECD Model Convention, the Commentary on which is as follows:

28. “An exception from the rule of paragraph 2 is provided for ships and aircraft operated in international traffic and for boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, aircraft and boats. **Normally,**~~G~~**g**ains from the alienation of such assets are taxable only in the State in which the place of effective management of the enterprise operating such ships, aircraft and boats is situated. This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 22. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of such enterprise is aboard a ship or a boat. Contracting States which would prefer to confer the exclusive taxing right on the State of residence or to use a combination of the residence criterion and the place of effective management criterion are free, in bilateral conventions, to substitute ~~to~~**for** paragraph 3 a provision corresponding to those proposed in **[**…**]** the Commentary on Article 8.~~” [para. 28]~~

Paragraph 4

8. This paragraph, which **broadly corresponds to paragraph 4 of the OECD Model Convention,** allows a Contracting State to tax a gain on an alienation of shares of a company or on an alienation of interests in other entities the property of which consists principally of immovable property situated in that State ~~and is not found in the OECD Model Convention,~~ is designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of such property, it is necessary to tax the sale of shares in such a company. This is especially so where ownership of the shares carries the right to occupy the property. In order to

achieve its objective, paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State. In 1999, the **former** Group of Experts decided to amend paragraph 4 to expand its scope to include interests in partnerships, trusts and estates which own immovable property. It also decided to exclude from its scope such entities whose property consists directly or indirectly principally of immovable property used by them in their business activities. However, this exclusion will not apply to an immovable property management company, partnership, trust or estate. In order to fulfil its purpose, paragraph 4 must apply whether the company, partnership, trust or estate owns the immovable property directly or indirectly, such as, through one or more interposed entities. Contracting States may agree in bilateral negotiations ~~on~~ **that** paragraph 4 also ~~applying~~ **applies** to gains from the alienation of other corporate interests or rights forming part of a substantial participation in a company. For the purpose of this paragraph, the term "principally" in relation to the ownership of an immovable property means the value of such immovable property exceeding 50 per cent of the aggregate value of all assets owned by such company, partnership, trust or estate.

NOTE BY THE SECRETARIAT: CHANGES BELOW IN PARAGRAPHS 9-16 WERE IN GENERAL ACCEPTED BY THE COMMITTEE DURING THE ANNUAL SESSION IN 2010. SEE DOCUMENT E/C. 18/2010/3 AND CHAPTER E IN THE REPORT FROM THAT YEAR.

Paragraph 5

9. **Some countries hold the view that a Contracting State should be able to tax a gain on the alienation of shares of a company resident in that State, whether the alienation occurs within or outside that State. However, it is recognized that for administrative reasons the right to tax should be limited to the alienation of shares of a company in the capital of which the alienator at any time during the 12 month period preceding the alienation, held, directly or indirectly, a substantial participation. In this context, '12 month period' means the period beginning with the date which is one calendar year earlier than the date of the alienation and ending at the time of the alienation. The determination of what is a substantial participation is left to bilateral negotiations, in the course of which an agreed percentage can be determined.** ~~The Group of Experts had examined the question of laying down a concessional rate of tax (compared to normal domestic rate) on gains arising on alienation of shares, other than the shares referred to in paragraph 4, that is, not being shares of principally immovable property owning companies. Since the gains arising on alienation of shares being taxed in a concessional manner is likely to encourage investment in shares, promote foreign direct investment and portfolio investment, and thereby give impetus to the industrialization of the country, the Contracting States may consider discussing this matter during bilateral negotiations and make necessary provision in the bilateral tax treaties.~~

10. This paragraph provides for taxation of a gain on the alienation of shares as contemplated in the paragraph above but excludes gains from the alienation of shares to which paragraph 4 of ~~a~~Article 13 of the Model Convention applies. The wording clearly stipulates that a gain on the alienation of any number of shares may be taxed in the State in which the company is a resident as long as the shareholding is substantial at any time during the 12 month period preceding the alienation. A substantial shareholding is determined according to the percentage shareholding decided in the relevant bilateral negotiations. Consequently, even if a substantial shareholding is alienated through a number of transfers of smaller shareholdings, the taxing right granted by the paragraph will still apply if the shares transferred were alienated at any time during the 12 month period. ~~During the discussion of this paragraph, several~~

~~members of the Group argued that a Contracting State should be able to tax gain on a sale of shares of a company resident in that State, whether the sale occurs within or outside the State, but it was recognized that for administrative reasons the right to tax should be limited to sale of substantial participation. The determination of what is a substantial participation was left to bilateral negotiations, in the course of which an agreed percentage can be determined.~~

NOTE BY THE SECRETARIAT: AT THE ANNUAL SESSION IN 2010, MEMBERS OF THE COMMITTEE AND CERTAIN OBSERVERS INDICATED A PREFERENCE TO INCLUDE A REFERENCE TO PARAGRAPH 2 OF ARTICLE 3, UNDER PARAGRAPH 11. THE EXPERT GROUP MEETING IN JUNE 2011 AGREED NOT TO PROPOSE INCLUSION OF SUCH A REFERENCE.

11. It will be up to the law of the State imposing the tax to determine which transactions give rise to a gain on the alienation of shares and how to determine the level of holdings of the alienator, in particular, how to determine an interest held indirectly. An indirect holding in this context may include ownership by related persons that is imputed to the alienator. Anti-avoidance rules of the law of the State imposing the tax may also be relevant in determining the level of the alienator's direct or indirect holdings. The treaty text itself or associated documents could alternatively expand on the meaning of these concepts. ~~Some countries might consider that the Contracting State in which a company is resident should be allowed to tax the alienation of its shares only if a substantial portion of the company's assets are situated in that State, and in bilateral negotiations might urge such a limitation. Other countries might prefer that paragraph 5 be omitted entirely.~~

12. The question of laying down a concessionary rate of tax (compared with the normal domestic rate) on gains arising on alienation of shares, other than the shares referred to in paragraph 4, that is, not being shares of companies principally owning immovable property, has also been considered. Since the gains arising on alienation of shares being taxed in a concessionary manner is likely to encourage investment in shares, promote foreign direct investment and portfolio investment, and thereby give impetus to the industrialization of the country, countries may consider discussing this matter during bilateral negotiations and making necessary provision in the bilateral tax treaties.

13. It is costly to tax gains from the alienation of quoted shares. In addition, developing countries may find it economically rewarding to boost their capital markets by not taxing gains from the alienation of quoted shares. Countries that wish to do so may include in their bilateral tax treaties the following:

> **'Gains, other than those to which paragraph 4 applies, derived by a resident of a Contracting State from the alienation of shares of a company which is a resident of the other Contracting State, excluding shares in which there is substantial and regular trading on a recognized stock exchange, may be taxed in that other State if the alienator, at any time during the 12 month period preceding such alienation, held directly or indirectly at least per cent (the percentage is to be established through bilateral negotiations) of the capital of that company.'**

Comment [MB6]: The document prepared before the EGM in June 2011 said "other than". The document prepared before the annual session in 2010, and which in general was accepted by the Committee, uses "excluding".

The treaty text itself or associated documents could expand on the meaning of the phrases 'substantial and regular trading' and 'recognized stock exchange'.

14. Some countries might consider that the Contracting State in which a company is resident

should be allowed to tax the alienation of its shares only if a substantial portion of the company's assets are situated in that State and in bilateral negotiations might seek to include such a limitation.

15. Other countries engaged in bilateral negotiations might seek to have paragraph 5 omitted entirely, where they take the view that taxation in the source State of capital gains in these situations may create economic double taxation in the corporate chain, thus hampering foreign direct investment. This consideration is, in particular, relevant for countries that apply a participation exemption not only to dividends received from a substantial shareholding, but also to capital gains made on shares in relation to such substantial holdings.

16. [If countries choose not to tax the gains derived in the course of corporate reorganizations, they are of course also free to do so.]

Comment [MB7]: At the 2010 annual session, a request was made to extend the paragraph to indicate that agreement not to tax gains derived in the course of corporate reorganisations could be included in the treaty text during bilateral negotiations. Members wishing to propose amendments to the paragraph were requested to submit their comments to the subcommittee

Paragraph 6

~~12~~**17**. This paragraph reproduces Article 13, paragraph **45**, of the OECD Model Convention with a drafting adjustment replacing the words "in paragraphs 1, 2**,** ~~and~~ 3 **and 4**" with "in paragraphs 1, 2, 3, 4 and 5". The Commentary on Article 13, paragraph 4, of the OECD Model Convention is therefore relevant, mutatis mutandis, to paragraph 6. This Commentary reads as follows:

> ***29.*** ~~"~~As regards gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3**, 4** and **[5]**, paragraph **[6]** provides that they are taxable only in the State of which the alienator is a resident **[…]** ~~This corresponds to the rules laid down in Article 22." [para. 29]~~
>
> ***30.*** ~~"~~The Article does not contain special rules for gains from the alienation of shares in a company **(other than shares of a company dealt with in paragraph[s] 4 [and 5])** or of securities, bonds, debentures and the like. Such gains are, therefore, taxable only in the State of which the alienator is a resident.~~" [para. 30]~~
>
> ***31.*** ~~"~~If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price and the par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated profits and not as a capital gain. The Article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in Article 10: such taxation is permitted because such difference is covered by the definition of the term 'dividends' contained in paragraph 3 of Article 10 and interpreted in paragraph 28 of the Commentary relating thereto. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with Article 11 **(see also paragraphs 20 and 21 of the Commentary on Article 11)**.~~" [para. 31]~~
>
> **[*32.* There is a need to distinguish the capital gain that may be derived from the alienation of shares acquired upon the exercise of a stock-option granted to an employee or member of a board of directors from the benefit derived from the stock-option that is covered by Articles 15 or 16. The principles on which that distinction is based are discussed in paragraphs 12.2 to 12.5 of the Commentary on Article 15 and paragraph 3.1 of the Commentary on Article 16 [of the OECD Model Convention].]**

Comment [MB8]: This information was included in the OECD Commentary for the 2003 update.

Comment [MB9]: This reference has been part of the OECD Commentary since 1977 (and updated in 1992) and is also relevant under the UN Model.

Comment [MB10]: Should be treated in the same way as new OECD paragraphs on stock-options suggested for inclusion in the commentaries on Article 15 and 16.

~~13~~**18** However, as indicated in paragraph 2 above, most members from developing countries suggested the following alternative to Article 13, paragraph **45**, of the OECD Model Convention:

> "**45**. Gains from the alienation of any property other than those gains mentioned in paragraphs 1, 2**, 3** and ~~3~~**4** may be taxed in the Contracting State in which they arise according to the

law of that State."

This alternative is equivalent to saying that either or both States may tax according to their own laws and that the State of residence will eliminate double taxation under ~~a~~**A**rticle 23. Countries choosing this alternative may wish through bilateral negotiations to clarify which particular source rules will apply to establish where a gain shall be considered to arise.

Article 14

INDEPENDENT PERSONAL SERVICES

1. Article 14 of the United Nations Model Convention reproduces in subparagraph 1(a) and paragraph 2 the essential provisions of Article 14 of the OECD Model Convention **(1997 version). The whole of Article 14 and the Commentary thereon were deleted from the OECD Model Convention on 29 April 2000.** Paragraph 1, subparagraph (b), allows the country of source to tax in one situation in addition to the one contained in Article 14, paragraph 1, of the **1997** OECD Model Convention. More completely, while the **former** OECD Model Convention allow~~s~~**ed** the source country to tax income from independent personal services only if the income ~~is~~ **was** attributable to a fixed base of the taxpayer, the United Nations Model Convention also allows taxation at source if the taxpayer is present in that country for more than 183 days in any twelve-month period commencing or ending in the fiscal year concerned.

2. In the discussion of ~~a~~**A**rticle 14, some members from developing countries expressed the view that taxation by the source country should not be restricted by the criteria of existence of a fixed base and length of stay and that the source of income should be the only criterion. Some members from developed countries, on the other hand, felt that the exportation of skills, like the exportation of tangible goods, should not give rise to taxation in the country of destination unless the person concerned has a fixed base in that country comparable to a permanent establishment. They therefore supported the fixed base criterion, although they also accepted that taxation in the source country is justified by continued presence in that country of the person rendering the service. Some members from developing countries also expressed support for the fixed base criterion. Other members from developing countries expressed preference for the criterion based on length of stay.

3. In developing the 1980 Model, several members from developing countries had proposed a third criterion, namely, that of the amount of remuneration. Under that criterion, remuneration for independent personal services could be taxed by the source country if it exceeded a specified amount, regardless of the existence of a fixed base or the length of stay in that country.

4. As a compromise, the 1980 Model included three alternative criteria found in subparagraphs (a)-(c) of paragraph 1, the satisfaction of any one of which would give the source country the right to tax the income derived from the performance of personal activities by an individual who is a resident of the other State. However, in 1999, the Group of Experts decided to omit the third criterion, namely, the amount of remuneration, specified in subparagraph (c), retaining subparagraphs (a) and (b).

5. Subparagraph (a), which reproduces the sole criterion in the OECD Model Convention, provides that the income may be taxed if the individual has a fixed base regularly available to him for performing his activities. Though the presence of a fixed base gives the right to tax, the amount of income that is subject to tax is limited to that which is attributable to the fixed base.

6. Subparagraph (b) as amended in 1999, extends the source country's right to tax by providing that the source country may tax if the individual is present in the country for a period or periods aggregating at least 183 days in any twelve-month period commencing or ending in the fiscal year concerned, even if there is no fixed base. Only income derived from activities exercised in that country, however, may be taxed. Prior to the amendment, the requirement of minimum stay in the Contracting State was a "period or periods amounting to or exceeding in the aggregate 183 days in the fiscal year concerned". A member from a developed country, however, expressed a preference for retaining the previous wording for technical reasons. By virtue of the amendment, the provisions of ~~a~~**A**rticle 14, paragraph 1, subparagraph (b), have been brought on a par with those of article 15, paragraph 2, subparagraph (a), relating to the minimum period of stay in the other Contracting State.

7. Prior to its deletion, subparagraph (c) provided a further criterion for source country tax when neither of the two conditions specified in subparagraphs (a) and (b) is met. It was provided that if the remuneration for the services performed in the source country exceeds a certain amount (to be determined in bilateral negotiations), the source country may tax, but only if the remuneration is received from a resident of the source country or from a permanent establishment or fixed base of a resident of any other country which is situated in that country.

8. It was observed that any monetary ceiling limit fixed in this behalf becomes meaningless over a period of time due to inflation and would only have the effect of limiting the amount of potentially valuable services that the country will be able to import. Moreover, the provision to this effect appeared only in 6 per cent of the existing bilateral tax treaties finalized between 1980 and 1997. It was, accordingly, decided to delete subparagraph (c) of paragraph 1 of article 14.

9. The Group discussed the relationship between article 14 and subparagraph 3(b) of article 5. It was generally agreed that remuneration paid directly to an individual for his performance of activity in an independent capacity was subject to the provisions of article 14. Payments to an enterprise in respect of the furnishing by that enterprise of the activities of employees or other personnel are subject to articles 5 and 7. The remuneration paid by the enterprise to the individual who performed the activities is subject either to ~~a~~**A**rticle 14 (if he is an independent contractor engaged by the enterprise to perform the activities) or article 15 (if he is an employee of the enterprise). If the parties believe that further clarification of the relationship between ~~a~~**A**rticle 14 and articles 5 and 7 is needed, they may make such clarification in the course of negotiations.

10. Since ~~a~~**A**rticle 14 of the United Nations Model Convention contains all the essential provisions of Article 14 of the **1997** OECD Model Convention, the **former** OECD Commentary on that Article is relevant. That Commentary reads as follows:

> "The Article is concerned with what are commonly known as professional services and with other activities of an independent character. This excludes industrial and commercial activities and also professional services performed in employment, e.g.~~,~~ a physician serving as a medical officer in a factory. It should, however, be observed that the ~~a~~**A**rticle does not concern independent activities of artistes and sportsmen, these being covered by Article 17." [para. 1]
>
> "The meaning of the term 'professional services' is illustrated by some examples of typical liberal professions. The enumeration has an explanatory character only and is not exhaustive. Difficulties of interpretation which might arise in special cases may be solved by mutual agreement between the competent authorities of the Contracting States concerned." [para. 2]
>
> "The provisions of the Article are similar to those for business profits and rest in fact on the same principles as those of Article 7. The provisions of Article 7 and the Commentary thereon could therefore be used as guidance for interpreting and applying Article 14. Thus the principles laid down in Article 7 for instance as regards allocation of profits between head office and permanent establishment could be applied also in apportioning income between the State of

residence of a person performing independent personal services and the State where such services are performed from a fixed base. Equally, expenses incurred for the purposes of a fixed base, including executive and general expenses, should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment **[…]** Also in other respects Article 7 and the Commentary thereon could be of assistance for the interpretation of Article 14, e.g.~~,~~ in determining whether computer software payments should be classified as commercial income within ~~a~~**A**rticle 7 or 14 or as royalties within Article 12." [para. 3]

Comment [UN11]: The OECD Commentary from the 1997 version here include a reference to paragraph 3 of Article 7: "(cf. paragraph 3 of Article 7)". To ensure a correct citation this reference it should be indicated that the full text has not been cited.

"Even if Articles 7 and 14 are based on the same principles, it was thought that the concept of permanent establishment should be reserved for commercial and industrial activities. The term 'fixed base' has therefore been used. It has not been thought appropriate to try to define it, but it would cover, for instance, a physician's consulting room or the office of an architect or a lawyer. A person performing independent personal services would probably not as a rule have premises of this kind in any other State than of his residence. But if there is in another State a centre of activity of a fixed or a permanent character, then that State should be entitled to tax the person's activities." [para. 4]

11. Some countries interpret ~~a~~Article 14 differently from the interpretation delineated in paragraphs 9 and 10 above. These countries may, therefore, wish to clarify their positions and agree on these aspects bilaterally, if not already dealt with.

Comment [UN12]: New UN para. 11 was agreed on at the Committee's annual session of 2010, cf. para.77 of the Report from that session.

Article 15

DEPENDENT PERSONAL SERVICES

1. Article 15 of the United Nations Model Convention reproduces Article 15 of the OECD Model Convention**. The only differences are that the heading of the OECD Article now reads "INCOME FROM EMPLOYMENT" and ~~that~~ the reference to "fixed base" in subparagraph 2 c) has been taken out. These changes stem from the elimination of Article 14 from the OECD Model Convention in 2000.** T~~t~~he Commentary on **Article 15 of the OECD Model Convention** ~~which~~ reads as follows:

1. ~~"~~Paragraph 1 establishes the general rule as to the taxation of income from employment (other than pensions), namely, that such income is taxable in the State where the employment is actually exercised. **The issue of whether or not services are provided in the exercise of an employment may sometimes give rise to difficulties which are discussed in paragraphs 8.1 ff.** Employment is exercised in the place where the employee is physically present when performing the activities for which the employment income is paid. One consequence of this would be that a resident of a Contracting State who derived remuneration, in respect of an employment, from sources in the other State could not be taxed in that other State in respect of that remuneration merely because the results of this work were exploited in that other State.~~" [para. 1]~~

2. ~~"~~The general rule is subject to exception only in the case of pensions (Article 18) and of remuneration and pensions in respect of government service (Article 19). Non-employment remuneration of members of boards of directors of companies is the subject of Article 16.~~" [para. 2]~~

2.1 ~~"~~Member countries have generally understood the term 'salaries, wages and other similar remuneration' to include benefits in kind received in respect of an employment (e.g. **stock-options,** the use of a residence or automobile, health or life insurance coverage and club memberships).~~" [para. 2.1]~~

2.2 The condition provided by the Article for taxation by the State of source is that the salaries, wages or other similar remuneration be derived from the exercise of

employment in that State. This applies regardless of when that income may be paid to, credited to or otherwise definitively acquired by the employee.

3. ~~“~~Paragraph 2 contains, however, a general exception to the rule in paragraph 1. This exception covers all individuals rendering **[**dependent personal**]** services **in the course of an employment** (sales representatives, construction workers, engineers**,** etc.), to the extent that their remuneration does not fall under the provisions of other Articles, such as those applying to government services or artistes and sportsmen.~~” [para. 3]~~

4. ~~“~~The three conditions prescribed in this paragraph must be satisfied for the remuneration to qualify for the exemption. The first condition is that the exemption is limited to the 183-day period. It is further stipulated that this time period may not be exceeded ‘in any twelve month period commencing or ending in the fiscal year concerned’. This contrasts with the 1963 Draft Convention and the 1977 Model Convention which provided that the 183 day period[15] should not be exceeded ‘in the fiscal year concerned’, a formulation that created difficulties **[**in cases**]** where the fiscal years of the Contracting States did not coincide and which opened up opportunities in the sense that operations were sometimes organi~~z~~**s**ed in such a way that, for example, workers stayed in the State concerned for the last 5 1/2 months of one year and the first 5 1/2 months of the following year. The present wording of subparagraph 2 ~~(~~a) does away with such opportunities for tax avoidance. **In applying that wording, all possible periods of twelve consecutive months must be considered, even periods which overlap others to a certain extent. For instance, if an employee is present in a State during 150 days between 1 April 01 and 31 March 02 but is present there during 210 days between 1 August 01 and 31 July 02, the employee will have been present for a period exceeding 183 days during the second 12 month period identified above even though he did not meet the minimum presence test during the first period considered and that first period partly overlaps the second.**~~” [para. 4~~]

5. ~~“~~Although various formulas have been used by ~~M~~**m**ember countries to calculate the 183 day period, there is only one way which is consistent with the wording of this paragraph: the ‘days of physical presence’ method. The application of this method is straightforward as the individual is either present in a country or he is not. The presence could also relatively easily be documented by the taxpayer when evidence is required by the tax authorities. Under this method the following days are included in the calculation: part of a day, day of arrival, day of departure and all other days spent inside the State of activity such as Saturdays and Sundays, national holidays, holidays before, during and after the activity, short breaks (training, strikes, lock-out, delays in supplies), days of sickness (unless they prevent the individual from leaving and he would have otherwise qualified for the exemption) and death or sickness in the family. However, days spent in the State of activity in transit in the course of a trip between two points outside the State of activity should be excluded from the computation. It follows from these principles that any entire day spent outside the State of activity, whether for holidays, business trips, or any other reason, should not be taken into account. A day during any part of which, however brief, the taxpayer is present in a State counts as a day of presence in that State for purposes of computing the 183 day period.~~” [para. 5]~~

5.1 **Days during which the taxpayer is a resident of the source State should not, however, be taken into account in the calculation. Subparagraph *a)* has to be read in the context of the first part of paragraph 2, which refers to “remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other**

[15] The same change was made in 1999 in the United Nations Model Convention.

Contracting State", which does not apply to a person who resides and works in the same State. The words "the recipient is present", found in subparagraph *a)*, refer to the recipient of such remuneration and, during a period of residence in the source State, a person cannot be said to be the recipient of remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State. The following examples illustrate this conclusion:

— Example 1: From January 01 to December 01, X lives in, and is a resident of, State S. On 1 January 02, X is hired by an employer who is a resident of State R and moves to State R where he becomes a resident. X is subsequently sent to State S by his employer from 15 to 31 March 02. In that case, X is present in State S for 292 days between 1 April 01 and 31 March 02 but since he is a resident of State S between 1 April 01 and 31 December 01, this first period is not taken into account for purposes of the calculation of the periods referred to in subparagraph *a)*.

— Example 2: From 15 to 31 October 01, Y, a resident of State R, is present in State S to prepare the expansion in that country of the business of ACO, also a resident of State R. On 1 May 02, Y moves to State S where she becomes a resident and works as the manager of a newly created subsidiary of ACO resident of State S. In that case, Y is present in State S for 184 days between 15 October 01 and 14 October 02 but since she is a resident of State S between 1 May and 14 October 02, this last period is not taken into account for purposes of the calculation of the periods referred to in subparagraph *a)*.

6. "The second condition is that the employer paying the remuneration must not be a resident of the State in which the employment is exercised. Some ~~M~~**m**ember countries may, however, consider that it is **in**appropriate to extend the exception of paragraph 2 to cases where the employer is not a resident of the State of residence of the employee, as there might then be administrative difficulties in determining the employment income of the employee or in enforcing withholding obligations on the employer. Contracting States that share this view are free to adopt bilaterally the following alternative wording of subparagraph 2~~(~~ b):

'~~(~~b) the remuneration is paid by, or on behalf of, an employer who is a resident of the first-mentioned State, and'.~~" [para. 7]~~

6.1 **The application of the second condition in the case of fiscally transparent partnerships presents difficulties since such partnerships cannot qualify as a resident of a Contracting State under Article 4 (see paragraph 8.2 of the Commentary on Article 4). While it is clear that such a partnership could qualify as an "employer" (especially under the domestic law definitions of the term in some countries, *e.g.* where an employer is defined as a person liable for a wage tax), the application of the condition at the level of the partnership regardless of the situation of the partners would therefore render the condition totally meaningless.**

6.2 **The object and purpose of subparagraphs *b)* and *c)* of paragraph 2 are to avoid the source taxation of short-term employments to the extent that the employment income is not allowed as a deductible expense in the State of source because the employer is not taxable in that State as he neither is a resident nor has a permanent establishment therein. These subparagraphs can also be justified by the fact that imposing source deduction requirements with respect to short-term employments in a given State may be considered to constitute an excessive administrative burden where the employer neither**

resides nor has a permanent establishment in that State. In order to achieve a meaningful interpretation of subparagraph *b)* that would accord with its context and its object, it should therefore be considered that, in the case of fiscally transparent partnerships, that subparagraph applies at the level of the partners. Thus, the concepts of "employer" and "resident", as found in subparagraph *b)*, are applied at the level of the partners rather than at the level of a fiscally transparent partnership. This approach is consistent with that under which other provisions of tax conventions must be applied at the partners' rather than at the partnership's level. While this interpretation could create difficulties where the partners reside in different States, such difficulties could be addressed through the mutual agreement procedure by determining, for example, the State in which the partners who own the majority of the interests in the partnership reside (*i.e.* the State in which the greatest part of the deduction will be claimed).

7. ~~"~~Under the third condition, if the employer has **a permanent establishment [or a fixed base if he performs professional services or other activities of an independent character]** in the State in which the employment is exercised ~~a permanent establishment (or a fixed base if he performs professional services or other activities of an independent character)~~, the exemption is given ~~only~~ on condition that the remuneration is not borne by ~~a~~ **that** permanent establishment **[**or a fixed base which he has in that State**]**. **The phrase "borne by" must be interpreted in the light of the underlying purpose of subparagraph *c)* of the Article, which is to ensure that the exception provided for in paragraph 2 does not apply to remuneration** ~~is deductible~~ **that could give rise to a deduction, having regard to the principles of Article 7 and the nature of the remuneration, in computing the profits of a permanent establishment situated in the State in which the employment is exercised**~~" [para. 7.1]~~

7.1 The fact that the employer has, or has not, actually claimed a deduction for the remuneration in computing the profits attributable to the permanent establishment is not necessarily conclusive since the proper test is whether any deduction otherwise available with respect to that remuneration should be taken into account in determining the profits attributable to the permanent establishment. That test would be met, for instance, even if no amount were actually deducted as a result of the permanent establishment being exempt from tax in the source country or of the employer simply deciding not to claim a deduction to which he was entitled. The test would also be met where the remuneration is not deductible merely because of its nature (e.g. where the State takes the view that the issuing of shares pursuant to an employee stock-option does not give rise to a deduction) rather than because it should not be allocated to the permanent establishment.

7.2 For the purpose of determining the profits attributable to a permanent establishment pursuant to paragraph 2 of Article 7, the remuneration paid to an employee of an enterprise of a Contracting State for employment services rendered in the other State for the benefit of a permanent establishment of the enterprise situated in that other State may, given the circumstances, either give rise to a direct deduction or give rise to the deduction of a notional charge, e.g. for services rendered to the permanent establishment by another part of the enterprise. In the latter case, since the notional charge required by the legal fiction of the separate and independent enterprise that is applicable under paragraph 2 of Article 7 is merely a mechanism provided for by that paragraph for the sole purpose of determining the profits attributable to the permanent establishment, this fiction does not affect the determination of whether or not the remuneration is borne by the permanent establishment.

8. ~~"~~**There is a direct relationship between the principles underlying the exception of paragraph 2 and Article 7. Article 7 is based on the principle that an enterprise of a**

Contracting State should not be subjected to tax in the other State unless its business presence in that other State has reached a level sufficient to constitute a permanent establishment. The exception of paragraph 2 of Article 15 extends that principle to the taxation of the employees of such an enterprise where the activities of these employees are carried on in the other State for a relatively short period. Subparagraphs *b*) and *c*) make it clear that the exception is not intended to apply where the employment services are rendered to an enterprise the profits of which are subjected to tax in a State either because it is carried on by a resident of that State or because it has a permanent establishment therein to which the services are attributable. ~~Paragraph 2 has given rise to numerous cases of abuse through adoption of the practice known as 'international hiring out of labour'. In this system, a local employer wishing to employ foreign labour for one or more periods of less than 183 days recruits through an intermediary established abroad who purports to be the employer and hires the labour out to the employer. The worker thus fulfils prima facie the three conditions laid down by paragraph 2 and may claim exemption from taxation in the country where he is temporarily working. To prevent such abuse, in situations of this type, the 'employer' should be interpreted in the context of paragraph 2. In this respect, it should be noted that the term 'employer' is not defined in the Convention but it is understood that the employer is the person having rights on the work produced and bearing the relative responsibility and risks. In cases of international hiring-out of labour, these functions are to a large extent exercised by the user. In this context, substance should prevail over form, i.e., each case should be examined to see whether the functions of employer were exercised mainly by the intermediary or by the user. It is therefore up to the Contracting States to agree on situations in which the intermediary does not fulfil the conditions required for him to be considered as the employer within the meaning of paragraph 2. In settling this question, the competent authorities may refer not only to the above-mentioned indications but to a number of circumstances enabling them to establish that the real employer is the user of the labour (and not the foreign intermediary):~~

- ~~the hirer does not bear the responsibility or risk for the results produced by the employee's work;~~
- ~~the authority to instruct the worker lies with the user;~~
- ~~the work is performed at a place which is under the control and responsibility of the user;~~
- ~~the remuneration to the hirer is calculated on the basis of the time utilized, or there is in other ways a connection between this remuneration and wages received by the employee;~~
- ~~tools and materials are essentially put at the employee's disposal by the user;~~
- ~~the number and qualifications of the employees are not solely determined by the hirer." [para. 8]~~

8.1 **It may be difficult, in certain cases, to determine whether the services rendered in a State by an individual resident of another State, and provided to an enterprise of the first State (or that has a permanent establishment in that State), constitute employment services, to which Article 15 applies, or services rendered by a separate enterprise, to which Article 7 applies or, more generally, whether the exception applies. While the Commentary previously dealt with cases where arrangements were structured for the main purpose of obtaining the benefits of the exception of paragraph 2 of Article 15, it was found that similar issues could arise in many other cases that did not involve tax-motivated transactions and the Commentary was amended to provide a more comprehensive discussion of these questions.**

8.2 **In some States, a formal contractual relationship would not be questioned for tax purposes unless there were some evidence of manipulation and these States, as a matter**

of domestic law, would consider that employment services are only rendered where there is a formal employment relationship.

8.3 **If States where this is the case are concerned that such approach could result in granting the benefits of the exception provided for in paragraph 2 in unintended situations (*e.g.* in so-called "hiring-out of labour" cases), they are free to adopt bilaterally a provision drafted along the following lines:**

> **Paragraph 2 of this Article shall not apply to remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State and paid by, or on behalf of, an employer who is not a resident of that other State if:**
> ***a)*** **the recipient renders services in the course of that employment to a person other than the employer and that person, directly or indirectly, supervises, directs or controls the manner in which those services are performed; and**
> ***b)*** **those services constitute an integral part of the business activities carried on by that person.**

8.4 **In many States, however, various legislative or jurisprudential rules and criteria (*e.g.* substance over form rules) have been developed for the purpose of distinguishing cases where services rendered by an individual to an enterprise should be considered to be rendered in an employment relationship (contract of service) from cases where such services should be considered to be rendered under a contract for the provision of services between two separate enterprises (contract for services). That distinction keeps its importance when applying the provisions of Article 15, in particular those of subparagraphs 2 *b*) and *c*). Subject to the limit described in paragraph 8.11 and unless the context of a particular convention requires otherwise, it is a matter of domestic law of the State of source to determine whether services rendered by an individual in that State are provided in an employment relationship and that determination will govern how that State applies the Convention.**

8.5 **In some cases, services rendered by an individual to an enterprise may be considered to be employment services for purposes of domestic tax law even though these services are provided under a formal contract for services between, on the one hand, the enterprise that acquires the services, and, on the other hand, either the individual himself or another enterprise by which the individual is formally employed or with which the individual has concluded another formal contract for services.**

8.6 **In such cases, the relevant domestic law may ignore the way in which the services are characterised in the formal contracts. It may prefer to focus primarily on the nature of the services rendered by the individual and their integration into the business carried on by the enterprise that acquires the services to conclude that there is an employment relationship between the individual and that enterprise.**

8.7 **Since the concept of employment to which Article 15 refers is to be determined according to the domestic law of the State that applies the Convention (subject to the limit described in paragraph 8.11 and unless the context of a particular convention requires otherwise), it follows that a State which considers such services to be employment services will apply Article 15 accordingly. It will, therefore, logically conclude that the enterprise to which the services are rendered is in an employment**

relationship with the individual so as to constitute his employer for purposes of subparagraph 2 *b*) and *c*). That conclusion is consistent with the object and purpose of paragraph 2 of Article 15 since, in that case, the employment services may be said to be rendered to a resident of the State where the services are performed.

8.8 **As mentioned in paragraph 8.2, even where the domestic law of the State that applies the Convention does not offer the possibility of questioning a formal contractual relationship and therefore does not allow the State to consider that services rendered to a local enterprise by an individual who is formally employed by a non-resident are rendered in an employment relationship (contract of service) with that local enterprise, it is possible for that State to deny the application of the exception of paragraph 2 in abusive cases.**

8.9 **The various approaches that are available to States that want to deal with such abusive cases are discussed in the section "Improper use of the Convention" in the Commentary on Article 1. As explained in paragraph 9.4 of that Commentary, it is agreed that States do not have to grant the benefits of a tax convention where arrangements that constitute an abuse of the Convention have been entered into. As noted in paragraphs 9.5 of that Commentary, however, it should not be lightly assumed that this is the case (see also paragraph 22.2 of that Commentary).**

8.10 **The approach described in the previous paragraphs therefore allows the State in which the activities are exercised to reject the application of paragraph 2 in abusive cases and in cases where, under that State's domestic law concept of employment, services rendered to a local enterprise by an individual who is formally employed by a non-resident are rendered in an employment relationship (contract of service) with that local enterprise. This approach ensures that relief of double taxation will be provided in the State of residence of the individual even if that State does not, under its own domestic law, consider that there is an employment relationship between the individual and the enterprise to which the services are provided. Indeed, as long as the State of residence acknowledges that the concept of employment in the domestic tax law of the State of source or the existence of arrangements that constitute an abuse of the Convention allows that State to tax the employment income of an individual in accordance with the Convention, it must grant relief for double taxation pursuant to the obligations incorporated in Articles 23 A and 23 B (see paragraphs 32.1 to 32.7 of the Commentary on these articles). The mutual agreement procedure provided by paragraph 1 of Article 25 will be available to address cases where the State of residence does not agree that the other State has correctly applied the approach described above and, therefore, does not consider that the other State has taxed the relevant income in accordance with the Convention.**

8.11 **The conclusion that, under domestic law, a formal contractual relationship should be disregarded must, however, be arrived at on the basis of objective criteria. For instance, a State could not argue that services are deemed, under its domestic law, to constitute employment services where, under the relevant facts and circumstances, it clearly appears that these services are rendered under a contract for the provision of services concluded between two separate enterprises. The relief provided under paragraph 2 of Article 15 would be rendered meaningless if States were allowed to deem services to constitute employment services in cases where there is clearly no employment relationship or to deny the quality of employer to an enterprise carried on by a non-**

resident where it is clear that that enterprise provides services, through its own personnel, to an enterprise carried on by a resident. Conversely, where services rendered by an individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises, that State should logically also consider that the individual is not carrying on the business of the enterprise that constitutes that individual's formal employer; this could be relevant, for example, for purposes of determining whether that enterprise has a permanent establishment at the place where the individual performs his activities.

8.12 **It will not always be clear, however, whether services rendered by an individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises. Any disagreement between States as to whether this is the case should be solved having regard to the following principles and examples (using, where appropriate, the mutual agreement procedure).**

8.13 **The nature of the services rendered by the individual will be an important factor since it is logical to assume that an employee provides services which are an integral part of the business activities carried on by his employer. It will therefore be important to determine whether the services rendered by the individual constitute an integral part of the business of the enterprise to which these services are provided. For that purpose, a key consideration will be which enterprise bears the responsibility or risk for the results produced by the individual's work. Clearly, however, this analysis will only be relevant if the services of an individual are rendered directly to an enterprise. Where, for example, an individual provides services to a contract manufacturer or to an enterprise to which business is outsourced, the services of that individual are not rendered to enterprises that will obtain the products or services in question.**

8.14 **Where a comparison of the nature of the services rendered by the individual with the business activities carried on by his formal employer and by the enterprise to which the services are provided points to an employment relationship that is different from the formal contractual relationship, the following additional factors may be relevant to determine whether this is really the case:**

- **who has the authority to instruct the individual regarding the manner in which the work has to be performed;**
- **who controls and has responsibility for the place at which the work is performed;**
- **the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided (see paragraph 8.15 below);**
- **who puts the tools and materials necessary for the work at the individual's disposal;**
- **who determines the number and qualifications of the individuals performing the work;**
- **who has the right to select the individual who will perform the work and to terminate the contractual arrangements entered into with that individual for that purpose;**
- **who has the right to impose disciplinary sanctions related to the work of that individual;**
- **who determines the holidays and work schedule of that individual.**

8.15 **Where an individual who is formally an employee of one enterprise provides services to another enterprise, the financial arrangements made between the two enterprises will clearly be relevant, although not necessarily conclusive, for the purposes**

of determining whether the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided. For instance, if the fees charged by the enterprise that formally employs the individual represent the remuneration, employment benefits and other employment costs of that individual for the services that he provided to the other enterprise, with no profit element or with a profit element that is computed as a percentage of that remuneration, benefits and other employment costs, this would be indicative that the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided. That should not be considered to be the case, however, if the fee charged for the services bears no relationship to the remuneration of the individual or if that remuneration is only one of many factors taken into account in the fee charged for what is really a contract for services (*e.g.* where a consulting firm charges a client on the basis of an hourly fee for the time spent by one of its employee to perform a particular contract and that fee takes account of the various costs of the enterprise), provided that this is in conformity with the arm's length principle if the two enterprises are associated. It is important to note, however, that the question of whether the remuneration of the individual is directly charged by the formal employer to the enterprise to which the services are provided is only one of the subsidiary factors that are relevant in determining whether services rendered by that individual may properly be regarded by a State as rendered in an employment relationship rather than as under a contract for services concluded between two enterprises.

8.16 **Example 1: Aco, a company resident of State A, concludes a contract with Bco, a company resident of State B, for the provision of training services. Aco is specialised in training people in the use of various computer software and Bco wishes to train its personnel to use recently acquired software. X, an employee of Aco who is a resident of State A, is sent to Bco's offices in State B to provide training courses as part of the contract.**

8.17 **In that case, State B could not argue that X is in an employment relationship with Bco or that Aco is not the employer of X for purposes of the convention between States A and B. X is formally an employee of Aco whose own services, when viewed in light of the factors in paragraphs 8.13 and 8.14, form an integral part of the business activities of Aco. The services that he renders to Bco are rendered on behalf of Aco under the contract concluded between the two enterprises. Thus, provided that X is not present in State B for more than 183 days during any relevant twelve month period and that Aco does not have in State B a permanent establishment which bears the cost of X's remuneration, the exception of paragraph 2 of Article 15 will apply to X's remuneration.**

8.18 **Example 2: Cco, a company resident of State C, is the parent company of a group of companies that includes Dco, a company resident of State D. Cco has developed a new worldwide marketing strategy for the products of the group. In order to ensure that the strategy is well understood and followed by Dco, which sells the group's products, Cco sends X, one of its employees who has worked on the development of the strategy, to work in Dco's headquarters for four months in order to advise Dco with respect to its marketing and to ensure that Dco's communications department understands and complies with the worldwide marketing strategy.**

8.19 **In that case, Cco's business includes the management of the worldwide marketing activities of the group and X's own services are an integral part of that business activity.**

While it could be argued that an employee could have been easily hired by Dco to perform the function of advising the company with respect to its marketing, it is clear that such function is frequently performed by a consultant, especially where specialised knowledge is required for a relatively short period of time. lso, the function of monitoring the compliance with the group's worldwide marketing strategy belongs to the business of Cco rather than to that of Dco. The exception of paragraph 2 of Article 15 should therefore apply provided that the other conditions for that exception are satisfied.

8.20 **Example 3: A multinational owns and operates hotels worldwide through a number of subsidiaries. Eco, one of these subsidiaries, is a resident of State E where it owns and operates a hotel. X is an employee of Eco who works in this hotel. Fco, another subsidiary of the group, owns and operates a hotel in State F where there is a shortage of employees with foreign language skills. For that reason, X is sent to work for five months at the reception desk of Fco's hotel. Fco pays the travel expenses of X, who remains formally employed and paid by Eco, and pays Eco a management fee based on X's remuneration, social contributions and other employment benefits for the relevant period.**

8.21 In that case, working at the reception desk of the hotel in State F, when examined in light of the factors in paragraphs 8.13 and 8.14, may be viewed as forming an integral part of Fco's business of operating that hotel rather than of Eco's business. Under the approach described above, if, under the domestic law of State F, the services of X are considered to have been rendered to Fco in an employment relationship, State F could then logically consider that Fco is the employer of X and the exception of paragraph 2 of Article 15 would not apply.

8.22 **Example 4: Gco is a company resident of State G. It carries on the business of filling temporary business needs for highly specialised personnel. Hco is a company resident of State H which provides engineering services on building sites. In order to complete one of its contracts in State H, Hco needs an engineer for a period of five months. It contacts Gco for that purpose. Gco recruits X, an engineer resident of State X, and hires him under a five month employment contract. Under a separate contract between Gco and Hco, Gco agrees to provide the services of X to Hco during that period. Under these contracts, Gco will pay X's remuneration, social contributions, travel expenses and other employment benefits and charges.**

8.23 **In that case, X provides engineering services while Gco is in the business of filling short-term business needs. By their nature the services rendered by X are not an integral part of the business activities of his formal employer. These services are, however, an integral part of the business activities of Hco, an engineering firm. In light of the factors in paragraphs 8.13 and 8.14, State H could therefore consider that, under the approach described above, the exception of paragraph 2 of Article 15 would not apply with respect to the remuneration for the services of the engineer that will be rendered in that State.**

8.24 **Example 5: Ico is a company resident of State I specialised in providing engineering services. Ico employs a number of engineers on a full time basis. Jco, a smaller engineering firm resident of State J, needs the temporary services of an engineer to complete a contract on a construction site in State J. Ico agrees with Jco that one of Ico's engineers, who is a resident of State I momentarily not assigned to any contract concluded by Ico, will work for four months on Jco's contract under the direct**

supervision and control of one of Jco's senior engineers. Jco will pay Ico an amount equal to the remuneration, social contributions, travel expenses and other employment benefits of that engineer for the relevant period, together with a 5 per cent commission. Jco also agrees to indemnify Ico for any eventual claims related to the engineer's work during that period of time.

8.25 **In that case, even if Ico is in the business of providing engineering services, it is clear that the work performed by the engineer on the construction site in State J is performed on behalf of Jco rather than Ico. The direct supervision and control exercised by Jco over the work of the engineer, the fact that Jco takes over the responsibility for that work and that it bears the cost of the remuneration of the engineer for the relevant period are factors that could support the conclusion that the engineer is in an employment relationship with Jco. Under the approach described above, State J could therefore consider that the exception of paragraph 2 of Article 15 would not apply with respect to the remuneration for the services of the engineer that will be rendered in that State.**

8.26 **Example 6: Kco, a company resident of State K, and Lco, a company resident of State L, are part of the same multinational group of companies. A large part of the activities of that group are structured along function lines, which requires employees of different companies of the group to work together under the supervision of managers who are located in different States and employed by other companies of the group. X is a resident of State K employed by Kco; she is a senior manager in charge of supervising human resources functions within the multinational group. Since X is employed by Kco, Kco acts as a cost centre for the human resource costs of the group; periodically, these costs are charged out to each of the companies of the group on the basis of a formula that takes account of various factors such as the number of employees of each company. X is required to travel frequently to other States where other companies of the group have their offices. During the last year, X spent three months in State L in order to deal with human resources issues at Lco.**

8.27 **In that case, the work performed by X is part of the activities that Kco performs for its multinational group. These activities, like other activities such as corporate communication, strategy, finance and tax, treasury, information management and legal support, are often centralised within a large group of companies. The work that X performs is thus an integral part of the business of Kco. The exception of paragraph 2 of Article 15 should therefore apply to the remuneration derived by X for her work in State L provided that the other conditions for that exception are satisfied.**

8.28 **Where, in accordance with the above principles and examples, a State properly considers that the services rendered on its territory by an individual have been rendered in an employment relationship rather than under a contract for services concluded between two enterprises, there will be a risk that the enterprises would be required to withhold tax at source in two jurisdictions on the remuneration of that individual even though double taxation should ultimately be avoided (see paragraph 8.10 above). This compliance difficulty may be partly reduced by tax administrations making sure that their domestic rules and practices applicable to employment are clear and well understood by employers and are easily accessible. Also, the problem can be alleviated if the State of residence allows enterprises to quickly adjust the amount of tax to be**

withheld to take account of any relief for double taxation that will likely be available to the employee.

9. ~~"~~Paragraph 3 applies to the remuneration of crews of ships or aircraft operated in international traffic, or of boats engaged in inland waterways transport, a rule which follows up to a certain extent the rule applied to the income from shipping, inland waterways transport and air transport, that is, to tax them in the Contracting State in which the place of effective management of the enterprise concerned is situated. In the Commentary on Article 8, it is indicated that Contracting States may agree to confer the right to tax such income on the State of the enterprise operating the ships, boats or aircraft. The reasons for introducing that possibility in the case of income from shipping, inland waterways and air transport operations are valid also in respect of remuneration of the crew. Accordingly Contracting States are left free to agree on a provision which gives the right to tax such remuneration to the State of the enterprise. Such a provision, as well as that of paragraph 3 of Article 15, assumes that the domestic laws of the State on which the right to tax is conferred allows it to tax the remuneration of a person in the service of the enterprise concerned, irrespective of his residence. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or **a** boat. According to the domestic laws of some ~~M~~**m**ember countries, tax is levied on remuneration received by non-resident members of the crew in respect of employment aboard ships only if the ship has the nationality of such a State. For that reason conventions concluded between these States provide that the right to tax such remuneration is given to the State of the nationality of the ship. On the other hand many States cannot make use of such a taxation right and the provision could in such cases lead to non-taxation. However, States having that taxation principle in their domestic laws may agree bilaterally to confer the right to tax remuneration in respect of employment aboard ships on the State of the nationality of the ship.~~" [para. 9~~]

10. ~~"~~It should be noted that no special rule**s** regarding the taxation of income of frontier workers **or of employees working on trucks and trains travelling between States** ~~is~~**are** included as it would be more suitable for the problems created by local conditions to be solved directly between the States concerned." ~~[para. 10]~~

11. ~~"~~No special provision has been made regarding remuneration derived by visiting professors or students employed with a view to their acquiring practical experience. Many conventions contain rules of some kind or other concerning such cases, the main purpose of which is to facilitate cultural relations by providing for a limited tax exemption. Sometimes, tax exemption is already provided under domestic taxation laws. The absence of specific rules should not be interpreted as constituting an obstacle to the inclusion of such rules in bilateral conventions whenever this is felt desirable.~~" [para. 11]~~

The treatment of employee stock-options

Comment [MB13]: New OECD Commentary on employee stock-options suggested for inclusion.

12. **The different country rules for taxing employee stock-options create particular problems which are discussed below. While many of these problems arise with respect to other forms of employee remuneration, particularly those that are based on the value of shares of the employer or a related company, they are particularly acute in the case of stock-options. This is largely due to the fact that stock-options are often taxed at a time (*e.g.* when the option is exercised or the shares sold) that is different from the time when the employment services that are remunerated through these options are rendered.**

_12.1_ As noted in paragraph 2.2, the Article allows the State of source to tax the part of the stock-option benefit that constitutes remuneration derived from employment exercised in that State even if the tax is levied at a later time when the employee is no longer employed in that State.

12.2 While the Article applies to the employment benefit derived from a stock-option granted to an employee regardless of when that benefit is taxed, there is a need to distinguish that employment benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (_e.g._ upon cancellation or acquisition by the employer or issuer). Once the option is exercised or alienated, however, the employment benefit has been realised and any subsequent gain on the acquired shares (_i.e._ the value of the shares that accrues after exercise) will be derived by the employee in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the employee obtained from his employment, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so). Where, however, the option that has been exercised entitles the employee to acquire shares that will not irrevocably vest until the end of a period of required employment, it will be appropriate to apply this Article to the increase in value, if any, until the end of the required period of employment that is subsequent to the exercise of the option.

_12.3_ The fact that the Article does not apply to a benefit derived after the exercise or alienation of the option does not imply in any way that taxation of the employment income under domestic law must occur at the time of that exercise or alienation. As already noted, the Article does not impose any restriction as to when the relevant income may be taxed by the State of source. Thus, the State of source could tax the relevant income at the time the option is granted, at the time the option is exercised (or alienated), at the time the share is sold or at any other time. The State of source, however, may only tax the benefits attributable to the option itself and not what is attributable to the subsequent holding of shares acquired upon the exercise of that option (except in the circumstances described in the last sentence of the preceding paragraph).

_12.4_ Since paragraph 1 must be interpreted to apply to any benefit derived from the option until it has been exercised, sold or otherwise alienated, it does not matter how such benefit, or any part thereof, is characterised for domestic tax purposes. As a result, whilst the Article will be interpreted to allow the State of source to tax the benefits accruing up to the time when the option has been exercised, sold or otherwise alienated, it will be left to that State to decide how to tax such benefits, _e.g._ as either employment income or capital gain. If the State of source decides, for example, to impose a capital gains tax on the option when the employee ceases to be a resident of that country, that tax will be allowed under the Article. The same will be true in the State of residence. For example, while that State will have sole taxation right on the increase of value of the share obtained after exercise since this will be considered to fall under Article 13 of the Convention, it may well decide to tax such increase as employment income rather than as a capital gain under its domestic law.

_12.5_ The benefits resulting from a stock-option granted to an employee will not, as a general rule, fall under either Article 21, which does not apply to income covered by other Articles, or Article 18, which only applies to pension and other similar

remuneration, even if the option is exercised after termination of the employment or retirement.

12.6 **Paragraph 1 allows the State of source to tax salaries, wages and other similar remuneration derived from employment exercised in that State. The determination of whether and to what extent an employee stock-option is derived from employment exercised in a particular State must be done in each case on the basis of all the relevant facts and circumstances, including the contractual conditions associated with that option (*e.g.* the conditions under which the option granted may be exercised or disposed of). The following general principles should be followed for that purpose.**

12.7 **The first principle is that, as a general rule, an employee stock-option should not be considered to relate to any services rendered after the period of employment that is required as a condition for the employee to acquire the right to exercise that option. Thus, where a stock-option is granted to an employee on the condition that he provides employment services to the same employer (or an associated enterprise) for a period of three years, the employment benefit derived from that option should generally not be attributed to services performed after that three year period.**

12.8 **In applying the above principle, however, it is important to distinguish between a period of employment that is required to obtain the right to exercise an employee stock-option and a period of time that is merely a delay before such option may be exercised (a blocking period). Thus, for example, an option that is granted to an employee on the condition that he remains employed by the same employer (or an associated enterprise) during a period of three years can be considered to be derived from the services performed during these three years while an option that is granted, without any condition of subsequent employment, to an employee on a given date but which, under its terms and conditions, can only be exercised after a delay of three years, should not be considered to relate to the employment performed during these years as the benefit of such an option would accrue to its recipient even if he were to leave his employment immediately after receiving it and waited the required three years before exercising it.**

12.9 **It is also important to distinguish between a situation where a period of employment is required as a condition for the acquisition of the right to exercise an option, *i.e.* the vesting of the option, and a situation where an option that has already vested may be forfeited if it is not exercised before employment is terminated (or within a short period after). In the latter situation, the benefit of the option should not be considered to relate to services rendered after vesting since the employee has already obtained the benefit and could in fact realise it at any time. A condition under which the vested option may be forfeited if employment is terminated is not a condition for the acquisition of the benefit but, rather, one under which the benefit already acquired may subsequently be lost. The following examples illustrate this distinction:**

— **Example 1: On 1 January of year 1, a stock-option is granted to an employee. The acquisition of the option is conditional on the employee continuing to be employed by the same employer until 1 January of year 3. The option, once this condition is met, will be exercisable from 1 January of year 3 until 1 January of year 10 (a so-called**

"American" option[2]). It is further provided, however, that any option not previously exercised will be lost upon cessation of employment. In that example, the right to exercise that option has been acquired on 1 January of year 3 (*i.e.* the date of vesting) since no further period of employment is then required for the employee to obtain the right to exercise the option.

— **Example 2: On 1 January of year 1, a stock-option is granted to an employee. The option is exercisable on 1 January of year 5 (a so-called "European" option). The option has been granted subject to the condition that it can only be exercised on 1 January of year 5 if employment is not terminated before that date. In that example, the right to exercise that option is not acquired until 1 January of year 5,which is the date of exercise, since employment until that date is required to acquire the right to exercise the option (*i.e.* for the option to vest).**

12.10 **There are cases where that first principle might not apply. One such case could be where the stock-option is granted without any condition to an employee at the time he either takes up an employment, is transferred to a new country or is given significant new responsibilities and, in each case, the option clearly relates to the new functions to be performed by the employee during a specific future period. In that case, it may be appropriate to consider that the option relates to these new functions even if the right to exercise the option is acquired before these are performed. There are also cases where an option vested technically but where that option entitles the employee to acquire shares which will not vest until the end of a period of required employment. In such cases, it may be appropriate to consider that the benefit of the option relates to the services rendered in the whole period between the grant of the option and the vesting of the shares.**

12.11 **The second principle is that an employee stock-option should only be considered to relate to services rendered before the time when it is granted to the extent that such grant is intended to reward the provision of such services by the recipient for a specific period. This would be the case, for example, where the remuneration is demonstrably based on the employee's past performance during a certain period or is based on the employer's past financial results and is conditional on the employee having been employed by the employer or an associated enterprise during a certain period to which these financial results relate. Also, in some cases, there may be objective evidence demonstrating that during a period of past employment, there was a well-founded expectation among participants to an employee stock-option plan that part of their remuneration for that period would be provided through the plan by having stock-options granted at a later date. This evidence might include, for example, the consistent practice of an employer that has granted similar levels of stock-options over a number of years, as long as there was no indication that this practice might be discontinued. Depending on other factors, such evidence may be highly relevant for purposes of determining if and to what extent the stock-option relates to such a period of past employment.**

12.12 **Where a period of employment is required to obtain the right to exercise an employee's stock-option but such requirement is not applied in certain circumstances,**

[2] Under an "American" stock-option, the right to acquire a share may be exercised during a certain period (typically a number of years) whilst under a European stock-option, that right may only be exercised at a given moment (*i.e.* on a particular date).

e.g. **where the employment is terminated by the employer or where the employee reaches retirement age, the stock-option benefit should be considered to relate only to the period of services actually performed when these circumstances have in fact occurred.**

12.13 **Finally, there may be situations in which some factors may suggest that an employee stock-option is rewarding past services but other factors seem to indicate that it relates to future services. In cases of doubt, it should be recognised that employee stock-options are generally provided as an incentive to future performance or as a way to retain valuable employees. Thus, employee stock-options are primarily related to future services. However, all relevant facts and circumstances will need to be taken into account before such a determination can be made and there may be cases where it can be shown that a stock-option is related to combined specific periods of previous and future services (*e.g.* options are granted on the basis of the employee having achieved specific performance targets for the previous year, but they become exercisable only if the employee remains employed for another three years).**

12.14 **Where, based on the preceding principles, a stock-option is considered to be derived from employment exercised in more than one State, it will be necessary to determine which part of the stock-option benefit is derived from employment exercised in each State for purposes of the application of the Article and of Articles 23 A and 23 B. In such a case, the employment benefit attributable to the stock-option should be considered to be derived from a particular country in proportion of the number of days during which employment has been exercised in that country to the total number of days during which the employment services from which the stock-option is derived has been exercised. For that purpose, the only days of employment that should be taken into account are those that are relevant for the stock-option plan, *e.g.* those during which services are rendered to the same employer or to other employers the employment by whom would be taken into account to satisfy a period of employment required to acquire the right to exercise the option.**

12.15 **It is possible for member countries to depart from the case-by-case application of the above principles (in paragraphs 12.7 to 12.14) by agreeing to a specific approach in a bilateral context. For example, two countries that tax predominantly at exercise of an option may agree, as a general principle, to attribute the income from an option that relates primarily to future services to the services performed by an employee in the two States between date of grant and date of exercise. Thus, in the case of options that do not become exercisable until the employee has performed services for the employer for a specific period of time, two States could agree to an approach that attributes the income from the option to each State based on the number of days worked in each State by the employee for the employer in the period between date of grant and date of exercise. Another example would be for two countries that have similar rules for the tax treatment of employee stock-options to adopt provisions that would give to one of the Contracting States exclusive taxation rights on the employment benefit even if a minor part of the employment services to which the option relates have been rendered in the other State. Of course, member countries should be careful in adopting such approaches because they may result in double taxation or double non-taxation if part of the employment is exercised in a third State that does not apply a similar approach.**

2. Although ~~a~~**A**rticles 14, 15, 19 and 23 may generally be adequate to prevent double taxation of visiting teachers, some countries may wish to include a visiting teachers article in their treaties.

Reference is made to paragraphs 11 to 13 of the Commentary on ~~a~~**A**rticle 20 for a comprehensive treatment of this subject.

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

1. Article 16, paragraph 1, of the United Nations Model Convention reproduces Article 16 of the OECD Model Convention.

2. Since ~~a~~**A**rticle 16, paragraph 1, of the United Nations Model Convention reproduces the whole of Article 16 of the OECD Model Convention, the Commentary on the latter Article, which reads as follows, is relevant:

1. ~~"~~This Article relates to remuneration received by a resident of a Contracting State, whether an individual or a legal person, in the capacity of a member of a board of directors of a company which is a resident of the other Contracting State. Since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company.~~" [para. 1]~~

1.1 ~~"~~Member countries have generally understood the term 'fees and other similar payments' to include benefits in kind received by a person in that person's capacity as a member of the board of directors of a company (e.g.~~,~~ **stock-options** the use of a residence or automobile, health or life insurance coverage and club memberships).~~" [para. 1.1]~~

2. ~~"~~A member of the board of directors of a company often also has other functions with the company, e.g.~~,~~ as ordinary employee, adviser, consultant, etc. It is clear that the Article does not apply to remuneration paid to such a person on account of such other functions.~~" [para. 2]~~ [This position does not apply under the United Nations Model Convention **to the extent that paragraph 2 of Article 16 applies**.]

3. ~~"~~In some countries organs of companies exist which are similar in function to the board of directors. Contracting States are free to include in bilateral conventions such organs of companies under a provision corresponding to Article 16.~~" [para. 3]~~

Comment [UN14]: This suggested change is related to the one made to the commentary on Article 15 cf. paragraphs 12 to 12.15 of the OECD Commentary on that Article.

3.1 **Many of the issues discussed under paragraphs 12 to 12.15 of the [OECD] Commentary on Article 15 in relation to stock-options granted to employees will also arise in the case of stock-options granted to members of the board of directors of companies. To the extent that stock-options are granted to a resident of a Contracting State in that person's capacity as a member of the board of directors of a company which is a resident of the other State, that other State will have the right to tax the part of the stock-option benefit that constitutes director's fees or a similar payment (see paragraph 1.1 above) even if the tax is levied at a later time when the person is no longer a member of that board. While the Article applies to the benefit derived from a stock-option granted to a member of the board of directors regardless of when that benefit is taxed, there is a need to distinguish that benefit from the capital gain that may be derived from the alienation of shares acquired upon the exercise of the option. This Article, and not Article 13, will apply to any benefit derived from the option itself until it has been exercised, sold or otherwise alienated (*e.g.* upon cancellation or acquisition by the company or issuer). Once the option is exercised or alienated, however, the benefit taxable under this Article has been realised and any subsequent gain on the acquired shares (*i.e.* the value of the shares that accrues after exercise) will be derived by the member of the board of**

directors in his capacity of investor-shareholder and will be covered by Article 13. Indeed, it is at the time of exercise that the option, which is what the director obtained in his capacity as such, disappears and the recipient obtains the status of shareholder (and usually invests money in order to do so).

3. Article 16 of the United Nations Model Convention also includes a second paragraph not in the OECD Model Convention, dealing with remuneration received by top-level managerial officials.

4. The **former** Group of Experts decided that where a top-level managerial position of a company resident in a Contracting State is occupied by a resident of the other Contracting State, the remuneration paid to that official should be subject to the same principle as directors' fees.

The term "top-level managerial position" refers to a limited group of positions that involve primary responsibility for the general direction of the affairs of the company, apart from the activities of the directors. The term covers a person acting as both a director and a top-level manager.

Article 17

ARTISTES AND SPORTSPERSONS

1. Article 17 of the United Nations Model Convention reproduces Article 17 of the OECD Model Convention with one modification. Instead of the word "sportsman" used in the OECD Model Convention (in place of "athlete" earlier used in both the United Nations and OECD Model Conventions), it has been decided to use the gender neutral word "sportsperson", which unlike the term "entertainer" was not followed in paragraph 1 by illustrative examples but is nevertheless likewise to be construed in a broad manner consistent with the spirit and purpose of the article.

2. The Commentary on Article 17 of the OECD Model Convention is as follows:

"Paragraph 1 provides that artistes and sportsmen who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are of **[**an independent or of a dependent**]** nature. This provision is an exception to the rules in Article **[**14**]** and to that in paragraph 2 of Article 15, respectively." [para. 1]

Comment [UN15]: The OECD Commentary has been changed and the words "independent and "dependent" have been replaced by "business" and "employment". These changes stem from the deletion of article 14 in the OECD Model.

"This provision makes it possible to avoid the practical difficulties which often arise in taxing artistes and sportsmen performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to **[**independent**]** activities. To achieve this it would be sufficient to amend the text of the Article so that an exception is made only to the provisions of Article **[**14**]**. In such a case, artistes and sportsmen performing ~~for a salary or wages~~ **in the course of an employment** would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article." [para. 2]

"Paragraph 1 refers to artistes and sportsmen. It is not possible to give a precise definition of 'artiste', but paragraph 1 includes examples of persons who would be regarded as such. These examples should not be considered as exhaustive. On the one hand, the term 'artiste' clearly includes the stage performer, film actor, actor (including for instance a former sportsman) in a television commercial. The Article may also apply to income received from activities which involve a political, social, religious or charitable nature, if an entertainment character is present. On the other hand, it does not extend to a visiting conference speaker or to administrative or support staff (e.g.~~,~~ cameramen for a film, producers, film directors, choreographers, technical staff, road crew for a pop group etc.). In between there is a grey area where it is necessary to review the overall balance of the activities of the person concerned." [para. 3]

"An individual may both direct a show and act in it, or may direct and produce a television programme or film and take a role in it. In such cases it is necessary to look at what the individual actually does in the State where the performance takes place. If his activities in that State are predominantly of a performing nature, the Article will apply to all the resulting income he derives in that State. If, however, the performing element is a negligible part of what he does in that State, the whole of the income will fall outside the Article. In other cases an apportionment should be necessary." [para. 4]

"Whilst no precise definition is given of the term 'sportsmen', it is not restricted to participants in traditional athletic events (e.g.~~,~~ runners, jumpers, swimmers). It also covers, for example, golfers, jockeys, footballers, cricketers and tennis players, as well as racing drivers." [para. 5]

"The Article also applies to income from other activities which are usually regarded as of an entertainment character, such as those deriving from billiards and snooker, chess and bridge tournaments." [para. 6]

"Income received by impresarios, etc. for arranging the appearance of an artiste or sportsman is outside the scope of the Article, but any income they receive on behalf of the artiste or sportsman is of course covered by it." [para. 7]

"Paragraph 1 applies to income derived directly and indirectly by an individual artiste or sportsman. In some cases the income will not be paid directly to the individual or his impresario or agent. For instance, a member of an orchestra may be paid a salary rather than receive payment for each separate performance: a Contracting State where a performance takes place is entitled, under paragraph 1, to tax the proportion of the musician's salary which corresponds to such a performance. Similarly, where an artiste or sportsman is employed by~~,~~ e.g.~~,~~ a one person company, the State where the performance takes place may tax an appropriate proportion of any remuneration paid to the individual. In addition, where its domestic laws 'look through' such entities and treat the income as accruing directly to the individual, paragraph 1 enables that State to tax income derived from appearances in its territory and accruing in the entity for the individual's benefit, even if the income is not actually paid as remuneration to the individual." [para. 8]

"Besides fees for their actual appearances, artistes and sportsmen often receive income in the form of royalties or of sponsorship or advertising fees. In general, other Articles would apply whenever there was no direct link between the income and a public exhibition by the performer in the country concerned. Royalties for intellectual property rights will normally be covered by Article 12 rather than Article 17 (~~cf.~~**see** paragraph 18 of the Commentary on Article 12), but in general~~,~~ advertising and sponsorship fees will fall outside the scope of Article 12. Article 17 will apply to advertising or sponsorship income, etc. which is related directly or indirectly to performances or appearances in a given State. Similar income which could not be attributed to such performances or appearances would fall under the standard rules of Article **[**14**]** or Article 15, as appropriate. Payments received in the event of the cancellation of a performance are also outside the scope of Article 17, and fall under Articles 7**[**, 14**]** or 15, as the case may be." [para. 9]

"The Article says nothing about how the income in question is to be computed. It is for a Contracting State's domestic law to determine the extent of any deductions for expenses. Domestic laws differ in this area, and some provide for taxation at source, at a low rate based on the gross amount paid to artistes and sportsmen. Such rules may also apply to income paid to groups or incorporated teams, troupes, etc.**[ ]**" [para. 10]

"Paragraph 1 of the Article deals with income derived by individual artistes and sportsmen from their personal activities. Paragraph 2 deals with situations where income from their activities accrues to other persons. If the income of an entertainer or sportsman accrues to another person, and the State of source does not have the statutory right to look through the person receiving the income to tax it as income of the performer, paragraph 2 provides that the portion of the income which cannot be taxed in the hands of the performer may be taxed in

Comment [UN16]: Paragraph 10 of the OECD Commentary now includes a new passage which was adopted as part of the the 2008 update. The new passage reads as follows:

"Some States, however, may consider that the taxation of the gross amount may be inappropriate in some circumstances even if the applicable rate is low. These States may want to give the option to the taxpayer to be taxed on a net basis. This could be done through the inclusion of a paragraph drafted along the following lines:

Where a resident of a Contracting State derives income referred to in paragraph 1 or 2 and such income is taxable in the other Contracting State on a gross basis, that person may, within [period to be determined by the Contracting States] request the other State in writing that the income be taxable on a net basis in that other State. Such request shall be allowed by that other State. In determining the taxable income of such resident in the other State, there shall be allowed as deductions those expenses deductible under the domestic laws of the other State which are incurred for the purposes of the activities exercised in the other State and which are available to a resident of the other State exercising the same or similar activities under the same or similar conditions."

the hands of the person receiving the remuneration. If the person receiving the income ~~is an enterprise~~ **carries on business activities**, tax may be applied by the source country even if the income is not attributable to a permanent establishment there. **[**If the person receiving the income is an individual, the income may be taxed even in the absence of a fixed base.**]** But it will not always be so. There are three main situations of this kind~~.~~**:**

~~(~~a) The first is the management company which receives income for the appearance of, e.g.~~,~~ a group of sportsmen (which is not itself constituted as a legal entity).

~~(~~b) The second is the team, troupe, orchestra, etc. which is constituted as a legal entity. Income for performances may be paid to the entity. Individual members of the team, orchestra, etc. will be liable to tax under paragraph 1, in the State in which a performance is given, on any remuneration (or income accruing for their benefit) as a counterpart to the performance; however, if the members are paid a fixed periodic remuneration and it would be difficult to allocate a portion of that income to ~~a~~ particular performance**s**, ~~M~~**m**ember countries may decide, unilaterally or bilaterally, not to tax it. The profit element accruing from a performance to the legal entity would be liable to tax under paragraph 2.

~~(~~c) 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. Other countries cannot do this. Where a performance takes place in such a country, paragraph 2 permits it to impose a tax on the profits diverted from the income of the artiste or sportsman to the enterprise. It may be, however, that the domestic laws of some States do not enable them to apply such a provision. Such States are free to agree to other solutions or to leave paragraph 2 out of their bilateral conventions." [para. 11]

"Where, in the cases dealt with in paragraphs 1 and 2, the exemption method for relieving double taxation is used by the State of residence of the person receiving the income, that State would be precluded from taxing such income even if the State where the activities were performed could not make use of its right to tax. It is therefore understood that the credit method should be used in such cases. The same result could be achieved by stipulating a subsidiary right to tax for the State of residence of the person receiving the income, if the State where the activities are performed cannot make use of the right conferred on it by paragraphs 1 and 2. Contracting States are free to choose any of these methods in order to ensure that the income does not escape taxation." [para. 12]

"Article 17 will ordinarily apply when the artiste or sportsman is employed by a Government and derives income from that Government . . . Certain conventions contain provisions excluding artistes and sportsmen employed in organi~~z~~**s**ations which are subsidi~~z~~**s**ed out of public funds from the application of Article 17." [para. 13]

"Some countries may consider it appropriate to exclude from the scope of the Article events supported from public funds. Such countries are free to include a provision to achieve this but the exemptions should be based on clearly definable and objective criteria to ensure that they are given only where intended. Such a provision might read as follows:

'The provisions of paragraphs 1 and 2 shall not apply to income derived from activities performed in a Contracting State by artistes or sportsmen if the visit to that State is wholly or mainly supported by public funds of one or both of the Contracting States or political

Comment [UN17]: Text in brackets deleted under the OECD Commentary. Stem from the deletion of article 14 of the OECD Model.

Comment [UN18]: The OECD Commentary now includes new paragraphs 11.1 and 11.2, added for the 2000 update.

subdivisions or local authorities thereof. In such a case, the income is taxable only in the Contracting State in which the artiste or the sportsman is a resident.' "[para. 14]

3. ~~Some members of the Group~~ **When this issues was last considered by the former Group of Experts, some members** indicated that the examples given in the Commentary on Article 17, paragraph 2, of the OECD Model Convention should not be understood as limiting the field of application of taxation to the incomes mentioned in that Commentary. In fact, the wording of the Commentary would allow taxation of the enterprise in the other Contracting State, with the same limitations as those imposed for artistes or sportspersons resident in a Contracting State and carrying out activities in the other State.

4. On the other hand, members expressed the view that some countries might wish paragraph 2 to have a narrower scope.

Article 18

PENSIONS AND SOCIAL SECURITY PAYMENTS

A. GENERAL CONSIDERATIONS

1. Two alternative versions are given for ~~a~~**A**rticle 18 of the United Nations Model Convention, ~~a~~**A**rticle 18 A and ~~a~~**A**rticle 18 B.

2. Article 18 A, like Article 18 of the OECD Model Convention, ~~assigns to~~ **provides that** the ~~country~~**State** of residence ~~the~~ **has an** exclusive right to tax pensions and other similar remuneration.~~, but i~~**I**t departs**, however,** from the OECD Article by granting to the **State of** source ~~country the~~ **an** exclusive right to tax ~~when~~ the payments ~~involved are~~ made within the framework of a public scheme which is part of the social security system of that State or a political subdivision or a local authority thereof.

Comment [MB19]: Note by a member of the Subcommittee: I have eliminated the references to the assignment of taxing rights. The Convention does not assign taxing rights but allows the State of source to exercise (or not) the taxing rights provided for in its domestic law.

3. **Under** Article 18 B~~, provides for a sharing between the country of residence and~~ the ~~country~~ **State** of source ~~of the right to~~ **may** tax pensions and other similar remuneration **and the provisions of Article 23 A or 23 B will determine whether that right is exclusive (exemption method) or merely prior to that of the State of residence (credit method). Article 18 B allows, however, exclusive source taxation** ~~of~~ when the payments ~~involved~~ are ~~not~~ made within the framework of a public scheme which is part of the social security system of a State or a political subdivision or a local authority thereof. ~~In the latter case, the right to tax belongs only to the source country.~~

Comment [MB20]: Note by a member of the Subcommittee: I have deleted the reference to the sharing of the right to tax between the State of source and the State of residence which seems not fully accurate.

~~2. Some members of the Group pointed out that some countries wanted to be able to negotiate the question whether the country of residence should have the right to tax residents on social security payments.~~

Comment [MB21]: Note by a member of the Subcommittee: This is dealt with in the Commentary on paragraph 2 of Alternative A.

B. COMMENTARY ON THE TWO ALTERNATIVE VERSIONS OF ARTICLE 18

Commentary on the paragraphs of ~~*a*~~***A****rticle 18 A*

Paragraph 1

~~3~~**4**. **According to this paragraph, pensions, and other similar remuneration, paid in respect of private employment are taxable only in the State of residence of the recipient.** Since ~~article 18 A~~ **this paragraph** reproduces ~~in its first paragraph~~ the text of Article 18 of the OECD Model Convention, the **Committee considers that the following part of the OECD** Commentary ~~on the latter Article~~ is

~~relevant~~ **applicable**. ~~However, since the United Nations Model Convention provides a separate rule in paragraph 2, dealing with social security benefits, the discussion in the OECD Commentary of social security benefits is moved in this Commentary to the discussion of paragraph 2. The OECD Commentary observes:~~

> ~~"According to this Article, pensions paid in respect of private employment are taxable only in the State of residence of the recipient. The provision also covers widows' and orphans' pensions and other similar payments such as annuities paid in respect of past employment. It also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19." [para. 1]~~
>
> ~~"The treatment under the taxation laws of the . . . countries of amounts paid to an employee on the cessation of his employment is highly diversified. Some States regard such a payment as a pension, private or Government as the case may be, paid as a lump sum. In such a case it would be natural to consider the income as falling under Article 18 or 19. In the tax laws of other States such a payment is looked upon as the final remuneration for the work performed. Then it should of course be treated under Article 15 or 19, as the case may be. Others again consider such a payment as a bonus which is not taxable under their income tax laws but perhaps subjected to a gift tax or a similar tax. It has not been possible to reach a common solution on the tax treatment of payments of this kind under the Model Convention. If the question of taxing such payments should arise between Contracting States, the matter therefore has to be solved by recourse to the provisions of Article 25." [para. 3]~~

[1.] According to this Article, pensions paid in respect of private employment are taxable only in the State of residence of the recipient. Various policy and administrative considerations support the principle that the taxing right with respect to this type of pension, and other similar remuneration, should be left to the State of residence. For instance, the State of residence of the recipient of a pension is in a better position than any other State to take into account the recipient's overall ability to pay tax, which mostly depends on worldwide income and personal circumstances such as family responsibilities. This solution also avoids imposing on the recipient of this type of pension the administrative burden of having to comply with tax obligations in States other than that recipient's State of residence.

Comment [MB22]: Note by a member of the Subcommittee: I have deleted paragraph [2] referring to the taxation of pensions at source and to alternative provisions discussed in paragraphs [12] to [21] of the OECD Commentary. Source taxation is provided for in Article 18 B and the arguments in favor of source taxation are discussed there. The paragraphs [12] to [21] are not fully quoted because some of these paragraphs raise arguments against source taxation and because, unlike Article 18 B, the proposed alternatives do not determine which State is the State of source

Scope of the Article

[3.] The types of payment that are covered by the Article include not only pensions directly paid to former employees but also to other beneficiaries (e.g. surviving spouses, companions or children of the employees) and other similar payments, such as annuities, paid in respect of past employment. The Article also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19. The Article only applies, however, to payments that are in consideration of past employment; it would therefore not apply, for example, to an annuity acquired directly by the annuitant from capital that has not been funded from an employment pension scheme. The Article applies regardless of the tax treatment of the scheme under which the relevant payments are made; thus, a payment made under a pension plan that is not eligible for tax relief could nevertheless constitute a "pension or other similar remuneration" (the tax mismatch that could arise in such a situation is discussed below).

[4.] Various payments may be made to an employee following cessation of employment. Whether or not such payments fall under the Article will be determined by the nature of the payments, having regard to the facts and circumstances in which they are made, as explained in the following two paragraphs.

[5.] While the word "pension", under the ordinary meaning of the word, covers only periodic payments, the words "other similar remuneration" are broad enough to cover non-periodic payments. For instance, a lump-sum payment in lieu of periodic pension payments that is made on or after cessation of employment may fall within the Article.

[6.] Whether a particular payment is to be considered as other remuneration similar to a pension or as final remuneration for work performed falling under Article 15 is a question of fact. For example, if it is shown that the consideration for the payment is the commutation of the pension or the compensation for a reduced pension then the payment may be characterised as "other similar remuneration" falling under the Article. This would be the case where a person was entitled to elect upon retirement between the payment of a pension or a lump-sum computed either by reference to the total amount of the contributions or to the amount of pension to which that person would otherwise be entitled under the rules in force for the pension scheme. The source of the payment is an important factor; payments made from a pension scheme would normally be covered by the Article. Other factors which could assist in determining whether a payment or series of payments fall under the Article include: whether a payment is made on or after the cessation of the employment giving rise to the payment, whether the recipient continues working, whether the recipient has reached the normal age of retirement with respect to that particular type of employment, the status of other recipients who qualify for the same type of lump-sum payment and whether the recipient is simultaneously eligible for other pension benefits. Reimbursement of pension contributions (e.g. after temporary employment) does not constitute "other similar remuneration" under Article 18. Where cases of difficulty arise in the taxation of such payments, the Contracting States should solve the matter by recourse to the provisions of Article 25.

[7.] Since the Article applies only to pensions and other similar remuneration that are paid in consideration for past employment, it does not cover other pensions such as those that are paid with respect to previous independent personal services. Some States, however, extend the scope of the Article to cover all types of pensions, including Government pensions; States wishing to do so are free to agree bilaterally to include provisions to that effect.

Cross-border issues related to pensions

[8.] The globalisation of the economy and the development of international communications and transportation have considerably increased the international mobility of individuals, both for work-related and personal reasons. This has significantly increased the importance of cross-border issues arising from the interaction of the different pension arrangements which exist in various States and which were primarily designed on the basis of purely domestic policy considerations. As these issues often affect large numbers of individuals, it is desirable to address them in tax conventions so as to remove obstacles to the international movement of persons, and employees in particular.

[9.] Many such issues relate to mismatches resulting from differences in the general tax policy that States adopt with respect to retirement savings. In many States, tax incentives are provided for pension contributions. Such incentives frequently take the form of a tax deferral so that the part of the income of an individual that is contributed to a pension arrangement as well as the income earned in the scheme or any pension rights that accrue to the individual are exempt from tax. Conversely, the pension benefits from these arrangements are taxable upon receipt. Other States, however, treat pension contributions like other forms of savings and neither exempt these

contributions nor the return thereon; logically, therefore, they do not tax pension benefits. Between these two approaches exist a variety of systems where contributions, the return thereon, the accrual of pension rights or pension benefits are partially taxed or exempt.

[10.] Other issues arise from the existence of very different arrangements to provide retirement benefits. These arrangements are often classified under the following three broad categories:

— statutory social security schemes;
— occupational pension schemes;
— individual retirement schemes.

The interaction between these three categories of arrangements presents particular difficulties. These difficulties are compounded by the fact that each State may have different tax rules for the arrangements falling in each of these categories as well as by the fact that there are considerable differences in the extent to which States rely on each of these categories to ensure retirement benefits to individuals (*e.g.* some States provide retirement benefits almost exclusively through their social security system while others rely primarily on occupational pension schemes or individual retirement schemes).

[11.] The issues arising from all these differences need to be fully considered in the course of bilateral negotiations[, in particular to avoid double taxation or non-taxation, and, where appropriate, addressed through specific provisions].

5. Many countries have adopted the approach under which, subject to specific conditions, tax on contributions to, and earnings in, pension schemes or on the accrual of pension rights is totally or partially deferred and is recovered when pension benefits are paid. Other countries, however, treat pension contributions, or [some kind of them], like other forms of savings and neither exempt those contributions nor the return thereon. Those countries generally do not tax the corresponding pension benefits. Where an individual has been granted tax relief in a country that has adopted the first approach and, before the payment of all or part of the pension benefits, that individual becomes a resident of a country having adopted the second approach, the mismatch in the approaches adopted by the two countries will result in a situation where no tax will ever be payable on the relevant income. In order to avoid such unintended result, countries could include in paragraph 1 an additional sentence along the following lines:

> **However such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein and the payment is not subject to tax in the first-mentioned State under the ordinary rules of its tax law.**

6. The Committee considers that the following part of the OECD Commentary which is dealing with exempt pensions is also applicable to paragraph 1:

[22.] *[S]*ome States do not tax pension payments generally or otherwise exempt particular categories or parts of pension payments. In these cases, the provisions of the Article, which provides for taxation of pensions in the State of residence, may result in taxation by that State of pensions which were designed not to be taxed and the amount of which may well have been determined having regard to that exemption. This may result in undue financial hardship for the recipient of the pension.

Comment [MB23]: Note by a member of the Subcommittee: I have deleted the last sentence of paragraph [11] referring to the sections on cross-border issues of the OECD Commentary. This section is not fully quoted and, when quoted, it is generally not quoted under the Commentary on paragraph 1 of Alternative A but elsewhere.

A member of the Committee has proposed to quote only the first part of the first sentence ("The issues arising from all these differences need to be fully considered in the course of bilateral negotiations …") and to drop the reference to the avoidance of double taxation. She considers indeed that the aim of tax conventions is to eliminate double taxation but not to avoid double non-taxation.

Comment [MB24]: Note by a member of the Subcommittee: This provision differs from the provision proposed under paragraph 15, d) of the OECD Commentary on Article 18 of the OECD Model *("However such pensions and other similar remuneration may also be taxed in the other Contracting State **in which they arise** if these payments are not subject to tax in the first-mentioned State under the ordinary rules of its tax law.")* The OECD alternative does not determine which State is considered as the State of source while Article 18 B does (see paragraph 13 below).

[23] To avoid the problems resulting from this type of mismatch, some States include in their treaties provisions to preserve the exempt treatment of pensions when the recipient is a resident of the other Contracting State. These provisions may be restricted to specific categories of pensions or may address the issue in a more comprehensive way. An example of that latter approach would be a provision drafted along the following lines:

> **Notwithstanding any provision of this Convention, any pension or other similar remuneration paid to a resident of a Contracting State in respect of past employment exercised in the other Contracting State shall be exempt from tax in the first-mentioned State if that pension or other remuneration would be exempt from tax in the other State if the recipient were a resident of that other State.**

Paragraph 2

47. **Under** ~~T~~this paragraph ~~assigns to~~ the ~~country~~ **State** of source ~~the~~ **has an** exclusive right to tax pensions paid ~~out~~ and other payments made within the framework of a public scheme which is part of the social security system of that State or a political subdivision or a local authority thereof.. **Countries using the credit method as the general method for relieving double taxation in their conventions are thus, as an exception to that method, obliged to exempt from tax such payments to their residents as are dealt with under paragraph 2.** ~~As can be seen from paragraph 2 of the OECD Commentary quoted below, no consensus emerged within the OECD Committee on Fiscal Affairs on the inclusion in the text of Article 18 of such an exclusive right.~~ The ~~assignment to~~ **exclusive right of** the **State of** source ~~country of the exclusive right~~ to tax pensions paid ~~out~~ and other payments made under a public scheme which is part of the social security system is predicated on the rationale that the payments involved are wholly or largely financed out of the tax revenues of the **State of** source ~~country~~. This is the case when there are no contributions by the prospective beneficiaries of the payments or when the contractual savings contributed under the social security scheme have to be supplemented by the tax revenues of the **State of** source ~~country~~. Such may not always be the case however when the social security system functions on the basis of the capitalization principle rather than that of the distribution principle. ~~The OECD Commentary observes:~~

> ~~"Some States consider pensions paid out under a public pension scheme which is part of their social security system similar to Government pensions. Such States argue on that basis that the State of source, i.e., the State from which the pension is paid, should have a right to tax such pensions. Many conventions concluded by these States contain provisions to that effect, sometimes including also other payments made under the social security legislation of the State of source. Such payments are for instance sickness benefits, unemployment benefits and benefits on account of industrial injury. Contracting States having that view may agree bilaterally on an additional paragraph to the Article giving the State of source a right to tax payments made under its social security legislation. A paragraph of that kind could be drafted along the following lines:~~
>
> > ~~'Notwithstanding the provisions of paragraph 1, pensions and other payments made under the social security legislation of a Contracting State may be taxed in that State.'~~
>
> ~~Where the State of which the recipient of such payments is a resident applies the exemption method the payments will be taxable only in the State of source, while States using the credit method may tax the payments and give credit for the tax levied in the State of source. Some States using the credit method as the general method in their conventions may, however, consider that the State of source should have an exclusive right to tax such payments. Such States should then substitute the words 'shall be taxable only' for the words 'may be taxed' in the above draft provision." [para. 2]~~

8. No consensus emerged within the OECD Committee on Fiscal Affairs on the inclusion in the text of Article 18 of the OECD Model of a provision allowing the State of source to tax payments made under its social security system. However, the OECD Commentary proposes an alternative paragraph providing for such right. The Committee considers that the following part of the OECD Commentary (as it read on 22 October 2010) is applicable to paragraph 2:

[28] Although the above draft provision refers to the social security … *[system]* of each Contracting State, there are limits to what it covers. "Social security" generally refers to a system of mandatory protection that a State puts in place in order to provide its population with a minimum level of income or retirement benefits or to mitigate the financial impact of events such as unemployment, employment-related injuries, sickness or death. A common feature of social security systems is that the level of benefits is determined by the State. Payments that may be covered by the provision include retirement pensions available to the general public under a public pension scheme, old age pension payments as well as unemployment, disability, maternity, survivorship, sickness, social assistance, and family protection payments that are made by the State or by public entities constituted to administer the funds to be distributed. As there may be substantial differences in the social security systems of the Contracting States, it is important for the States that intend to use the draft provision to verify, during the course of bilateral negotiations, that they have a common understanding of what will be covered by the provision.

Comment [MB25]: Note by a member of the Subcommittee: In paragraph [28], I have deleted, in the beginning, the term "legislation" used in the OECD alternative provision and replaced it by the term *"[system]"* used in paragraph 2. … [1]

9. Some countries using the credit method as the general method for the elimination of double taxation of income derived by their residents may consider that the State of source should not have an exclusive right to tax social security payments. Those countries should then substitute the words "may be taxed" for the words "shall be taxable only" in paragraph 2 of their treaties.

~~5~~**10**. The **countries that wish** ~~Group of Experts had suggested that the provisions of paragraph 2 of article 18 (alternative A) and paragraph 3 of article 18 (alternative B) may require amendment~~ to deal with the consequences of **the** privatization of **their** social security system~~s.~~ **may propose to amend the provisions of paragraph 2 along the following lines in order to cover their privatised system:**

> **Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme or a mandatory private scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.**

~~6. As of 1999, there does not appear to be any treaty text which clearly addresses the issue of privatization of social security systems. It is true that in some treaty texts, the right to tax the social security payments is attributed to the State of residence, rather than the State of source, though this does not address the issue raised above.~~

~~7. Privatized social security systems can be found in a number of countries in Latin America and East Europe. The issues concerning double taxation consequent upon the introduction of privatized social security systems have not been noticed so far. This issue is still under examination and the results of enquiry in this behalf will be brought to the notice of the Group of Experts in due course.~~

Commentary on the paragraphs of ~~a~~**A***rticle 18 B*

~~8~~**11**. ~~During the discussion, s~~Several ~~members of the Group of Experts from developing~~ countries ~~expressed the view~~ **consider** that pensions **paid in consideration of past employment** should not be taxed exclusively in the beneficiary's ~~country~~ **State** of residence. **Various policy considerations support this rule.** ~~They pointed out that, s~~ **S**ince pensions ~~were~~ **are** in substance a form of deferred compensation for services performed in the **State of** source~~ country~~, they should be taxed at source as normal employment income would be. **When tax relief is granted for pension contributions, the tax on part of the employment income is deferred until retirement and the tax so deferred should be recovered even if the individual has ceased to be a resident before all or part of the pension benefits is paid.** ~~They further observed that p~~**P**ension flows between some developed and developing countries ~~were~~ **may** not **be** reciprocal and in some cases represent~~ed~~ a relatively substantial net outflow for the developing country. ~~Several members said they favoured exclusive taxation of pensions at source but would be willing to grant an exemption from source taxation for amounts equivalent to the personal exemptions allowable in the source country. Other members were generally of the view that pensions should be taxed only in the beneficiary's country of residence. They suggested that, since the amounts involved were generally not substantial, countries would not suffer measurably if they agreed to taxation in the country of residence. Those members also made the point that the country of residence is probably in a better position than the source country to tailor its taxation of pensions to the taxpayer's ability to pay.~~

[12. If the State of source imposes a final withholding tax on the gross amount of the pensions or does not grant any personal allowances to non-residents, the source taxation of pensions may result in excessive taxation. This issue should be discussed during negotiations. The Contracting States may agree in those cases that the State of source shall grant to a resident of the other State any personal allowances, reliefs and reductions for taxation purposes granted to its own residents in the proportion which the pensions and other similar remunerations bear to its world income. A sentence drafted along the following lines may be added in paragraph 2:

> **The other State shall grant to a resident of the first-mentioned State any personal allowances, reliefs and reductions for taxation purposes which it grants to its own residents. Those allowances, reliefs and reductions shall be granted in the proportion which the pensions and other similar remunerations taxable in that State bear to the world income taxable in the first-mentioned State.]**

~~9~~**13**. ~~A question was raised about how pension payments would be taxed in the case of employees who had~~ **The State of source might be considered to be the State in which the fund is established, the State where the relevant work has been performed or the State where deductions have been claimed. It is fairly common for employees of transnational corporations to** perform~~ed~~ services consecutively in several different countries**. In such case, taxation in the State where those services were performed or in which relief was granted would raise uncertainty and administrative difficulties for both taxpayers and tax authorities because it would create the possibility of different parts of the same pension being taxable in different States of source.**~~— a fairly common practice among employees of transnational corporations. If such employees were taxed in each jurisdiction in which they had previously worked to earn the pension, then each pension payment might be taxed in several jurisdictions. It was also observed that it would be very difficult for the head office of a company to allocate each pension among the various countries in which the pensioner had worked during his years of employment.~~ It ~~was~~ **is** generally agreed, therefore, that taxation of pension at source should be construed to mean taxation at the place in which the pension payments originate~~d~~, not the place in which the services ~~had been~~ **were** performed **or in which tax relief was granted. [Now many individuals spend, however, significant parts of their career outside the State in which the pension fund paying their pension benefits is established. In such case, the link between the pension benefits and the State in which the fund is established could be considered as too tenuous to justify that those benefits come within the taxing jurisdiction of that State.]**.

Paragraph 1

~~10~~**14**. This paragraph, although it recognizes the right of the ~~country~~ **State** of residence **of the**

Comment [MB26]: Note by a member of the Subcommittee: A member of the Committee considers that paragraph 12, which explains the fourth sentence found in paragraph 8 of the current Commentary, is negative with regard to taxation of pensions at source. However, gross taxation of pensions at source could have harmful consequences for pensioners. Contracting States should therefore be fully aware of that problem and of one possible solution.

Comment [MB27]: Note by a member of the Subcommittee: The two last sentences reflect the discussion under paragraph [13] of the OECD Commentary (which is not quoted). Those sentences explain why it would not seem appropriate to grant the State where the fund is established the right to tax the pension benefits. Indeed, even if that solution is endorsed under Article 18B, any consideration allowing the Contracting States to make a well informed choice between both alternatives A and B should be mentioned.

recipient to tax pensions and other similar remuneration, leaves open the possibility that the ~~country~~ **State** of source may also be given the right to tax in certain conditions which are defined in paragraph 2. **Paragraph 4 of the Commentary on paragraph 1 of Article 18 A is applicable in order to determine the scope of the Article 18 B and to consider the cross-border issues related to pensions.**

Paragraph 2

~~11~~**15**. As indicated above, the ~~country~~ **State** of source may ~~be allowed to~~ tax **pensions and other similar remuneration paid in consideration of past employment** ~~but only~~ if the payments involved are made by a resident of that ~~country~~ **State** or a permanent establishment situated therein.

16. Some countries could, however, consider that the State which has given tax relief with regard to contributions to the pension scheme or to the accrual of pension rights should have the right to tax the resultant pension. This could be the case where countries grant also tax relief with respect to contributions to or pension rights within foreign pension funds. The following provision is an example of such a provision:

> **However such pensions and other similar remuneration may also be taxed in the other Contracting State to the extent that they arise from contributions that have qualified for tax relief in that other State.**

As already explained in paragraph 14, this approach would raise administrative difficulties, especially in the case of individuals who have worked in more than one country during their career. Such difficulties should be addressed in order to avoid situations for example where two countries would claim to have source taxation rights on the same pension.

Paragraph 3

~~12~~**17**. Since paragraph 3 of ~~a~~**A**rticle 18 B is identical to paragraph 2 of ~~a~~**A**rticle 18 A, the Commentary on the latter paragraph (see above) is fully applicable to the former.

~~13~~**18**. The OECD Model Convention in the Commentary on Article 18 at paragraphs ~~4~~ **31** to ~~37~~**69** has dealt with the question of tax treatment of contributions to foreign pension schemes**, the question of tax obstacles to the portability of pension rights and the question of the tax exempt treatment of investment income derived by pension funds established in the other Contracting State**. ~~Some members of the Group of Experts pointed out that i~~**I**ncorporation of these paragraphs in the **Commentary on Article 18 in the** United Nations Model Convention ~~dealing with this subject~~ would send a strong positive signal to potential inward investors. Allowing recognition of cross-border pension contributions **and facilitating cross-border transfer of pension rights from a pension scheme to another** will also stimulate movement of personnel to foreign countries. ~~It is, therefore, considered important to reproduce paragraphs 4 to 37 of the OECD Commentary as under~~ **The Committee considers that the following part of the OECD Commentary** ~~**(as it read on 22 October 2010)**~~ **is therefore relevant to Article 18A and Article 18B**:

Comment [MB28]: Note by a member of the Subcommittee: I have not quoted paragraphs 29 and 30 of the OECD Commentary on Article 18 which are dealing with issues related to individual private saving schemes established to provide retirement benefits. These schemes take various legal forms and the application of the alternative provision proposed by the OECD Commentary could lead to an increase of the administrative burden for tax administrations.

~~"~~The tax treatment of contributions to foreign pension schemes

A. General comments

[31] It is characteristic of multinational enterprises that their staff are expected to be willing to work outside their home country from time to time. The terms of service under which staff are sent to work in other countries are of keen interest and importance to both the employer and the employee. One consideration is the pension arrangements that are made for the employee in question. **[Similarly, individuals who move to other countries to provide independent services are often confronted with cross-border tax issues related to the pension arrangements that they have established in their home country.]**~~" [para. 4]~~

Comment [MB29]: Note by a member of the Subcommittee: A[nother] member of the Committee considers that Article 18 is primarily for pensions in consideration of past employment. Covering pension arrangements relating to non-employee covered by Article 14 may not be appropriate. Although the status of employees and self-employed individuals is different, the problems they may encounter with respect to their pension arrangements are similar. This may justify that their pension arrangements benefit from the same treatment.

[32] ~~Employees sent abroad to work~~ **Individuals working abroad** will often wish to continue contributing to a pension scheme **(including a social security scheme that provides pension benefits)** in their home country during their absence abroad. This is **both** because switching schemes can lead to a loss of rights and benefits, and because many practical difficulties can arise from having pension arrangements in a number of countries.~~" [para. 5]~~

[33] The tax treatment accorded to pension contributions **made by or for individuals working outside** ~~of employees who are assigned to work outside~~ their home country varies both from country to country and depending on the circumstances of the individual case. Before taking up an overseas assignment **or contract, pension contributions made by or for these individuals,** ~~employees~~ commonly qualify for tax relief ~~on pension contributions paid~~ in the home country. When **the individual works** ~~assigned~~ abroad, **the contributions** ~~employees~~ in some cases continue to qualify for relief. Where ~~an~~ **the** individual, for example, remains resident and fully taxable in the home country, pension contributions made to a pension scheme established in the home country will generally continue to qualify for relief there. But frequently, contributions paid in the home country by an individual ~~assigned to~~ work**ing** abroad do not qualify for relief under the domestic laws of either the home country or the host country. Where this is the case it can become expensive, if not prohibitive, to maintain membership of a pension scheme in the home country during a foreign assignment **or contract**. Paragraph ~~11~~**37** below suggests a provision which Member countries can, if they wish, include in bilateral treaties to provide reliefs for the pension contributions **made by or for individuals** ~~of employees assigned to~~ work**ing** outside their home country.~~" [para. 6]~~

[34] However, some ~~M~~**m**ember countries may not consider that the solution to the problem lies in a treaty provision, preferring, for example, the pension scheme to be amended to secure deductibility of contributions in the host State. Other countries may be opposed to including the provision **below** in treaties where domestic legislation allows ~~deductions~~ **relief** only ~~for~~ **with respect to** contributions paid to residents. In such cases it may be **in**appropriate to include the suggested provision in a bilateral treaty.~~" [para. 7]~~

[35] ~~The suggested provision does not address itself to contributions made to social security schemes (general State pension schemes dependent upon contribution records, whether or not contributors are employees) as the right or obligation to join a social security scheme is primarily a matter of social legislation rather than tax law. Many Member countries have entered into bilateral social security totalisation agreements which may help to avoid the problem with respect to contributions to social security schemes. The provision also does not contain provisions relating either to the deductibility by the employer of employer pension contributions in respect of employees working abroad or to the treatment of income accrued within the plan. All of these issues can be dealt with in bilateral negotiations."~~ **The suggested provision covers contributions made to all forms of pension schemes, including individual retirement schemes as well as social security schemes. Many Member countries have entered into bilateral social security totalisation agreements which may help to partially avoid the problem with respect to contributions to social security schemes; these agreements, however, usually do not deal with the tax treatment of cross-border contributions. In the case of an occupational scheme to which both the employer and the employees contribute, the provision covers both these contributions. Also, the provision is not restricted to the issue of the deductibility of the contributions as it deals with all aspects of the tax treatment of the contributions as regards the individual who derive benefits from a pension scheme. Thus the provision deals with issues such as whether or not the employee should be taxed on the employment benefit that**

an employer's contribution constitutes and whether or not the investment income derived from the contributions should be taxed in the hands of the individual. It does not, however, deal with the taxation of the pension fund on its income (this issue is dealt with in paragraph 69 below). Contracting States wishing to modify the scope of the provision with respect to any of these issues may do so in their bilateral negotiations. ~~[para. 8]~~

~~"The provision is confined to the tax treatment of contributions to pension schemes by or on behalf of individuals who exercise employments within the meaning of Article 15 away from their home State. It does not deal with contributions by individuals who render independent personal services within the meaning of Article 14. However, Member countries may wish, in bilateral negotiations, to agree on a provision covering individuals rendering services within both Article 14 and Article 15." [para. 9]~~

~~"~~B. Aim of the provision

[36] The aim of the provision is to ensure that, as far as possible, ~~an employee is~~ **individuals are** not discouraged from taking up ~~an~~ overseas ~~assignment~~ **work** by the tax treatment of **their** contributions ~~made~~ to a home country pension scheme ~~by an employee working abroad~~. The provision seeks, first, to determine the general equivalence of pension plans in the two countries and then to establish limits to the ~~deductibility of employee~~ contributions **to which the tax relief applies** based on the limits in the laws of both countries.~~" [para. 10]~~

~~"~~C. Suggested provision

[37] The following is the suggested text of the provision that could be included in bilateral conventions to deal with the problem identified above:

~~(a) Contributions borne by an individual who renders dependent personal services in a Contracting State to a pension scheme established in and recognised for tax purposes in the other Contracting State shall be deducted, in the first-mentioned State, in determining the individual's taxable income, and treated in that State, in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that first-mentioned State, provided that:~~

~~(i) the individual was not a resident of that State, and was contributing to the pension scheme, immediately before he began to exercise employment in that State; and~~

~~(ii) the pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognised as such for tax purposes by that State.~~

~~(b) For the purposes of subparagraph (a):~~

~~(i) the term 'a pension scheme' means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the dependent personal services referred to in subparagraph (a); and~~

~~(ii) a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State." [para. 11]~~

1. Contributions to a pension scheme established in and recognised for tax purposes in a Contracting State that are made by or on behalf of an individual who renders services in the other Contracting State shall, for the purposes of determining the individual's tax payable and the profits of an enterprise which may be taxed in that State, be treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that State, provided that:

a) the individual was not a resident of that State, and was participating in the pension scheme,

immediately before beginning to provide services in that State, and

b) the pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognised as such for tax purposes by that State.

2. For the purposes of paragraph 1:

a) the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the services referred to in paragraph 1; and

b) a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State.

[38] The above provision is restricted to pension schemes established in one of the two Contracting States. As it is not unusual for individuals to work in a number of different countries in succession, some States may wish to extend the scope of the provision to cover situations where an individual moves from one Contracting State to another while continuing to make contributions to a pension scheme established in a third State. Such an extension may, however, create administrative difficulties if the host State cannot have access to information concerning the pension scheme (e.g. through the exchange of information provisions of a tax convention concluded with the third State); it may also create a situation where relief would be given on a non-reciprocal basis because the third State would not grant similar relief to an individual contributing to a pension scheme established in the host State. States which, notwithstanding these difficulties, want to extend the suggested provision to funds established in third States can do so by adopting an alternative version of the suggested provision drafted along the following lines:

1. Contributions made by or on behalf of an individual who renders services in a Contracting State to a pension scheme

a) recognised for tax purposes in the other Contracting State,

b) in which the individual participated immediately before beginning to provide services in the first-mentioned State,

c) in which the individual participated at a time when that individual was providing services in, or was a resident of, the other State, and

d) that is accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognized as such for tax purposes by that State,

shall, for the purposes of

e) determining the individual's tax payable in the first-mentioned State, and

f) determining the profits of an enterprise which may be taxed in the first-mentioned State,

be treated in that State in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that first-mentioned State.

2. For the purposes of paragraph 1:

a) the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the services referred to in paragraph 1; and

b) a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State.

D. Characteristics of the suggested provision

[39] The following paragraphs discuss the main characteristics of the suggested provision found in paragraph 37 above.

[40] ~~Subparagraph (a)~~ **Paragraph 1** of the suggested provision lays down the characteristics of both the ~~employee~~ **individual** and the contributions ~~to~~ **in respect of** which the provision applies. It also provides the principle that contributions ~~borne by~~ **made by or on behalf of** an individual rendering ~~dependent personal~~ services ~~within the meaning of Article 15~~ in one Contracting State (the host State) to a defined pension scheme in the other Contracting State (the home State) are to be ~~relieved from tax~~ **treated for tax purposes** in the host State, **in the same way and** subject to the same conditions and limitations as ~~relief for~~ contributions to domestic pension schemes of the host State.~~" [para. 12]~~

[41] **Tax** ~~R~~relief ~~for~~ **with respect to** contributions to the home country pension scheme under the conditions outlined can be given by either the home country, being the country where the pension scheme is situated or by the host country, where the economic activities giving rise to the contributions are carried out.~~" [para. 13]~~

[42] A solution in which relief would be given by the home country might not be effective, since the ~~employee~~ **individual** might have no or little taxable income in that country. Practical considerations therefore suggest that it would be preferable for relief to be given by the host country and this is the solution adopted in the suggested provision.~~" [para. 14]~~

[43] In looking at the characteristics of the ~~employee~~ **individual**, ~~sub~~paragraph ~~(a)~~ **1** makes it clear that, in order to get the relief from taxation in the host State, the ~~employee~~ **individual** must not have been resident in the host State immediately prior to working there.~~" [para. 15]~~

[44] ~~Subparagraph (a)~~ **Paragraph 1** does not, however, limit the application of the provision to ~~secondees~~ **individuals** who become resident in their host State. In many cases ~~employees~~ **individuals** working abroad who remain resident in their home State will continue to qualify for relief there, but this will not be so in all cases. The suggested provision therefore applies to non-residents working in the host State as well as to ~~secondees~~ **individuals** ~~to the host State~~ who attain residence status there. In some Member countries the domestic legislation may restrict deductibility to contributions borne by residents, and these Member countries may wish to restrict the suggested provision to cater for this. Also, States with a special regime for non-residents (e.g.~~,~~ taxation at **a** special low rate) may, in bilateral negotiations, wish to agree on a provision restricted to residents.~~" [para. 16]~~

[45] In the case where individuals temporarily cease to be resident in the host country in order to join a pension scheme in a country with more relaxed rules, individual States may want a provision which would prevent the possibility of abuse. One form such a provision could take would be a nationality test which could exclude from the suggested provision individuals who are nationals of the host State.~~" [para. 17]~~

[46] As **already noted,** it is not unusual for ~~employees to be seconded to~~ **individuals to work in** a number of different countries in succession**; for that reason** the suggested provision is not limited to ~~employees~~ **individuals** who are residents of the home State immediately prior to ~~exercising employment~~ **providing services** in the host State. The provision covers an ~~employee~~ **individual** coming to the host State from a third country as it is only limited to ~~employees~~ **individuals** who were not resident in the host country before ~~taking up employment~~ **starting to work** there. However, Article 1 restricts the scope of the Convention to residents of one or both Contracting States. An ~~employee~~ **individual** who is neither a resident of the host State nor of the home State where the pension scheme is established is therefore outside the scope of the Convention between the two States.~~" [para. 18]~~

[47] The suggested provision places no limits on the length of time for which an ~~employee~~ **individual** can work in a host State. It could be argued that, if an ~~employee~~ **individual** works in the host State for long enough, it in effect becomes his home country and the provision should no longer apply. Indeed, some host countries already restrict relief for contributions to foreign

~~employee/ employer~~ pension schemes to cases where the ~~seconded employees~~ **individuals** are present on a temporary basis.~~" [para. 19]~~

[48] In addition, the inclusion of a time limit may be helpful in preventing the possibility of abuse outlined in paragraph ~~17~~**45** above. In bilateral negotiations, individual countries may find it appropriate to include a limit on the length of time for which an ~~employee~~ **individual** may ~~exercise an employment~~ **provide services** in the host State after which reliefs granted by the suggested provision would no longer apply.~~" [para. 20]~~

[49] In looking at the characteristics of the contributions, ~~subparagraph (a)~~ **paragraph 1** provides a number of tests. It makes **it** clear that the provision applies only to contributions ~~borne by~~ **made by or on behalf of** an individual to a pension scheme established in and recogni~~z~~sed for tax purposes in the home State. The phrase 'recogni~~z~~sed for tax purposes' is further defined in ~~subdivision (b)(ii)~~ **subparagraph 2b)** of the suggested provision. **The phrase "made by or on behalf of" is intended to apply to contributions that are made directly by the individual as well as to those that are made for that individual's benefit by an employer or another party (e.g. a spouse). While paragraph 4 of Article 24 ensures that the employer's contributions to a pension fund resident of the other Contracting State are deductible under the same conditions as contributions to a resident pension fund, that provision may not be sufficient to ensure the similar treatment of employer's contributions to domestic and foreign pension funds. This will be the case, for example, where the employer's contributions to the foreign fund are treated as a taxable benefit in the hands of the employee or where the deduction of the employer's contributions is not dependent on the fund being a resident but, rather, on other conditions (e.g. registration with tax authorities or the presence of offices) which have the effect of generally excluding foreign pension funds. For these reasons, employer's contributions are covered by the suggested provision even though paragraph 4 of Article 24 may already ensure a similar relief in some cases.**~~" [para. 21]~~

[50] The second test applied to the characteristics of the contributions is that the contributions should be made to a home State scheme recogni~~z~~**s**ed by the competent authority of the host State as generally corresponding to a scheme recogni~~z~~**s**ed as such for tax purposes by the host State. This operates on the premise that only contributions to recogni~~z~~**s**ed schemes qualify for relief in ~~M~~**m**ember countries. This limitation does not, of course necessarily secure equivalent tax treatment of contributions paid where an ~~employee~~ **individual** was working abroad and of contributions while working in the home country. If the host State's rules for recogni~~z~~**s**ing pension schemes were narrower than those of the home State, the ~~employee~~ **individual** could find that contributions to his home country pension scheme were less favourably treated when he was working in the host country than when working in the home country.~~" [para. 22]~~

[51] However, it would not be in accordance with the stated aim of securing, as far as possible, equivalent tax treatment of ~~employee~~ contributions to **foreign schemes to** give relief for contributions which do not — at least broadly — correspond to domestically recogni~~z~~**s**ed schemes. To do so would mean that the amount of relief in the host State would become dependent on legislation in the home State. In addition, it could be hard to defend treating ~~employees~~ **individuals** working side by side differently depending on whether their pension scheme was at home or abroad (and if abroad, whether it was one country rather than another). By limiting the suggested provision to schemes which generally correspond to those in the host country such difficulties are avoided.~~" [para. 23]~~

[52] The suggested provision makes it clear that it is for the competent authority of the host State to determine whether the scheme in the home State generally corresponds to recogni~~z~~**s**ed schemes in the host State. Individual States may wish, in bilateral negotiations, to **specify expressly to which existing schemes the provision will apply or to** establish what interpretation the competent authority places on the term ‘generally corresponding’; for example how widely it is interpreted and what tests are imposed.~~” [para. 24]~~

[53] The contributions covered by the provision are limited ~~to~~ **in** payments to schemes to which the ~~employee~~ **individual** was ~~contributing~~ **participating** before ~~he began~~ **beginning** to ~~exercise his employment~~ **provide services** in the host State. This means that contributions to new pension schemes which an ~~employee~~ **individual** joins while in the host State are excluded from the suggested provision.~~” [para. 25]~~

[54] It is, however, recogni~~z~~sed that special rules may be needed to cover cases where new pension schemes are substituted for previous ones. For instance, in some Member countries the common practice may be that, if a company employer is taken over by another company, the existing company pension scheme for its employees may be ended and a new scheme opened by the new employer. In bilateral negotiations, therefore, individual States may wish to supplement the provision to cover such substitution schemes**; this could be done by adding the following sub-paragraph to paragraph 2 of the suggested provision:**

“c) a pension scheme that is substituted for, but is substantially similar to, a pension scheme accepted by the competent authority of a Contracting State under subparagraph b) of paragraph 1 shall be deemed to be the pension scheme that was so accepted.~~” [para. 26]~~

[55] ~~Subparagraph (a)~~ **Paragraph 1** also sets out the relief to be given by the host State if the characteristics of the ~~employee~~ **individual** and the contributions fall within the terms of the provision. In brief, ~~the relief is to be given in a way which corresponds to the manner in which relief would be given if the~~ contributions **must be treated for tax purposes in a way which corresponds to the manner in which they would be treated if these contributions** were to a scheme established in the host State. **Thus, the contributions will qualify for the same tax relief (e.g. be deductible), for both the individual and the employer (where the individual is employed and contributions are made by the employer) as if these contributions had been made to a scheme in the host State. Also, the same treatment has to be given as regards the taxation of an employee on the employment benefit derived from an employer’s contribution to either a foreign or a local scheme (see paragraph 58 below).**~~” [para. 27]~~

[56] This measure of relief does not, of course, necessarily secure equivalent tax treatment given to contributions paid when an ~~employee~~ **individual** is working abroad and contributions paid when he is working in the home country. Similar considerations apply here to those discussed in paragraphs ~~22~~**50** and ~~23~~**51** above. The measure does, however, ensure equivalent treatment of the contributions of ~~colleagues~~ **co-workers**. The following example is considered. The home country allows relief for pension contributions subject to a limit of 18 per cent of income. The host country allows relief subject to a limit of 20 per cent. The suggested provision in paragraph ~~11~~**37** would require the host country to allow relief up to its domestic limit of 20 per cent. Countries wishing to adopt the limit in the home country would need to amend the wording of the provision appropriately.~~” [para. 28]~~

[57] The amount and method of giving the relief would depend upon the domestic tax treatment of pension contributions by the host State. This would settle such questions as whether ~~such~~ contributions qualify for relief in full, or only in part, and whether relief should be given as a deduction in computing taxable income (and if so, which income, e.g. **in the case of an individual**, only employment ***[, independent personal services]*** **or business** income or all income) or as a tax credit.~~” [para. 29]~~

[58] **For an individual who participates in an occupational pension scheme,** ~~B~~**b**eing assigned to work abroad may not only mean that ~~an~~ **this** employee’s contributions to a pension scheme in his home country cease to qualify for tax relief. It may also mean that contributions to the pension scheme by the employer are regarded as **the** employee’s income for tax purposes. In some Member countries employees are taxed on employer’s contributions to domestic

Comment [MB30]: Note by a member of the Subcommittee: I have added *[, independent personal services]* in order to cover income dealt with in Article 14. Is this, however, necessary?

scheme**s** whilst working in the home country whereas in others these contributions remain exempt. ~~The provision, therefore, is silent on the treatment of such contributions, although Member countries may wish to extend the suggested provision in bilateral treaties, to~~ **Since it applies to both employees' and employers' contribution, the suggested provision** ensure**s** that~~ the~~ employer**s**'~~s~~ contributions in the context of **the** employees' tax liability are accorded the same treatment that such contributions to domestic schemes would receive.~~" [para. 30]~~

[59] ~~Subdivision (b)(i)~~ **Subparagraph 2a)** defines a pension scheme for the purposes of ~~sub~~paragraph ~~(a)~~ **1**. It makes it clear that, for these purposes, a pension scheme is an arrangement in which the individual who makes the payments participates in order to secure retirement benefits. These benefits must be payable in respect of ~~the exercise of the employment~~ **services provided** in the host State. All the above conditions must apply to the pension scheme before it can qualify for relief under the suggested provision.~~" [para. 31]~~

[60] ~~Subdivision (b)(i)~~ **Subparagraph 2a)** refers to the participation of the individual in the pension scheme in order to secure retirement benefits. This definition is intended to ensure that the proportion of contributions made to secure benefits other than periodic pension payments on retirement, e.g.~~,~~ a lump sum on retirement, will also qualify for relief under the provision.~~" [para. 32]~~

[61] The initial definition of a pension scheme is 'an arrangement'. This is a widely drawn term, the use of which is intended to encompass the various forms ~~that~~**which** pension schemes **(whether social security, occupational or individual retirement schemes)** may take in **different** ~~individual~~ ~~M~~**m**ember countries.~~" [para. 33]~~

[62] ~~Subdivision (b)(i)~~ **Subparagraph 2a)** sets out that participation in this scheme has to be by the individual who ~~exercises the employment~~ **provides services** referred to in ~~sub~~paragraph ~~(a)~~ **1** there is no reference to the identity of the recipient of the retirement benefits secured by participation in the scheme. This is to ensure that any proportion of contributions intended to generate ~~a widow or dependant's~~ pension **for other beneficiaries (e.g. surviving spouses, companions or children of employees)** may be eligible for relief under the suggested provision.~~" [para. 34]~~

[63] The definition of a pension scheme makes no distinction between pensions paid from State-run occupational pension schemes and similar privately-run schemes. Both are covered by the scope of the provision. **Social security schemes are therefore covered by the provision to the extent that contributions to such schemes can be considered to be with respect to the services provided in the host State by an individual, whether as an employee or in an independent capacity.**~~Any pensions, such as pensions from general State pension schemes dependent on contribution records whether or not contributors are employees, are excluded from the provision as the individual will not contribute to such schemes in order to receive benefits payable in respect of dependant personal services rendered." [para. 35]~~

[64] ~~Subdivision (b)(ii)~~ **Subparagraph 2 b)** further defines the phrase 'recogni~~z~~**s**ed for tax purposes'. As the aim of the provision is, so far as possible, to ensure that ~~the~~ contributions are neither more nor less favourably treated for tax purposes than they would be if the ~~employee~~ **individual** ~~was~~ **were** resident in his home State, it is right to limit the **scope of the** provision to contributions which would have qualified for relief if the ~~employee~~ **individual** had remained in the home State. The provision seeks to achieve this aim by limiting its scope to contributions made to a scheme only if contributions to this scheme would qualify for tax relief in that State.~~" [para. 36]~~

[65] This method of attempting to achieve parity of treatment assumes that in all ~~M~~**m**ember countries only contributions to recogni~~z~~**s**ed pension schemes qualify for relief. The tax treatment of contributions to pension schemes under Member countries' tax systems may differ from this assumption. It is recogni~~z~~**s**ed that, in bilateral negotiations, individual countries may wish to further define the qualifying pension schemes in terms that match the respective domestic laws of the treaty partners. **They may also wish to define other terms used in the provision, such as "renders services" and "provides services**~~" [para. 37]~~

Tax obstacles to the portability to pension rights

[66] Another issue, which also relates to international labour mobility, is that of the tax consequences that may arise from the transfer of pension rights from a pension scheme established in one Contracting State to another scheme located in the other Contracting State. When an individual moves from one employer to another, it is frequent for the pension rights that this individual accumulated in the pension scheme covering the first employment to be transferred to a different scheme covering the second employment. Similar arrangements may exist to allow for the portability of pension rights to or from an individual retirement scheme.

[67] Such transfers usually give rise to a payment representing the actuarial value, at the time of the transfer, of the pension rights of the individual or representing the value of the contributions and earnings that have accumulated in the scheme with respect to the individual. These payments may be made directly from the first scheme to the second one; alternatively, they may be made by requiring the individual to contribute to the new pension scheme all or part of the amount received upon withdrawing from the previous scheme. In both cases, it is frequent for tax systems to allow such transfers, when they are purely domestic, to take place on a tax-free basis.

[68] Problems may arise, however, where the transfer is made from a pension scheme located in one Contracting State to a scheme located in the other State. In such a case, the Contracting State where the individual resides may consider that the payment arising upon the transfer is a taxable benefit. A similar problem arises when the payment is made from a scheme established in a State to which the relevant tax convention gives source taxing rights on pension payments arising therefrom as that State may want to apply that taxing right to any benefit derived from the scheme. Contracting States that wish to address that issue are free to include a provision drafted along the following lines:

> **Where pension rights or amounts have accumulated in a pension scheme established in and recognised for tax purposes in one Contracting State for the benefit of an individual who is a resident of the other Contracting State, any transfer of these rights or amounts to a pension scheme established in and recognised for tax purposes in that other State shall, in each State, be treated for tax purposes in the same way and subject to the same conditions and limitations as if it had been made from one pension scheme established in and recognised for tax purposes in that State to another pension scheme established in and recognised for tax purposes in the same State.**

The above provision could be modified to also cover transfers to or from pensions funds established and recognised in third States (this, however, could raise similar concerns as those described in the preamble of paragraph 38 above).

Exemption of the income of a pension fund

[69] Where, under their domestic law, two States follow the same approach of generally exempting from tax the investment income of pension funds established in their territory,

these States, in order to achieve greater neutrality with respect to the location of capital, may want to extend that exemption to the investment income that a pension fund established in one State derives from the other State. In order to do so, States sometimes include in their conventions a provision drafted along the following lines:

> **Notwithstanding any provision of this Convention, income arising in a Contracting State that is derived by a resident of the other Contracting State that was constituted and is operated exclusively to administer or provide pension benefits and has been accepted by the competent authority of the first-mentioned State as generally corresponding to a pension scheme recognised as such for tax purposes by that State, shall be exempt from tax in that State.**

Article 19

GOVERNMENT SERVICE

1. In 1999, three changes were made in ~~a~~**A**rticle 19. Firstly, the title of ~~a~~**A**rticle 19 was changed from "Remuneration and pensions in respect of government service" to "Government service". Secondly, in paragraphs 1 and 3, the word "remuneration" was replaced by the expression "salaries, wages and other similar remuneration". Thirdly, paragraph 3 was amended to refer to ~~a~~**A**rticle 17. **In 2011, some other changes were made in Article 19. Firstly, the words "other than a pension" were deleted in paragraph 1. Secondly, the words "Notwithstanding the provisions of paragraph 1" were added in paragraph 2. Thirdly, in paragraphs 2 and 3, the word "pension" was replaced by the words "pensions and other similar remuneration".** As a result, ~~a~~**A**rticle 19 of the United Nations Model Convention reproduces Article 19 of the OECD Model Convention. ~~The Group observed that, while the provisions of the article were generally acceptable to its members, some developing countries might in bilateral negotiations desire to place a monetary ceiling on the amount subject to subparagraph 2(b), which precludes a Contracting State from taxing pension payments that it makes to a resident or a national of the other State. The Group also felt that some developing countries might prefer that payments dealt with in aArticle 19 should be taxed only by the beneficiary's country of residence~~.

Comment [MB31]: Note by a member of the Subcommittee: It seems that the possible alternative provisions mentioned in paragraph 1 are generally not found in tax treaties. I therefore propose to delete those sentences.

2. Since ~~a~~**A**rticle 19 of the United Nations Model Convention incorporates all the provisions of Article 19 of the OECD Model Convention, ~~the following Commentary on the OECD Article is relevant~~ **the Committee considers that the following part of the OECD Commentary is applicable**:

> **[1]** ~~"~~This Article applies to salaries, wages, and other similar remuneration**, and pensions,** in respect of government service. Similar provisions in old bilateral conventions were framed in order to conform with the rules of international courtesy and mutual respect between sovereign States. They were therefore rather limited in scope. However, the importance and scope of Article 19 has increased on account of the fact that, consequent on the growth of the public sector in many countries, governmental activities abroad have been considerably extended. According to the original version of paragraph 1 of Article 19 in the 1963 Draft Convention~~,~~ the paying State had a right to tax payments made for services rendered to that State or political subdivision or local authority thereof. The expression 'may be taxed' was used and this did not connote an exclusive right of taxation.~~" [para. 1]~~
>
> **[2]** ~~"~~. . . ~~s~~***[S]***ubparagraph~~s~~ ~~(~~a) of paragraphs 1 and 2 are both based on the principle that the paying State shall have an exclusive right to tax the payments. Countries using the credit method as the general method for relieving double taxation in their conventions are thus, as an exception to that method, obliged to exempt from tax such payments to their residents as are dealt with under paragraphs 1 and 2. If both ~~the~~ Contracting States apply the exemption method for relieving

double taxation, they can continue to use the expression ‘may be taxed’ instead of ‘shall be taxable only’. In relation to such countries the effect will of course ~~will~~ be the same irrespective of which of these expressions they use. It is understood that the expression ‘shall be taxable only’ shall not prevent a Contracting State from taking into account the income exempted under subparagraph ~~(~~a) of paragraphs l and 2 in determining the rate of tax to be imposed on income derived by its residents from other sources. The principle of giving the exclusive taxing right to the paying State is contained in so many of the existing conventions between OECD ~~M~~**m**ember countries that it can be said to be already internationally accepted. It is also in conformity with the conception of international courtesy which is at the basis of the Article and with the provisions of the Vienna Conventions on Diplomatic and Consular Relations. It should, however, be observed that the Article is not intended to restrict the operation of any rules originating from international law in the case of diplomatic missions and consular posts (~~cf.~~**see** Article ~~27~~**28**) but deals with cases not covered by such rules.~~” [para. 2]~~

[2.1] ~~“~~In 1994, a further amendment was made to paragraph 1 by replacing the term ‘remuneration’ by the words ‘salaries, wages, and other similar remuneration’. This amendment was intended to clarify the scope of the Article, which only applies to State employees and to persons deriving pensions from past employment by a State, and not to persons rendering independent services to a State or deriving pensions related to such services.~~” [para. 2.1]~~

[2.2] ~~“~~Member countries have generally understood the term ‘salaries, wages and other similar remuneration . . . paid’ to include benefits in kind received in respect of services rendered to a State or political subdivision or local authority thereof (e.g.~~,~~ the use of a residence or automobile, health or life insurance coverage and club memberships).~~” [para. 2.2]~~

[3] ~~“~~The provisions of the Article apply to payments made not only by a State but also by its political subdivisions and local authorities (constituent states, regions, provinces, ~~‘~~départements~~’~~, cantons, districts, ~~‘~~arrondissements~~’~~, ~~‘~~Kreise~~’~~, municipalities, or groups of municipalities, etc.).~~” [para. 3]~~

[4] ~~“~~An exception from the principle of giving exclusive taxing power to the paying State is contained in subparagraph ~~(~~b) of paragraph 1. It is to be seen against the background that, according to the Vienna Conventions mentioned above, the receiving State is allowed to tax remuneration paid to certain categories of personnel of foreign diplomatic missions and consular posts, who are permanent residents or nationals of that State. Given that pensions paid to retired government officials ought to be treated for tax purposes in the same way as salaries or wages paid to such employees during their active time, an exception like the one in subparagraph ~~(~~b) of paragraph 1 is incorporated also in subparagraph ~~(~~b) of paragraph 2 regarding pensions. Since the condition laid down in subdivision ~~(~~b)(ii) of paragraph 1 cannot be valid in relation to a pensioner, the only prerequisite for the receiving State’s power to tax the pension is that the pensioner must be one of its own residents and nationals. ~~It should be noted that the expression ‘out of funds created by’ in subparagraph (a) of paragraph 2 covers the situation where the pension is not paid directly by the State, a political subdivision or a local authority but out of separate funds created by them” [para. 4]~~

[5] ~~“~~According to Article 19 of the 1963 Draft Convention, the services rendered to the State, political subdivision or local authority had to be rendered ‘in the discharge of functions of a governmental nature’. That expression was deleted in the 1977 Model Convention. Some OECD ~~M~~**m**ember countries, however, thought that the exclusion would lead to a widening of the scope of the Article. Contracting States who are of that view and who feel that such a widening is not desirable may continue to use, and preferably specify, the expression ‘in the discharge of functions of a governmental nature’ in their bilateral conventions.~~” [para. 5]~~

[5.1] Whilst the word “pension”, under the ordinary meaning of the word, covers only periodic payments, the words “other similar remuneration”, which were added to

paragraph 2 in 2005, are broad enough to cover non-periodic payments. For example, a lump-sum payment in lieu of periodic pension payments that is made to a former State employee after cessation of employment may fall within paragraph 2 of the Article. Whether a particular lump-sum payment made in these circumstances is to be considered as other remuneration similar to a pension falling under paragraph 2 or as final remuneration for work performed falling under paragraph 1 is a question of fact which can be resolved in light of the factors presented in paragraph 5 of the Commentary on Article 18.

[5.2] It should be noted that the expression "out of funds created by" in sub-paragraph a) of paragraph 2 covers the situation where the pension is not paid directly by the State, a political subdivision or a local authority but out of separate funds created by a government body. In addition, the original capital of the fund would not need to be provided by the State, a political subdivision or a local authority. The phrase would cover payments from a privately administered fund established for the government body.

[5.3] An issue arises where pensions are paid for combined private and government services. This issue may frequently arise where a person has been employed in both the private and public sector and receives one pension in respect of both periods of employment. This may occur either because the person participated in the same scheme throughout the employment or because the person's pension rights were portable. A trend towards greater mobility between private and public sectors may increase the significance of this issue.

[5.4] Where a civil servant having rendered services to a State has transferred a right to a pension from a public scheme to a private scheme the pension payments would be taxed only under Article 18 because such payment would not meet the technical requirement of subparagraph 2 a).

[5.5] Where the transfer is made in the opposite direction and the pension rights are transferred from a private scheme to a public scheme, some States tax the whole pension payments under Article 19. Other States, however, apportion the pension payments based on the relative source of the pension entitlement so that part is taxed under Article 18 and another part under Article 19. In so doing, some States consider that if one source has provided by far the principal amount of the pension, then the pension should be treated as having been paid exclusively from that source. Nevertheless, it is recognised that apportionment often raises significant administrative difficulties.

[5.6] Contracting States may be concerned about the revenue loss or the possibility of double non-taxation if the treatment of pensions could be changed by transferring the fund between public and private schemes. Apportionment may counter this; however, to enable apportionment to be applied to pensions rights that are transferred from a public scheme to a private scheme, Contracting States may, in bilateral negotiations, consider extending subparagraph 2 a) to cover the part of any pension or other similar remuneration that it is paid in respect of services rendered to a Contracting State or a political subdivision or a local authority thereof. Such a provision could be drafted as follows:

2. a) Notwithstanding the provisions of paragraph 1, the part of any pension or other similar remuneration that is paid in respect of services rendered to a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that Contracting State.

Alternatively Contracting States may address the concern by subjecting all pensions to a common treatment.

[6] ~~“~~Paragraphs 1 and 2 do not apply if the services are performed in connection with business carried on by the State, or one of its political subdivisions or local authorities, paying the salaries, wages, ~~or other similar remuneration, or the~~ pensions **or other similar remuneration**. In such cases the ordinary rules apply: Article 15 for wages and salaries, Article 16 for directors’ fees and other similar payments, Article 17 for artistes and sportsmen, and Article 18 for pensions. Contracting States, wishing for specific reasons to dispense with paragraph 3 in their bilateral conventions, are free to do so~~,~~ thus bringing in under paragraphs 1 and 2 also services rendered in connection with business. In view of the specific functions carried out by certain public bodies, e.g.~~,~~ State Railways, the Post Office, State-owned theatres etc., Contracting States wanting to keep paragraph 3 may agree in bilateral negotiations to include under the provisions of paragraphs 1 and 2 **salaries, wages, pensions, and other similar** remuneration paid by such bodies, even if they could be said to be performing business activities.~~” [para. 6]~~

3. ~~It was the intention of the Group that~~ ~~a~~**A**ll pensions paid in respect of services rendered to a Contracting State, political subdivision or local authority thereof ~~should be~~ **are** subject to ~~a~~**A**rticle 19, even if they ~~were~~ **are** paid under the social security system of one of the States. In most cases the treatment would be the same whether such payments were subject to ~~a~~**A**rticle 18 or ~~a~~**A**rticle 19. The treatment differs, however, in those cases described in subparagraph 2(b) of ~~a~~**A**rticle 19—where the recipient is both a resident and a national of the other State. Under ~~a~~**A**rticle 19, government service pensions received by such individuals are taxable only in the ~~country~~**State** of residence. If they were to be subject to tax under ~~a~~**A**rticle 18, they would be taxable only in the ~~country~~**State** of source. The purpose of this paragraph is to indicate that a public service pension paid by one ~~country~~**State**, even if it is paid under its social security system, to a resident of the other ~~country~~**State** who is a national of that other ~~country~~**State** is taxable only in the latter ~~country~~**State**. **Some countries prefer to extend the scope of Article 18 to cover also government pensions, so that private pensions and government pensions are subject to the same treatment. When such a solution is chosen, paragraph 2 of Article 19 is not necessary and should be deleted.**

4. It was proposed that the question of tax treatment of a Government meeting the expenses of artistes resident of one Contracting State performing their activities in another Contracting State might be dealt with in the Commentaries. However, it was considered that the Contracting States, if they so desire, may discuss the matter during bilateral negotiations. A reference is made to the Commentaries on ~~a~~**A**rticle 17 in this connection.

Article 20

STUDENTS

1. Article 20 of the United Nations Model Convention, as presently worded, reproduces substantially Article 20 of the OECD Model Convention. In 1999, paragraph 2, containing ~~new~~ provisions dealing with grants and scholarships and remuneration from employment not covered by paragraph 1, was ~~omitted~~ **deleted**.

2. Since ~~a~~**A**rticle 20 of the United Nations Model Convention reproduces Article 20 of the OECD Model Convention, the following Commentary on the latter Article is ~~relevant~~ **applicable**:

[1] ~~“~~ The rule established in this Article concerns certain payments received by students or business apprentices for the purpose of their maintenance, education or training. All such payments received from sources outside the State in which the student or business apprentice concerned is staying shall be exempted from tax in that State.~~" [para. 1]~~

[2] ~~"~~The word "immediately". . . *[makes]* clear that the Article does not cover a person who has once been a resident of a Contracting State but has subsequently moved his residence to a third State before visiting the other Contracting State.~~" [para. 2]~~

[3] The Article covers only payments received for the purpose of the recipient's maintenance, education or training. It does not, therefore, apply to a payment, or any part thereof, that is remuneration for services rendered by the recipient and which is covered by Article 15 (or by *[14 or]* Article 7 in the case of independent services). Where the recipient's training involves work experience, however, there is a need to distinguish between a payment for services and a payment for the recipient's maintenance, education or training. The fact that the amount paid is similar to that paid to persons who provide similar services and are not students or business apprentices would generally indicate that the payment is a remuneration for services. Also, payments for maintenance, education or training should not exceed the level of expenses that are likely to be incurred to ensure the recipient's maintenance, education or training.

[4] For the purpose of the Article, payments that are made by or on behalf of a resident of a Contracting State or that are borne by a permanent establishment which a person has in that State are not considered to arise from sources outside that State.

3. ~~5.~~ **Article 20** ~~Paragraph 2 in~~ **of** the 1980 version of the United Nations Model Convention **contained a paragraph 2 which** read as follows:

Comment [MB32]: It is suggested to move paragraph 5 to paragraph 3.

~~"~~(2) in respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a student or business apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the State which he is visiting.~~"~~

The question whether paragraph 2 of ~~a~~**A**rticle 20 should be deleted from the United Nations Model Convention had engaged the attention of the **former** Group of Experts for some time. In this connection, it is relevant to reproduce paragraphs 25 to 29 of the Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the Work of its Seventh Meeting held in December 1995 (ST/ESA/250):

"At its July 1995 meeting, the Steering Committee recommended that the group consider deleting from the Model Convention article 20, paragraph 2, which provided that if a visiting student had income not exempted by paragraph 1 from taxation in the visited country, the student should, in the taxation of non-exempted income, be entitled to the same exemptions, reliefs, and reductions as were allowed to residents of that country." [para. 25]

"A participant argued that the provision should be retained because it allowed visiting students to be taxed in the same way as resident students. Another participant responded that such parity was sometimes elusive because the resident student was taxable on all income, whereas a visiting student was taxable only on income from sources in the visited country." [para. 26]

"A proponent of deleting the provision noted that article 24, paragraph 4 (second sentence), stated that a country is not required to allow non-residents any personal allowances or other reliefs 'on account of civil status or family responsibilities' which might be allowed to residents; article 20, paragraph 2, it was argued, contradicted the provision of article 24." [para. 27]

"A participant noted that, as an alternative to article 14, paragraph 1(c), a treaty might provide for exemption in the host State, for the normal duration of studies, of remuneration not exceeding a certain annual amount, but only to the extent that the remuneration was also not exempted in the other State." [para. 28] [Paragraph 1(c) of article 14 was deleted in 1999.]

"After discussion, it was concluded that a majority of the Group, but not a consensus, favoured deletion of article 20, paragraph 2." [para. 29]

4. The matter was considered again at the ninth meeting of the **former** Group of Experts, in May 1999, and the Group agreed to delete paragraph 2 of ~~a~~**A**rticle 20. Article 20 thus conforms to Article 20 of the OECD Model Convention, with the addition of the word "trainee".

~~6~~**5**. Although, as worded, paragraph 2 covers grants and scholarships that have their source in the country visited as well as income from an employment in the country visited, the Commentaries to the 1980 Model made it clear that the paragraph was mainly concerned with income from employment. The wording was intended to put visiting students etc. on exactly the same basis as students who were residents for tax purposes of the State where they were studying, but not to treat visiting students more favourably than tax-resident students.

~~7~~**6**. Experience with the application of paragraph 2 in practice has shown that, as presently worded, it can give rise to difficult problems of administration. For example, if the visiting student is subject to tax in the State visited only on income from sources in that country, and not on his worldwide income, should the visitor be entitled to the full allowances which a resident who is taxed on his worldwide income is allowed? Similarly, should a married student, whose spouse does not come to the country with the student, be entitled to the married person's allowance? These issues cannot be settled from a strict reading of the text of paragraph 2 as it stands.

~~8~~**7**. A particular question that is begged by the inclusion of paragraph 2 is the tax residence status of a visiting student or business apprentice under the normal rules of residence in article 4. A student who is following a full-time course of studies may become a tax resident of the host State: in which case, he will become liable to tax there in respect of his worldwide income, and be entitled to all the personal reliefs, without the need of any special provision in article 20.

~~9~~**8**. Moreover, as the commentaries to the 1980 version went on to show, there are a number of further ways in which the countries may wish to consider expanding article 20 in the course of negotiations in order to cover particular problems which may arise in special bilateral situations. Examples are given, without suggesting any particular form of words to give effect to their intentions. The 1980 Commentaries said:

". . . some countries in bilateral negotiations might wish to expand the article by adding a paragraph permitting a further exemption (beyond that generally applicable as a personal exemption or similar allowance under the internal law of the Contracting State) of employment income under certain conditions. Some countries may, for example, wish to extend the exemption to remuneration received for services performed in the country where the student or business apprentice is present, but to limit the exemption to a specified amount of remuneration. In fixing the amount, countries may take into account the fact that students or business apprentices may incur additional costs because they are away from their home country. It may also be appropriate, in cases where the exemption is extended, to place a time limit on such exemption in the cases of business apprentices, and also perhaps in the cases of students, a longer period presumably being allowed in the latter situation."

~~10~~**9**. In the light of the practical difficulties of applying paragraph 2, and the fact that there are a number of other issues affecting students and business apprentices that may need to be addressed in bilateral negotiations, the **former** Group of Experts decided that, rather than attempt a comprehensive rewording, it was preferable to omit paragraph 2 from the Model Convention. Countries wishing to broaden the scope of article 20 to cover sources of income arising in the country visited should aim to draft a suitable provision as tightly as possible to meet their specific circumstances.

Article for teachers

~~11~~**10**. During the course of discussions in the Seventh Meeting of the Ad Hoc Group of Experts, several participants argued for the addition to the Model Convention of an article dealing with visiting teachers. Currently, under the Model Convention visiting teachers ~~were~~ **are** subject to ~~a~~**A**rticle 14, if the teaching services ~~were~~ **are** performed in an independent capacity; ~~a~~**A**rticle 15, if the services ~~were~~ **are** dependent; or ~~a~~**A**rticle 19, if the remuneration ~~was~~ **is** paid by a Contracting State. Many treaties have an additional article or paragraph dealing specifically with teachers and, sometimes, researchers, which typically exempted them from taxation in the source country if their stay did not exceed a prescribed length. It was noted that ~~a~~**A**rticles 14 and 15 commonly did not exempt a visiting teacher's compensation from taxation at source because they generally allowed source taxation of service performers who were present in the host country for more than 183 days, and many teaching assignments exceeded that period of time.

~~12~~**11**. There was considerable controversy among participants about the need to provide an independent article in the United Nations Model Convention dealing exclusively with visiting teachers. But substantially, all participants agreed that an article on teachers, if included in the Model Convention, should not have the effect of exempting a teacher from tax both in the home country and the country visited. One member suggested a compromise on the issue: that the Model Convention should not be amended to include a provision on visiting teachers but that an addition should be made in the Commentary, noting that many treaties contained such articles and providing advice for bilateral negotiations on the subject. There was general consensus for this suggestion.

~~13~~**12**. Accordingly, the **former** Group **of Experts** appointed a drafting committee to formulate language for inclusion in the Commentary on the Model Convention. After being discussed and amended, the following inclusion was adopted by the Group in 1999:

> "No special Model Convention provision has been made regarding remuneration derived by visiting professors and other teachers. In the absence of a special provision, articles 14,15,19 or 23 of the Model Convention, depending on the circumstances, would apply. Many bilateral conventions, however, contain rules of some kind or other concerning such persons, the main purpose of which is to facilitate cultural relations and the exchange of knowledge by providing for a limited tax exemption in the host country for visiting teachers. Sometimes, tax exemption is already provided under domestic taxation laws, which many consider to be the preferred way of solving double taxation problems of visiting teachers.
>
> Notwithstanding the applicability of articles 14, 15, 19 and 23 to prevent double taxation, some countries may wish to include an article on teachers. The variety of domestic tax rules in different countries, on the one hand, or the absence of such rules, on the other, constitute an impediment to a specific provision on teachers in the Model Convention. If, however, in bilateral negotiations, the Contracting States choose to include a provision relating to visiting teachers, the following issues should be considered in preparing such a provision:
>
> (a) The purpose of a tax treaty generally is to avoid double taxation, and double exemption of teachers is not desirable;
>
> (b) It is advisable to limit benefits for visits of a maximum duration (normally two years), and the time limit should be subject to expansion in individual cases by mutual agreement between competent authorities of the Contracting States. It should be determined whether income from the visits exceeding the time limit should be taxable as of the beginning of the visit or merely from the date beyond the expiration of the time limit;
>
> (c) Whether the benefits should be limited to teaching services performed at certain

institutions 'recognized' by the Contracting States in which the services are performed;

(d) Whether, in the case of visiting professors and other teachers who also do research, to limit benefits remuneration for research performed in the public (vs. private) interest;

(e) Whether an individual may be entitled to the benefits of the article more than once.~~"~~

Article 21

OTHER INCOME

1. Article 21 of the United Nations Model Convention reproduces Article 21 of the OECD Model Convention ~~in its entirety~~ **with the exception that paragraph 2 of the United Nations Model Convention also covers the case where the income is attributed to a fixed base which the beneficiary of the income has in the other Contracting State according to Article 14.** ~~and~~ **Article 21 of the United Nations Model Convention** also has an additional ~~paragraph~~ ~~(~~paragraph 3~~)~~ containing a general provision relating to items of income of a resident of a Contracting State not dealt with in the preceding articles and arising in the other Contracting State.

2. The ~~a~~**A**rticle covers ~~not only~~ income of a class not expressly dealt with in the preceding articles **(e.g. an alimony; a pension that is neither paid in consideration of past employment nor under a public scheme part of a social security system) as well as**~~, but also~~ income from sources not expressly referred to therein **(e.g. a rent paid by a resident of a Contracting State for the use of immovable property situated in a third State)**. The ~~a~~**A**rticle covers income arising in third States as well as income from a Contracting State.

Paragraph 1

3. This paragraph reproduces Article 21, paragraph 1, of the OECD Model Convention. ~~Part of the Commentary on the latter paragraph, quoted below, is relevant~~ **The Committee considers therefore that the following part of the OECD Commentary is applicable**:

> **[2]** ~~"~~Under this paragraph the exclusive right to tax is given to the State of residence. In cases of conflict between two residences, Article 4 will also allocate the taxation right in respect of third-State income.~~"~~ ~~[para. 2]~~
>
> **[3]** ~~"~~ . . . [W]hen income arises in a third State and the recipient of this income is considered as a resident by both Contracting States under their domestic law, the application of Article 4 will result in the recipient being treated as a resident of one Contracting State only and being liable to comprehensive taxation ("full tax liability") in that State only. In this case, the other Contracting State may not impose tax on the income arising from the third State, even if the recipient is not taxed by the State of which he is considered a resident under Article 4. In order to avoid non-taxation, Contracting States may agree to limit the scope of the Article to income which is taxed in the Contracting State of which the recipient is a resident and may modify the provisions of the paragraph accordingly . . .~~" [para. 3]~~

A reference is also invited to paragraph 5 of the Commentary below.

Paragraph 2

4. This paragraph reproduces Article 21, paragraph 2, of the OECD Model Convention **with the difference that paragraph 2 of the United Nations Model Convention also covers the case where the income is attributed to a fixed base which the beneficiary of the income has in the other Contracting State according to Article 14**. ~~The Commentary on the latter paragraph, quoted below, is therefore relevant~~ **The Committee considers that the following part of the OECD Commentary is applicable (the additional comments that appear in italics between square brackets, which are not part of the**

OECD Commentary, have been inserted in order to reflect the difference described):

[4] ~~“~~This paragraph provides for an exception from the provisions of paragraph 1 where the income is associated with the activity of a permanent establishment ***[or a fixed base]*** which a resident of a Contracting State has in the other Contracting State. The paragraph includes income from third States. In such a case, a right to tax is given to the Contracting State in which the permanent establishment ***[or the fixed base]*** is situated. Paragraph 2 does not apply to immovable property for which, according to paragraph 4 of Article 6, the State of situs has a primary right to tax . . . Therefore, immovable property situated in a Contracting State and forming part of the business property of a permanent establishment of an enterprise of that State situated in the other Contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient of the income is a resident. This is in consistency with the rules laid down in Articles 13 and 22 in respect of immovable property since paragraph 2 of those Articles applies only to movable property of a permanent establishment.~~” [para. 4]~~

[5] ~~“~~The paragraph also covers the case where the beneficiary and the payer of the income are both residents of the same Contracting State, and the income is attributed to a permanent establishment ***[or a fixed base,]*** which the beneficiary of the income has in the other Contracting State. In such a case a right to tax is given to the Contracting State in which the permanent establishment ***[or the fixed base]*** is situated. Where double taxation occurs, the State of residence should give relief under the provisions of Article 23 A or 23 B. However, a problem may arise as regards the taxation of dividends and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, the first State, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11. The State where the permanent establishment is situated would give a credit for such tax on the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit should not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws.~~” [para. 5]~~

Comment [MB33]: Comment by the Subcommittee: The 2010 update of OECD Model has included paragraphs 5.1 and 5.2 in the Commentary on Article 21 as a consequence of the revision of Article 7. As the Committee has decided not to retain the revised Article 7, those paragraphs are not quoted.

[6] ~~“~~Some States which apply the exemption method (Article 23 A) may have reason to suspect that the treatment accorded in paragraph 2 may provide an inducement to an enterprise of a Contracting State to attach assets such as shares, bonds or patents, to a permanent establishment situated in the other Contracting State in order to obtain more favourable tax treatment there. To counteract such arrangements which they consider would represent abuse, some States might take the view that the transaction is artificial and, for this reason, would regard the assets as not effectively connected with the permanent establishment. Some other States may strengthen their position by adding in paragraph 2 a condition providing that the paragraph shall not apply to cases where the arrangements were primarily made for the purpose of taking advantage of this provision. **Also, the requirement that a right or property be “effectively connected” with such a location requires more than merely recording the right or property in the books of the permanent establishment for accounting purposes**~~” [para. 6]~~

Comment [MB34]: Comment by the Subcommittee: The 2010 update of OECD Model has included the last sentence in paragraph 6 of the Commentary on Article 21 as a consequence of the revision of Article 7. As this last sentence seems anyway a wise clarification, this last sentence is quoted.

Paragraph 3

5. This paragraph constitutes an addition to Article 21 of the OECD Model Convention. It ~~is intended to permit the country~~ **allows the State** in which the income arises to tax such income if its law so provides while the provisions of paragraph 1 ~~would permit~~ **allows exclusive** taxation in the ~~country~~ **State** of residence. The concurrent application of the provisions of the two paragraphs may result

in double taxation. In such a situation, the provisions of ~~a~~**A**rticle 23 A or 23 B as appropriate ~~would be~~ **are** applicable, as in other cases of double taxation. In some cases paragraphs 2 and 3 may overlap; they would then produce the same result.

6. During the Ninth Meeting of the **former** Group of Experts held in 1999, there was extensive discussion regarding inclusion of a new paragraph dealing with ~~new~~ financial instruments. Three options were identified. First, the Contracting States could adopt ~~a~~**A**rticle 21 of the United Nations Model Convention with the three paragraphs. Second, the Contracting States could adopt paragraph 3 of ~~a~~**A**rticle 21 but add a reduced rate of tax in respect of income referred to in paragraph 3. Third, the Contracting States could adopt the United Nations Model Convention with the OECD version with paragraphs 1 and 2 only. These alternatives were considered useful in dealing with this subject. It was noted that the application of ~~new~~ financial products is relevant for options 2 and 3.

Optional additional paragraph

7. **The Committee considers that the following part of the OECD Commentary** ~~The following Commentary to Article 21 in the OECD Model Convention~~ is relevant:

> **[7]** ~~"~~Some countries have encountered difficulties in dealing with income arising from certain nontraditional financial instruments when the parties to the instrument have a special relationship. These countries may wish to add the following paragraph to Article 21:
>
> > ~~'~~[4]. Where, by reason of a special relationship between the person referred to in paragraph 1 and some other person, or between both of them and some third person, the amount of the income referred to in paragraph 1 exceeds the amount (if any) which would have been agreed upon between them in the absence of such a relationship, the provisions of this Article shall apply only to the last mentioned amount. In such a case, the excess part of the income shall remain taxable according to the laws of each Contracting State, due regard being had to the other applicable provisions of this Convention.
>
> **The inclusion of this additional paragraph should carry no implication about the treatment of innovative financial transactions between independent persons or under other provisions of the Convention.**~~' " [para. 7]~~
>
> **[8]** ~~"~~This paragraph restricts the operation of the provisions concerning the taxation of income not dealt with in other Articles in the same way that paragraph 6 of Article 11 restricts the operation of the provisions concerning the taxation of interest . . .~~" [para. 8]~~
>
> **[9]** ~~"~~Although the restriction could apply to any income otherwise subject to Article 21, it is not envisaged that in practice it is likely to be applied to payments such as alimony payments or social security payments but rather that it is likely to be most relevant where certain nontraditional financial instruments are entered into in circumstances and on terms such that they would not have been entered into in the absence of ~~a~~ **the** special relationship . . .~~" [para. 9]~~
>
> **[10]** ~~"~~The restriction of Article 21 differs from the restriction of Article 11 in two important respects. First, the paragraph permits, where the necessary circumstances exist, all of the payments under a nontraditional financial instrument to be regarded as excessive. Second, income that is removed from the operation of the interest Article might still be subject to some other Article of the Convention . . . Income to which Article 21 would otherwise apply is by definition not subject to any other Article. Therefore, if the Article 21 restriction removes a portion of income from the operation of that Article, then Articles 6 through 20 of the Convention are not applicable to that income at all, and each Contracting State may tax it under its domestic law.~~" [para. 10]~~
>
> **[11]** ~~"~~Other provisions of the Convention, however, will continue to be applicable to such income, such as Article 23 (Relief from Double Taxation), Article 25 (Mutual Agreement

Procedure)~~,~~ and Article 26 (Exchange of Information).~~" [para. 11]~~

~~"The Committee on Fiscal Affairs is actively studying the taxation of non-traditional financial instruments. Further changes to the Model or Commentaries may be necessary. The inclusion of proposed paragraph [4] carries no implication about the treatment of innovative financial transactions between independent persons or under other provisions of the Convention." [para. 12]~~

8. Some members of the **former** Group of Experts pointed out that there are very artificial devices entered into by persons to take advantage of the provisions of ~~a~~**A**rticle 21—especially if paragraph 3 is omitted or provides for only a reduced rate of tax in the source State—through, inter alia, creation or assignment of rights with respect to which income from, e.g., financial instruments arises. While substance over form rules, abuse of rights principles or any similar doctrine could be used to counter such arrangements, Contracting States which may want to address the issue specifically may include a clause on the following lines in their bilateral tax treaties:

~~"The provisions of this aArticle 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 rights in respect of which the income is paid to take advantage of this ~~a~~**A**rticle by means of that creation or assignment.~~"~~

9. Countries, generally, do not include, in Article 21, a clause indicating where the income is deemed to arise for the purposes of paragraph 3. The domestic laws of both Contracting States will determine the source of the income. The domestic laws of the Contracting States may however differ and this may lead to double taxation (or non-taxation where the State of residence of the beneficiary applies Article 23 A to eliminate double taxation). Countries which want to address the issue may include a clause on the following lines in their bilateral tax treaties:

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

Commentary on chapter IV

TAXATION OF CAPITAL

Article 22

CAPITAL

1. In the United Nations Model Convention, ~~a~~**A**rticle 22 deals with taxes on capital, to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties.

2. The question whether paragraphs 1 to 4 should continue to be placed within brackets has been examined by the **former** Group of Experts. There is a general agreement that brackets are not required for the first three paragraphs but it was decided to retain them so far as paragraph 4 was concerned. There was a strong argument that the situs State would have the right to tax where the property was situated in

that country; that would bring it into line with the treatment of the United Nations Model Convention of other income referred to in ~~a~~**A**rticle 21. In 1999, it ~~has been~~ **was** decided, to retain the brackets so far as paragraph 4 is concerned.

3. Should the negotiating parties decide to include an ~~a~~**A**rticle on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 **placed within brackets** ~~as shown~~ or wording that leaves taxation to the State in which the capital is located. If the wording of paragraph 4**, placed within brackets**~~, of the OECD Model Convention~~ is used, **the Committee considers that** the ~~whole~~**OECD** Commentary on Article 22, reproduced below, will be ~~relevant~~ **applicable**.

> **[1]** ~~"~~This Article deals only with taxes on capital, to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties. Taxes on capital to which the ~~a~~**A**rticle applies are those referred to in Article 2. ~~" [para. 1]~~

> **[2]** ~~"~~Taxes on capital generally constitute complementary taxation of income from capital. Consequently, taxes on a given element of capital can be levied, in principle, only by the State which is entitled to tax the income from this element of capital. However, it is not possible to refer purely and simply to the rules relating to the taxation of such class of income, for not all items of income are subject to taxation exclusively in one State. ~~" [para. 2]~~

> **[3]** ~~"~~The Article, therefore, enumerates first property which may be taxed in the State in which they are situated. To this category belong immovable property~~,~~ referred to in Article 6~~,~~ which a resident of a Contracting State owns and which is situated in the other Contracting State (paragraph 1)~~,~~ and 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 pertaining to a fixed base which a resident of a Contracting State has in the other Contracting State for the performance of independent personal services**]** (paragraph 2).~~" [para. 3]~~

Comment [MB35]: Comment by Subcommittee: The 2010 update of the OECD Model has included paragraphs 3.1 and 3.2 in the Commentary on Article 22 as a consequence of the revision of Article 7. As the Committee has decided not to retain the revised Article 7, those paragraphs are not quoted.

> **[4]** ~~"~~**Normally**, ~~S~~**s**hips and aircraft operated in international traffic and boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, boats or aircraft shall be taxable only in the State in which the place of effective management of the enterprise is situated (paragraph 3). This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 13. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat. Contracting States which would prefer to confer the exclusive taxing right on the State of residence or to use a combination of the residence criterion and the place of effective management criterion are free in bilateral conventions to substitute for paragraph 3 a provision corresponding to those proposed in paragraphs 2 and 3 of the Commentary on Article 8. Immovable property pertaining to the operation of ships, boats or aircraft may be taxed in the State in which they are situated~~,~~ in accordance with the rule laid down in paragraph 1. ~~" [para. 4]~~

> **[4.1] Paragraph 3 applies where the enterprise that owns the property operates itself the boats, ships or aircraft referred to in the paragraph, whether for its own transportation activities or when leasing the boats, ships or aircraft on charter fully equipped, manned and supplied. It does not apply, however, where the enterprise owning the boats, ships or aircraft does not operate them (for example, where the enterprise leases the property to another person, other than in the case of an occasional bare boat lease as …). In such a case, the capital will be covered by paragraph 2 or 4.**

> **[4.2] In their bilateral conventions, Member countries are free to clarify further the application of Article 22 in this situation. They might adopt the following alternative version of paragraph 3 of the Article *[…]*:**

3. Capital represented by property forming part of the business property of an enterprise the place of effective management of which is situated in a Contracting State, and consisting of ships and aircraft operated by such enterprise in international traffic and of movable property pertaining to the operation of such ships and aircraft shall be taxable only in that State.

[5] ~~“~~As regards elements of capital other than those listed in paragraphs 1 to 3, the ~~a~~**A**rticle provides that they are taxable only in the Contracting State of which the person to whom they belong is a resident (paragraph 4).~~“~~ ~~[para. 5]~~

[6] ~~“~~If, when the provisions of paragraph 4 are applied to elements of movable property under usufruct, double taxation subsists because of the disparity between domestic laws, the States concerned may resort to the mutual agreement procedure or settle the question by means of bilateral negotiations.~~“~~ ~~[para. 6]~~

[7] ~~“~~The Article does not provide any rule about the deductions of debts. The laws of OECD **m**~~M~~ember countries are too different to allow a common solution for such a deduction. The problem of the deduction of debts which could arise when the taxpayer and the creditor are not residents of the same State is dealt with in paragraph 4 of Article 24.~~“~~ ~~[para. 7]~~

Commentary on chapter V

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

Article 23

NOTE BY THE SECRETARIAT: CLAUDINE DEVILLET HAS PREPARED A SEPARATE CONFERENCE ROOM PAPER (CRP.2. ADD. 3) ON POTENTIALLY INCLUDING ARTICLE 23A (4) OF THE OECD MODEL IN ARTICLE 23A OF THE UNITED NATIONS MODEL.

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

A. GENERAL CONSIDERATIONS

1. The United Nations Model Convention **provides** ~~takes the same approach as the OECD Model Convention concerning methods for the elimination of double taxation and therefore reproduces the~~ two alternative versions of Article 23 **for the elimination of double taxation** ~~embodied in that Convention~~, namely ~~a~~**A**rticle 23 A on the exemption method and ~~a~~**A**rticle 23 B on the credit method.

2. The method by which a country gives relief from double taxation depends primarily on its general tax policy and the structure of its tax system. Owing to the differences which exist in the various tax systems, bilateral tax treaties provide the most flexible instrument for reconciling conflicting tax systems and for avoiding or mitigating double taxation.

3. **When the Model was earlier revised,** ~~M~~**m**embers ~~of the Group~~ from developing countries felt that, as regards relief measures to be applied by developed countries, the methods of tax exemption and tax credit could be used as appropriate. The exemption method was considered eminently suitable where exclusive tax jurisdiction over certain income was allotted to the country of source under a treaty; it might take the form of an exemption with progression. One of the principal defects of the foreign tax credit method, in the eyes of the developing countries, is that the benefit of low taxes in developing

countries or of special tax concessions granted by them may in large part inure to the benefit of the treasury of the capital-exporting country rather than to the foreign investor for whom the benefits were designed. Thus, revenue is shifted from the developing country to the capital-exporting country.

4. The effectiveness of the tax incentive measures introduced by most developing countries thus depends on the interrelationship between the tax systems of the developing countries and those of the capital-exporting countries from which the investment originates. It is of primary importance to developing countries to ensure that the tax incentive measures shall not be made ineffective by taxation in the capital-exporting countries using the foreign tax credit system. This undesirable result is to some extent avoided in bilateral treaties through a "tax-sparing" credit, by which a developed country grants a credit not only for the tax paid but for the tax spared by incentive legislation in the developing country. It is also avoided by the exemption method. The members ~~of the Group~~ from developing countries considered it necessary to underline their understanding that either the exemption method or the tax-sparing clause is, for these countries, a basic and fundamental aim in the negotiation of tax treaties. On the other hand, some members noted that studies have shown that tax factors may not themselves be decisive in the process of investment decisions and, therefore, in their view, tax sparing may not be an appropriate policy.

5. Many members from both developed and developing countries agreed with the view that tax-sparing credits should be included in treaties between developed and developing countries, where the developed country used the credit method. However, ~~a member from a developed country~~ **some members** expressed the view that for a variety of reasons tax-sparing credits are not an appropriate tool for economic development, an objective that can better be served by other measures.

6. While the exemption method of providing relief for double taxation eliminates the undesirable effects of the residence country's taxes on the source country's tax incentive scheme, many developed countries are unprepared to include this system in their treaties. Where the investor's home country applies the principle of foreign tax credit, the most effective method of preserving the effect of the tax incentives and concessions extended by developing countries is a tax-sparing credit. Three alternatives might be considered to cope with the problem.

7. First, a tax incentive granting country's internal legislation might include provisions allowing the incentive only if the taxpayer can show to the satisfaction of the tax administration that, upon remittance of its profits abroad, the laws of the country to which the profits are remitted will not, directly or indirectly, tax the income covered by the incentive or will give credit for tax forgone by the incentive. Such a provision would foreclose the possibility of the benefits of a tax incentive flowing from the developing country's fisc to the taxpayer and thence to the fisc of the developed country.

8. Second, a tax convention might include a provision barring each Contracting State from taxing the profits of an enterprise resident in that State from activities in the other State benefiting from tax incentives granted by the latter until the profits are repatriated or otherwise directly or indirectly remitted to the first Contracting State. Thus, those profits would have to be reinvested in the developing country in order to remain untaxed. Some accounting rules would have to be developed to reflect this provision, and a schedule or timetable for repatriation could be agreed upon by the Contracting States.

9. Third, the first Contracting State might be allowed to tax such profits, but be required, pursuant to a revenue-sharing agreement, to turn over to the Contracting State where the income was produced the amounts of tax revenue that can reasonably be attributed to the tax incentive granted by the country of source. This proposal has the attraction of preserving the incentive value of the developing country's fiscal sacrifice and of being relatively easy to administer. The existing rules in many developed countries for apportioning the source and nature of foreign income earned by its taxpayers may provide most of the information required to determine the tax revenues that can be attributed to a tax incentive.

10. On the other hand, some members contended that, theoretically, it could be argued that the effectiveness of the tax incentive measures introduced by many developing countries thus depends, in part, on the interrelationship between the tax systems of the developing countries and those of the capital-exporting countries which use the foreign tax credit system, that their tax incentives are "matched" by means of a "tax-sparing" credit, granted by the developed country. By a "tax-sparing" credit is meant a credit granted in respect of tax not only actually paid, but actually forgone under its incentive legislation.

11 ~~In some 20 years which have elapsed s~~**S**ince the original publication of the United Nations Model Convention, there have been various studies undertaken of the economic justification for adopting fiscal incentives with the objective of stimulating investment. According to ~~these~~ **some** members, these studies have demonstrated that tax factors may not themselves be decisive in the process of investment decisions made by the enterprises and therefore, in their view, tax sparing may not be an appropriate policy. Other factors play a greater role in forming the so-called "investment climate" of any given country, for example, political and economic stability, a judicial system perceived as impartial, the availability of a skilled workforce, and labour laws and social security costs that do not serve as unintended obstacles to the development of enterprise. It has been argued that fiscal incentives undermine the tax base and can lead to the damaging effects of tax incentive competition which then takes place between neighbouring States, as they try to outdo each other's incentives and lend themselves to fiscal manipulation. Moreover, where "matching" credit provisions have been included in tax treaties, there have been examples of the artificial structuring of business transactions in order to take advantage of them, leading both to erosion of the tax base and to an unintended economic distortion in the process of investment decision-making.

12. That said, the reality is that, as a policy matter, countries remain free to adopt those investment incentives that seem to them to be useful or unavoidable, given the pressure resulting from the existence of preferential tax regimes, such as tax-free zones in the other jurisdictions, although, as a matter of observation, there is a tendency in more recent years for these to be more narrowly targeted than formerly. For example, they may be restricted to specific areas of economic activity, or to specific geographical regions; and, instead of being open-ended, they tend to be relatively tightly time-limited. Where developing countries choose to adopt such fiscal incentives, some experts from developing countries consider that they should continue to have, as a treaty negotiating aim, the inclusion of a "matching" or "tax-sparing" provision in treaties with capital exporting countries which have a foreign tax credit system. Studies of ~~recent~~ tax treaties concluded between developed and developing countries show that tax-sparing provisions are still features, although these provisions, in their turn, now show a tendency to be more strictly time-limited than previously. Sometimes, there is a "break" or "sunset" clause, providing for the provision to be terminated after, say, five years, unless the treaty partner States agree to an extension. Where such clauses are included, it is the view of some experts from developing countries that the capital-importing country should provide, both in its domestic tax laws and in its treaties, some protection against a future decision by the treaty partner to refuse to extend the life of the tax-sparing provision. This might, for instance, take the form of a so-called "soak-up tax", which consists of a tax or levy designed to reduce the benefit granted by means of the domestic tax incentive legislation, by the amount which would otherwise be transferred to the treasury of the treaty partner, in the absence of a tax-sparing provision. Some countries do not, however, allow a foreign tax credit for soak-up taxes.

13. The flow of international investment can also be hampered if a country's system of eliminating double taxation, although following ~~a~~**A**rticle 23 in form, does not lead to the elimination of double taxation in practice. For example, a system's mechanical features may lead to unusable foreign tax credits. Not only is this inconsistent with the spirit of ~~a~~**A**rticle 23, but it also might impede foreign investment.

14. **The following extracts from the Commentary on Article 23 A and 23 B of the OECD Model Convention ~~(as it read on 22 July 2010)~~ are applicable to Articles 23 A and 23 B (the additional comments that appear in italics between square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the provisions of the OECD Model Convention and those of this Model as also to specify the applicable paragraph/subparagraph of this Model):**~~The Commentary on Articles 23 A and 23 B of the OECD Model Convention, which is fully relevant in the case of the United Nations Model Convention, contains the following preliminary remarks.~~

1. Preliminary remarks

~~"~~A. The scope of the Articles

1. These Articles deal with the so-called juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one State.~~" [para. 1]~~

2. This case has to be distinguished especially from the so-called economic double taxation, i.e.~~,~~ where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.~~" [para. 2]~~

3. International juridical double taxation may arise in three cases:

~~(~~a) where each Contracting State subjects the same person to tax on his worldwide income or capital (concurrent full liability to tax~~); [Please,~~ see paragraph 4 below**)**~~]~~;

~~(~~b) where a person is a resident of a Contracting State (R)[16] and derives income from, or owns capital in, the other Contracting State (S or E) and both States impose tax on that income or capital~~; [Please~~ **(**see paragraph 5 below**)**~~]~~;

~~(~~c) where each Contracting State subjects the same person, not being a resident of either Contracting State~~,~~ to tax on income derived from, or capital owned in, a Contracting State;~~:~~ this may result, for instance, in the case where a non-resident person has a permanent establishment **[**or fixed base**]** in one Contracting State (E) through which he derives income from, or owns capital in, the other Contracting State (S) (concurrent limited tax liability**, see paragraph 11 below**)." [para. 3] ~~[Please see paragraph 11 below]~~

4. ~~"~~The conflict in case ~~(~~a) is reduced to that of case ~~(~~b) by virtue of Article 4. This is because that Article defines the term 'resident of a Contracting State' by reference to the liability to tax of a person under domestic law by reason of his domicile, residence, place of management or any other criterion of a similar nature (paragraph 1 of Article 4) and by listing special criteria for the case of double residence to determine which of the two States is the State of residence (R) within the meaning of the Convention (paragraphs 2 and 3 of Article 4)~~" [para. 4]~~.

4.1 Article 4, however, only deals with cases of concurrent full liability to tax. The conflict in case *a)* may therefore not be solved if the same item of income is subject to the full liability to tax of two countries but at different times. The following example illustrates that problem. Assume that a resident of State R1 derives a taxable benefit from an employee stock-option that is granted to that person. State R1 taxes that benefit when the option is granted. The person subsequently becomes a resident of State R2, which taxes the benefit at the time of its subsequent exercise. In that case, the person is taxed by

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16 Throughout the Commentary on Articles 23 A and 23 B, the letter "R" stands for the State of residence within the meaning of the Convention, "S" for the State of source or situs, and "E" for the State where a permanent establishment **[**or a fixed base**]** is situated

each State at a time when he is a resident of that State and Article 4 does not deal with the issue as there is no concurrent residence in the two States.

4.2 The conflict in that situation will be reduced to that of case *b*) and solved accordingly to the extent that the employment services to which the option relates have been rendered in one of the Contracting States so as to be taxable by that State under Article 15 because it is the State where the relevant employment is exercised. Indeed, in such a case, the State in which the services have been rendered will be the State of source for purposes of elimination of double taxation by the other State. It does not matter that the first State does not levy tax at the same time (see paragraph 32.8). It also does not matter that that State considers that it levies tax as a State of residence as opposed to a State of source (see the last sentence of paragraph 8).

4.3 Where, however, the relevant employment services have not been rendered in either State, the conflict will not be one of source-residence double taxation. The mutual agreement procedure could be used to deal with such a case. One possible basis to solve the case would be for the competent authorities of the two States to agree that each State should provide relief as regards the residence-based tax that was levied by the other State on the part of the benefit that relates to services rendered during the period while the employee was a resident of that other State. Thus, in the above example, if the relevant services were rendered in a third State before the person became a resident of State R2, it would be logical for the competent authority of State R2 to agree to provide relief (either through the credit or exemption method) for the State R1 tax that has been levied on the part of the employment benefit that relates to services rendered in the third State since, at the time when these services were rendered, the taxpayer was a resident of State R1 and not of State R2 for purposes of the convention between these two States.

5. ~~“~~The conflict in case ~~(~~b) may be solved by allocation of the right to tax between the Contracting States. Such allocation may be made by renunciation of the right to tax either by the State of source or situs (S) or of the situation of the permanent establishment **[**or the fixed base**]** (E), or by the State of residence (R), or by a sharing of the right to tax between the two States. The provisions of the Chapters III and IV of the Convention, combined with the provisions of Article 23 A or 23 B, govern such allocation.~~” [para. 5]~~

6. ~~“~~For some items of income or capital, an exclusive right to tax is given to one of the Contracting States, and the relevant ~~a~~**A**rticle states that the income or capital in question ‘shall be taxable only’ in a Contracting State.[17] The words ‘shall be taxable only’ in a Contracting State preclude the other Contracting State from taxing, thus double taxation is avoided. The State to which the exclusive right to tax is given is normally the State of which the taxpayer is a resident within the meaning of Article 4, that is~~,~~ State R, but in four Articles[18] the exclusive right may be given to the other Contracting State (S) of which the taxpayer is not a resident within the meaning of Article 4.~~” [para. 6]~~

7. ~~“~~For other items of income or capital, the attribution of the right to tax is not exclusive, and

[17] **See**~~Cf~~. first sentence of paragraph 1 of Article 7, paragraphs 1 and 2 of Article 8, . . . paragraphs 3 and [6] of Article 13, **[**first sentence of paragraph 1 of Article 14,**]** first sentence of paragraph 1 and paragraph 2 of Article 15, Article 18 [except paragraphs 1 and 2 of alternative B], paragraphs 1 and 2 of Article 19, paragraph 1 of Article 21 and paragraphs 3 and 4 of Article 22.

[18] **See**~~Cf~~. paragraphs 1 and 2 of Article 8, paragraph 3 of Article 13, subparagraph ~~(~~*a*) of paragraphs 1 and 2 of Article 19 and paragraph 3 of Article 22.

the relevant Article then states that the income or capital in question 'may be taxed' in the Contracting State (S or E) of which the taxpayer is not a resident within the meaning of Article 4. In such case the State of residence (R) must give relief so **as** to avoid the double taxation. Paragraphs 1 and 2 of Article 23 A and paragraph 1 of Article 23 B are designed to give the necessary relief.~~" [para. 7]~~

8. ~~"~~Articles 23 A and 23 B apply to the situation in which a resident of State R derives income from, or owns capital in, the other Contracting State E or S (not being the State of residence within the meaning of the Convention) and that such income or capital, in accordance with the Convention, may be taxed in such other State E or S. The Articles, therefore, apply only to the State of residence and do not prescribe how the other Contracting State E or S has to proceed.~~" [para. 8]~~

9. ~~"~~Where a resident of the Contracting State R derives income from the same State R through a permanent establishment **[**or a fixed base**]** which he has in the other Contracting State E, State E may tax such income (except income from immovable property situated in State R) if it is attributable to the said permanent establishment **[**or fixed base**]** (paragraph 2 of Article 21). In this instance too, State R must give relief under Article 23 A or Article 23 B for income attributable to the permanent establishment **[**or fixed base**]** situated in State E, notwithstanding the fact that the income in question originally arises in State R... However, where the Contracting States agree to give to State R which applies the exemption method a limited right to tax as the State of source of dividends or interest within the limits fixed in paragraph 2 of the Articles 10 or 11 **or 12** then the two States should also agree upon a credit to be given by State E for the tax levied by State R, along the lines of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B.~~" [para. 9]~~

10. ~~"~~Where a resident of State R derives income from a third State through a permanent establishment **[**or a fixed base**]** which he has in State E, such State E may tax such income (except income from immovable property situated in the third State) if it is attributable to such permanent establishment **[**or fixed base**]** (paragraph 2 of Article 21). State R must give relief under Article 23 A or Article 23 B in respect of income attributable to the permanent establishment **[**or fixed base**]** in State E. There is no provision in the Convention for relief to be given by Contracting State E for taxes levied in the third State where the income arises~~:~~; however, under paragraph ~~4~~**3** of Article 24 any relief provided for in the domestic laws of State E (double taxation conventions excluded) for residents of State E is also to be granted to a permanent establishment in State E of an enterprise of State R . . .~~" [para. 10]~~

11. ~~"~~The conflict in case ~~(~~c) of paragraph 3 above is outside the scope of the Convention as, under Article 1, it applies only to persons who are residents of one or both of the States. It can, however, be settled by applying the mutual agreement procedure **(see also paragraph 10 above)**.~~" [para. 11]~~

~~"~~B. Description of methods for elimination of double taxation

12. In the existing conventions, two leading principles are followed for the elimination of double taxation by the State of which the taxpayer is a resident. For purposes of simplicity, only income tax is referred to in what follows; but the principles apply equally to capital tax.~~" [para. 12]~~

~~"~~1. The principle of exemption

13. Under the principle of exemption, the State of residence R does not tax the income which according to the Convention may be taxed in State E or S (nor, of course, also income which shall be taxable only in State E or S . . .).~~" [para. 13]~~

14. ~~—~~"The principle of exemption may be applied by two main methods:

~~(~~a) the income which may be taxed in State E or S is not taken into account at all by State R for the purposes of its tax; State R is not entitled to take the income so exempted into consideration when determining the tax to be imposed on the rest of the income; this method is called 'full exemption';

~~(~~b) the income which may be taxed in State E or S is not taxed by State R, but State R retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income; this method is called 'exemption with progression'.~~" [para. 14]~~

"2. The principle of credit

15. Under the principle of credit, the State of residence R calculates its tax on the basis of the taxpayer's total income including the income from the other State E or S which, according to the Convention, may be taxed in that other State (but not including income which shall be taxable only in State S**; see paragraph 6 above**). It then allows a deduction from its own tax for the tax paid in the other State.~~" [para. 15]~~

16. ~~"~~The principle of credit may be applied by two main methods:

~~(~~a) State R allows the deduction of the total amount of tax paid in the other State on income which may be taxed in that State,~~;~~ this method is called 'full credit';

~~(~~b) ~~T~~**t**he deduction given by State R for the tax paid in the other State is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State; this method is called 'ordinary credit'." [para. 16]

17. ~~"~~Fundamentally, the difference between the methods is that the exemption methods look at income, while the credit methods look at tax.~~" [para. 17]~~

~~"~~C. Operation and effects of the methods

18. An example in figures will facilitate the explanation of the effects of the various methods. Suppose the total income to be 100,000, of which 80,000 is derived from one State (State of residence R) and 20,000 from the other State (State of source S). Assume that in State R the rate of tax on an income of 100,000 is 35 per cent and on an income of 80,000 is 30 per cent. Assume further that in State S the rate of tax is either 20 per cent—case (i) or 40 per cent—case (ii), so that the tax payable therein on 20,000 is 4,000 in case (i) or 8,000 in case (ii), respectively.~~" [para. 18]~~

19. ~~"~~If the taxpayer's total income of 100,000 arises in State R, his tax would be 35,000. If he had an income of the same amount, but derived in the manner set out above, and if no relief is provided for in the domestic laws of State R and no conventions exist**s** between State R and State S, then the total amount of tax would be, in case (i): 35,000 plus 4,000 = 39,000, and in case (ii): 35,000 plus 8,000 = 43,000.~~" [para. 19]~~

"1. Exemption methods

20. Under the exemption methods, State R limits its taxation to that part of the total income which, in accordance with the various ~~a~~**A**rticles of the Convention, it has a right to tax, i.e.~~,~~ 80,000.

~~(~~a) Full exemption

State R imposes tax on 80,000 at the rate of tax applicable to 80,000, i.e.~~,~~ at 30 per cent.

Case (i) Case (ii)

Tax in State R, 30 **%**~~per cent~~ of 80,000 . . .	24,000	24,000
Plus tax in State S	4,000	8,000
Total taxes	28,000	32,000
Relief has been given by State R in the amount of	11,000	11,000

~~(~~b) Exemption with progression

State R imposes tax on 80,000 at the rate of tax applicable to total income wherever it arises (100,000), i.e.~~,~~ at 35 per cent.

	Case (i)	Case (ii)
Tax in State R, 35 **%**~~per cent~~ of 80,000 . . .	28,000	28,000
Plus tax in State S	4,000	8,000
Total taxes	32,000	36,000
Relief has been given by State R in the amount of	7,000	7,000”
	~~[para. 20]~~	

21. ~~“~~In both cases, the level of tax in State S does not affect the amount of tax given up by State R. If the tax on the income from State S is lower in State S than the relief to be given by State R—cases ~~(~~a~~)~~(i), ~~(~~a~~)~~ (ii), and ~~(~~b~~)~~ (i)—then the taxpayer will fare better than if his total income were derived solely from State R. In the converse case—case ~~(~~b~~)~~ (ii)—the taxpayer will be worse off.~~” [para. 21]~~

22. ~~“~~The example shows also that the relief given where State R applies the full exemption method may be higher than the tax levied in State S, even if the rates of tax in State S are higher than those in State R. This is due to the fact that under the full exemption method, not only the tax of State R on the income from State S is surrendered (35 per cent of 20,000 = 7,000**;** as under the exemption with progression)**,** but **that** also the tax on remaining income (80,000) is reduced by an amount corresponding to the differences in rates at the two income levels in State R (35 less 30 = 5 per cent applied to 80,000 = 4,000).~~” [para. 22]~~

~~“~~2. Credit methods

23. Under the credit methods, State R retains its right to tax the total income of the taxpayer, but against the tax so imposed, it allows a deduction.

~~(~~a) Full credit

State R computes tax on total income of 100,000 at the rate of 35 per cent and allows the deduction of the tax due in State S on the income from S.

	Case (i)	Case (ii)
Tax in State R, 35 **%**~~per cent~~ of 100,000 . .	35,000	35,000
~~L~~**l**ess tax in State S	-4,000	-8,000
Tax due . . .	31,000	27,000
Total taxes	35,000	35,000
Relief has been given by State R in the amount of	4,000	8,000

(b) Ordinary credit

State R computes tax on total income of 100,000 at the rate of 35 per cent and allows the deduction of the tax due in State S on the income from S, but in no case it allows more than the portion of tax in State R attributable to the income from S (maximum deduction). The maximum deduction would be 35 per cent of 20,000 = 7,000.

	Case (i)	Case (ii)
Tax in State R, 35 %~~per cent~~ of 100,000 . .	35,000	35,000
~~L~~less tax in State S	-4,000	
~~L~~less maximum **tax**~~deduction~~ . . .		-7,000
Tax due . . .	31,000	28,000
Total taxes	35,000	36,000
Relief has been given by State R in the amount of	4,000	7,000"
	~~[para. 23]~~	

24. ~~"~~A characteristic of the credit methods compared with the exemption methods is that State R is never obliged to allow a deduction of more than the tax due in State S.~~" [para. 24~~]

25. ~~"~~Where the tax due in State S is lower than the tax of State R appropriate to the income from State S (maximum deduction), the taxpayer will always have to pay the same amount of taxes as he would have had to pay if he were taxed only in State R, i.e.~~,~~ as if his total income were derived solely from State R.~~" [para. 25]~~

26. ~~"~~The same result is achieved, where the tax due in State S is the higher~~,~~ while State R applies the full credit, at least as long as the total tax due to State R is as high~~ as~~ or higher than the amount of the tax due in State S.~~" [para. 26]~~

27. ~~"~~Where the tax due in State S is higher and where the credit is limited (ordinary credit), the taxpayer will not get a deduction for the whole of the tax paid in State S. In such event the result would be less favourable to the taxpayer than if his whole income arose in State R, and in these circumstances the ordinary credit method would have the same effect as the method of exemption with progression.~~" [para. 27]~~

Table 23-1 Total amount of tax in the different cases illustrated above

A.All income arising in State R	Total tax = 35,000	
B.Income arising in two States, viz.80,000 in State R and 20,000 in State S	Total tax if tax in State S is	
	4,000(Case(i)	8,000(Case (ii)
No Convention (19)[3]	39,000	43,000
Fill exemption (20a)[4]	28,000	32,000
Exemption with progression (20b)	32,000	36,000
Full credit (23a)	35,000	35,000
Ordinary credit (23b)	35,000	36,000

[3] Numbers in brackets refer to paragraphs in this Commentary

[4] Numbers in brackets refer to paragraphs in this Commentary

Table 23-2 Amount of tax given up by the state of residence

	If tax in State s is	
	4,000(case(i)	8,000(case(ii)
No convention	0	0
Full exemption (20a)1	11,000	11,000
Exemption with progression(20b)	7,000	7,000
Full credit (23a)	4,000	8,000
Ordinary credit (23b)	4,000	7,000

~~“~~D. The methods proposed in the Articles

28. In the conventions concluded between OECD ~~M~~**m**ember countries both leading principles have been followed. Some States have a preference for the first one, some for the other. Theoretically~~,~~ a single principle could be held to be more desirable, but, on account of the preferences referred to, each State has been left free to make its own choice.~~” [para. 28]~~

29. ~~“~~On the other hand, it has been found important to limit the number of methods based on each leading principle to be employed. In view of this limitation, the Articles have been drafted so that ~~M~~**m**ember countries are left free to choose between two methods:

— the exemption method with progression (Article 23 A), and

— the ordinary credit method (Article 23 B).~~” [para. 29]~~

30. ~~“~~If two Contracting States both adopt the same method, it will be sufficient to insert the relevant Article in the convention. On the other hand, if the two Contracting States adopt different methods, both Articles may be amalgamated in one, and the name of the State must be inserted in each appropriate part of the Article, according to the method adopted by that State.~~” [para. 30]~~

31. ~~“~~Contracting States may use a combination of the two methods. Such combination is indeed necessary for a Contracting State R which generally adopts the exemption method in the case of income which under Articles 10 and 11 **[and 12]** may be subjected to a limited tax in the other Contracting State S. For such case, Article 23 A provides in paragraph 2 a credit for the limited tax levied in the other Contracting State S **[…]**. Moreover, States which in general adopt the exemption method may wish to exclude specific items of income from exemption and to apply to such items the credit method. In such case, paragraph 2 of Article 23 A could be amended to include these items of income.~~” [para. 31]~~

32. ~~“~~The two Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic laws and practice applicable. Contracting States which find it necessary to settle any problem in the ~~c~~**C**onvention itself are left free to do so in bilateral negotiations”. ~~[para. 32]~~

F. Timing mismatch

32.8 The provisions of the Convention that allow the State of source to tax particular items of income or capital do not provide any restriction as to when such tax is to be levied (see, for instance, paragraph 2.2 of the Commentary on Article 15). Since both Articles 23 A and 23 B require that relief be granted where an item of income or capital

may be taxed by the State of source in accordance with the rovisions of the Convention, it follows that such relief must be provided regardless of when the tax is levied by the State of source. The State of residence must therefore provide relief of double taxation through the credit or exemption method with respect to such item of income or capital even though the State of source taxes it in an earlier or later year. Some States, however, do not follow the wording of Article 23 A or 23 B in their bilateral conventions and link the relief of double taxation that they give under tax conventions to what is provided under their domestic laws. These countries, however, would be expected to seek other ways (the mutual agreement procedure, for example) to relieve the double taxation which might otherwise arise in cases where the State of source levies tax in a different taxation year.

~~B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 23 A~~

II. Commentary on the provisions of Article 23 A (exemption method)

~~14. Since article 23 A of the United Nations Model Convention reproduces Article 23 A of the OECD Model Convention, the Commentary on that Article is fully relevant:~~

~~"Paragraph 1~~

~~A. The obligation of the State of residence to give exemption~~

~~In the Article it is laid down that the State of residence R shall exempt from tax income and capital, which in accordance with the Convention 'may be taxed' in the other State E or S." [para. 33]~~

~~"The State of residence must accordingly give exemption whether or not the right to tax is in effect exercised by the other State. This method is regarded as the most practical one since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State." [para. 34]~~

~~"Occasionally, negotiating States may find it reasonable in certain circumstances, to make an exception to the absolute obligation on the State of residence to give exemption. Such may be the case, in order to avoid non-taxation, where under the domestic laws of the State of source no tax on specific items of income or capital is provided, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired. To avoid non-taxation of specific items of income, Contracting States may agree to amend the relevant Article itself . . . One might also make an exception to the general rule, in order to achieve a certain reciprocity, where one of the States adopts the exemption method and the other the credit method. Finally, another exception to the general rule may be made where a State wishes to apply to specific items of income the credit method rather than exemption . . ." [para. 35]~~

~~"As already mentioned . . . , the exemption method does not apply to such items of income which according to the Convention may be taxed in the State of residence but may also be subject to a limited tax in the other Contracting State. For such items of income, paragraph 2 of Article 23 A provides for the credit method . . ." [para. 36]~~

Paragraph 1

A. The obligation of the State of residence to give exemption

33. In the Article it is laid down that the State of residence R shall exempt from tax

income and capital which in accordance with the Convention “may be taxed” in the other State E or S.

34. The State of residence must accordingly exempt income and capital which may be taxed by the other State in accordance with the Convention whether or not the right to tax is in effect exercised by that other State. This method is regarded as the most practical one since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State.

35. Occasionally, negotiating States may find it reasonable in certain circumstances, in order to avoid double non-taxation, to make an exception to the absolute obligation on the State of residence to give exemption […] Such may be the case where no tax on specific items of income or capital is provided under the domestic laws of the State of source, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired. To avoid such double non-taxation of specific items of income, Contracting States may agree to amend the relevant Article itself […] One might also make an exception to the general rule, in order to achieve a certain reciprocity, where one of the States adopts the exemption method and the other the credit method. Finally, another exception to the general rule may be made where a State wishes to apply to specific items of income the credit method rather than exemption (see paragraph 31 above).

15. In the United Nations Model Convention, the right to tax in the country of source extends in many cases to income which under the OECD Model Convention is taxable only in the country of residence. As a consequence, many countries adopting the exemption method in their bilateral conventions may wish to restrict the application of paragraph 1 of ~~a~~**A**rticle 23 A, e.g., by limiting the exemption from tax to income effectively taxed in the country of source or by applying to some items of income the tax credit provided for in paragraph 2 of ~~a~~**A**rticle 23 A rather than the tax exemption. Also, because ~~a~~**A**rticle 23 A, paragraph 1, of the United Nations Model Convention has a much broader scope than the corresponding provision of the OECD Model Convention, **because of extended source country rights,** a State which generally chooses the exemption method may elect the credit method for specific items of income not mentioned in paragraph 2 of ~~a~~**A**rticle 23 A.

16. The OECD Commentary continues as follows:

“B. Alternative formulation of the Article

37. An effect of the exemption method as it is drafted in the Article is that the taxable income or capital in the State of residence is reduced by the amount exempted in that State. If in a particular State the amount of income as determined for income tax purposes is used as a measure for other purposes, e.g.~~,~~ social benefits, the application of the exemption method in the form proposed may have the effect that such benefits may be given to persons who ought not to receive them. To avoid such consequences, the Article may be altered so that the income in question is included in the taxable income in the State of residence. The State of residence must, in such cases, give up that part of the total tax appropriate to the income concerned. This procedure would give the same result as the Article in the form proposed. States can be left free to make such modifications in the drafting of the Article. If a State wants to draft the Article as indicated above, paragraph 1 may be drafted as follows:

‘Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, shall be taxable only or may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraph 2, allow as a deduction from the income tax or capital tax that part of the income tax or capital tax, respectively, which is applicable, as the case may be, to the income derived from or the capital owned in that other State.’

If the Article is so drafted, paragraph 3 would not be necessary and could be omitted.~~” [para. 37]~~

~~“~~C. Miscellaneous problems

38. Article 23 A contains the principle that the State of residence has to give exemption, but does not give detailed rules on how the exemption has to be implemented. This is consistent with the general pattern of the Convention. Articles 6 to 22 too lay down rules attributing the right to tax in respect of the various types of income or capital without dealing, as a rule, with the determination of taxable income or capital, deductions, rate of tax~~es,~~ etc. (**see**~~cf~~, however, **[**paragraph 3 of Article 7 and**]** Article 24). Experience has shown that many problems may arise. This is especially true with respect to Article 23 A. Some of them are dealt with in the following paragraphs. In the absence of a specific provision in the Convention, the domestic laws of each Contracting State are applicable. Some conventions contain an express reference to the domestic laws but of course this would not help where the exemption method is not used in the domestic laws. In such cases, Contracting States which face this problem should establish rules for the application of Article 23 A, if necessary, after having consulted with the competent authority of the other Contracting State (paragraph 3 of Article 25).~~” [para. 38]~~

~~“~~1. Amount to be exempted

39. The amount of income to be exempted from tax by the State of residence is the amount which, but for the Convention, would be subjected to domestic income tax according to the domestic laws governing such tax. It may, therefore, differ from the amount of income subjected to tax by the State of source according to its domestic laws.~~” [para. 39]~~

40. ~~“~~Normally, the basis for the calculation of income tax is the total net income, i.e.~~,~~ gross income less allowable deductions. Therefore, it is the gross income derived from the State of source less any allowable deductions (specified or proportional) connected with such income which is to be exempted.~~” [para. 40]~~

41. ~~“~~Problems arise from the fact that most countries provide in their respective taxation laws for additional deductions from total income or specific items of income to arrive at the income subject to tax. A numerical example may illustrate the problem:

~~(~~a) Domestic income (gross less allowable expenses) .	100
~~(~~b) Income from the other State (gross less allowable expenses). . .	100
~~(~~c) Total income . . .	200
~~(~~d) Deductions for other expenses provided for under the laws of the State of residence which are not connected with any of the income under ~~(~~a~~)~~ or ~~(~~b~~)~~, such as insurance premiums, contributions to welfare institutions	-20
~~(~~e) ‘Net’ income . . .	180
~~(~~f Personal and family allowances	-30
~~(~~g) Income subject to tax . . .	150

The question is, what amount should be exempted from tax, e.g.~~:~~

— 100 (line ~~(~~b~~)~~), leaving a taxable amount of 50;

— 90 (half of line ~~(~~e~~)~~, according to the ratio between line ~~(~~b~~)~~ and line ~~(~~c~~)~~), leaving 60 (line ~~(~~f~~)~~ being fully deducted from domestic income);

— 75 (half of line ~~(~~g~~)~~, according to the ratio between line ~~(~~b~~)~~ and line ~~(~~c~~)~~), leaving 75;

— or any other amount.~~” [para. 41]~~

42. “A comparison of the laws and practices of the OECD ~~M~~**m**ember countries shows that the amount to be exempted varies considerably from country to country. The solution adopted by a State will depend on the policy followed by that State and its tax structure. It may be the intention of a State that its residents always enjoy the full benefit of their personal and family allowances and other deductions. In other States these tax free amounts are apportioned. In many States personal or family allowances form part of the progressive scale, are granted as a deduction from tax, or are even unknown, the family status being taken into account by separate tax scales.~~” [para. 42]~~

43. “In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique. Contracting States which prefer to have special problems solved in their convention are, of course, free to do so in bilateral negotiations. Finally, attention is drawn to the fact that the problem is also of importance for States applying the credit method . . .~~” [para. 43]~~

“2. Treatment of losses

44. Several States in applying Article 23 A treat losses incurred in the other State in the same manner as they treat income arising in that State: as State of residence (State R), they do not allow deduction of a loss incurred from immovable property or a permanent establishment situated in the other State (E or S). Provided that this other State allows carry-over of such loss, the taxpayer will not be at any disadvantage as he is merely prevented from claiming a double deduction of the same loss namely in State E (or S) and in State R. Other States may, as State of residence R, allow a loss incurred in State E (or S) as a deduction from the income they assess. In such a case State R should be free to restrict the exemption under paragraph 1 of Article 23 A for profits or income which are made subsequently in the other State E (or S) by deducting from such subsequent profits or income the amount of earlier losses which the taxpayer can carry over in State E (or S). As the solution depends primarily on the domestic laws of the Contracting States and as the laws of the OECD ~~M~~**m**ember countries differ from each other substantially, no solution can be proposed in the Article itself, it being left to the Contracting States, if they find it necessary, to clarify the above-mentioned question and other problems connected with losses . . . bilaterally, either in the Article itself or by way of a mutual agreement procedure (paragraph 3 of Article 25).~~” [para. 44]~~

“3. Taxation of the rest of **the** income

45. Apart from the application of progressive tax rates which is now dealt with in paragraph 3 of the Article . . . some problems may arise from specific provisions of the tax laws. Thus, e.g.~~,~~ some tax laws provide that taxation starts only if a minimum amount of taxable income is reached or exceeded (tax exempt threshold). Total income before application of the Convention may clearly exceed such tax free threshold; but by virtue of the exemption resulting from the application of the Convention which leads to a deduction of the tax exempt income from total taxable income, the remaining taxable income may be reduced to an amount below this threshold. For the reasons mentioned in paragraph 43 above, no uniform solution can be proposed. It may be noted, however, that the problem will not arise, if the alternative formulation of paragraph 1 of Article 23 A . . . is adopted.~~” [para. 45]~~

46. “Certain States have introduced special systems for taxing corporate income . . . In States applying a split rate corporation tax . . . , the problem may arise whether the income to be exempted has to be deducted from undistributed income (to which the normal rate of tax applies) or from distributed income (to which the reduced rate applies) or whether the income to be exempted has to be attributed partly to distributed and partly to undistributed income. Where, under the laws of a State applying the split rate corporation tax, a supplementary tax is levied in the hands of a parent company on dividends which it received from a domestic subsidiary company but which it does not redistribute (on the grounds that such supplementary tax is a compensation for the benefit of a lower tax rate granted to the subsidiary on the distributions), the problem arises, whether such supplementary tax may be charged where the subsidiary pays its dividends out of income exempt from tax by virtue of the Convention. Finally~~,~~ a similar problem may arise in connection with taxes ('*précompte*', Advance Corporation Tax) which are levied on distributed profits of a corporation in order to cover the tax credit attributable to the shareholders . . . The question is whether such special taxes connected with the distribution of profits, could be levied insofar as distributions are made out of profits exempt from tax. It is left to Contracting States to settle these questions by bilateral negotiations.~~” [para. 46]~~

“Paragraph 2

47. In Articles 10 and 11 the right to tax dividends and interest is divided between the State of residence and the State of source. In these cases, the State of residence is left free not to tax if it wants to do so . . . and to apply the exemption method also to the above-mentioned items of income. However, where the State of residence prefers to make use of its right to tax such items of income, it cannot apply the exemption method to eliminate the double taxation since it would thus give up fully its right to tax the income concerned. For the State of residence, the application of the credit method would normally seem to give a satisfactory solution. Moreover, as already indicated in paragraph 31 above, States which in general apply the exemption method may wish to apply to specific items of income the credit method rather than exemption. Consequently, the paragraph is drafted in accordance with the ordinary credit method. The Commentary on Article 23 B hereafter applies mutatis mutandis to paragraph 2 of Article 23 A.~~” [para. 47]~~

48. “In the cases referred to in the previous paragraph, certain maximum percentages are laid down for tax reserved to the State of source. In such cases, the rate of tax in the State of residence will very often be higher than the rate in the State of source. The limitation of the deduction which is laid down in the second sentence of paragraph 2 and which is in accordance with the ordinary credit method is therefore of consequence only in a limited number of cases. If, in such cases, the Contracting States prefer to waive the limitation and to apply the full credit method, they can do so by deleting the second sentence of paragraph 2 . . .~~” [para. 48]~~

“Dividends from substantial holdings by a company

49. The combined effect of paragraphs 1 and 2 of Article 10 and Article 23 (Article 23 A and 23 B as appropriate) is that the State of residence of the shareholder is allowed to tax dividends arising in the other State, but that it must credit against its own tax on such dividends the tax which has been collected by the State where the dividends arise at a rate fixed under paragraph 2 of Article 10. This regime equally applies when the recipient of the dividends is a parent company receiving dividends from a subsidiary; in this case, the tax withheld in the State of the subsidiary—and credited in the State of the parent company—is limited to ~~[~~5~~]~~ per cent of the gross amount of the dividends by the application of subparagraph ~~(~~a) of paragraph 2 of Article 10.~~” [para. 49]~~

50. “These provisions effectively avoid the juridical double taxation of dividends but they do not prevent recurrent corporate taxation on the profits distributed to the parent company: first at the level of the subsidiary and again at the level of the parent company. Such recurrent taxation creates a very important obstacle to the development of international investment. Many States have recogni~~z~~sed this and have inserted in their domestic laws provisions designed to avoid this obstacle. Moreover, provisions to this end are frequently inserted in double taxation conventions.~~” [para. 50]~~

51. “The Committee on Fiscal Affairs has considered whether it would be appropriate to modify Article 23 of the Convention in order to settle this question. Although many States favoured the insertion of such a provision in the Model Convention this met with many difficulties, resulting from the diverse opinions of States and the variety of possible solutions. Some States, fearing tax evasion, preferred to maintain their freedom of action and to settle the question only in their domestic laws.~~” [para. 51]~~

52. “In the end, it appeared preferable to leave States free to choose their own solution to the problem. For States preferring to solve the problem in their conventions, the solutions would most frequently follow one of the principles below:

~~(~~a) Exemption with progression

The State of which the parent company is a resident exempts the dividends it receives from its subsidiary in the other State, but it may nevertheless take these dividends into account in computing the tax due by the parent company on the remaining income (such a provision will frequently be favoured by States applying the exemption method specified in Article 23 A).

~~(~~b) Credit for underlying taxes

As regards dividends received from the subsidiary, the State of which the parent company is a resident gives credit as provided for in paragraph 2 of Article 23 A or in paragraph 1 of Article 23 B, as appropriate, not only for the tax on dividends as such, but also for the tax paid by the subsidiary on the profits distributed (such a provision will frequently be favoured by States applying as a general rule the credit method specified in Article 23 B).

~~(~~c) Assimilation to a holding in a domestic subsidiary

The dividends that the parent company derives from a foreign subsidiary are treated, in the State of the parent company, in the same way for tax purposes as dividends received from a subsidiary which is a resident of that State.” ~~[para. 52]~~

53 “When the State of the parent company levies taxes on capital, a similar solution should also be applied to such taxes.~~” [para. 53]~~

54. “Moreover, States are free to fix the limits and methods of application of these provisions (definition and minimum duration of holding of the shares, proportion of the dividends deemed to be taken up by administrative or financial expenses) or to make the relief granted under the special regime subject to the condition that the subsidiary is carrying out a genuine economic activity in the State of which it is a resident, or that it derives the major part of its income from that State or that it is subject to a substantial taxation on profits therein.~~” [para. 54]~~

“Paragraph 3

55. The 1963 Draft Convention reserved expressly the application of the progressive scale of tax rates by the State of residence (last sentence of paragraph 1 of Article 23 A) and most conventions concluded between OECD ~~M~~**m**ember countries which adopt the exemption method follow this principle. According to paragraph 3 of Article 23 A, the State of residence retains the right to take the amount of exempted income or capital into consideration when determining the tax to be imposed on the rest of the income or capital. The rule applies even where the exempted income (or items of capital) and the taxable income (or items of capital) accrue to those persons (e.g.~~,~~ husband and wife) whose incomes (or items of capital) are taxed jointly according to the domestic laws. This principle of progression applies to income or capital exempted by virtue of paragraph 1 of Article 23 A as well as to income or capital which under any other provision of the Convention ‘shall be taxable only’ in the other Contracting State . . . This is the reason why, in the 1977 Model Convention, the principle of progression was transferred from paragraph 1 of Article 23 A to a new paragraph 3 of the said Article, and reference ~~is~~ **was** made to exemption ‘in accordance with any provision of the Convention’.~~” [para. 55]~~

56“ Paragraph 3 of Article 23 A relates only to the State of residence. The form of the Article does not prejudice the application by the State of source of the provisions of its domestic laws concerning the progression.~~” [para. 56]~~

~~C. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 23 B~~

III. Commentary on the provisions of Article 23 B (credit method)

~~18. Since article 23 B of the United Nations Model Convention reproduces Article 23 B of the OECD Model Convention, the Commentary on that Article, quoted below, is fully relevant:~~

"**Paragraph 1**

A. Methods

57. Article 23 B, based on the credit principle, follows the ordinary credit method: the State of residence (R) allows, as a deduction from its own tax on the income or capital of its resident, an amount equal to the tax paid in the other State E (or S) on the income derived from, or capital owned in, that other State E (or S), but the deduction is restricted to the appropriate proportion of its own tax..~~" [para. 57]~~

58 "The ordinary credit method is intended to apply also for a State which follows the exemption method but has to give credit, under paragraph 2 of Article 23 A, for the tax levied at limited rates in the other State on dividends and interest **(see paragraph 47 above)**. The possibility of some modification **as mentioned in paragraphs 47 and 48 above (full credit)** could, of course, also be of relevance in the case of dividends and interest paid to a resident of a State which adopted the ordinary credit method (**see also paragraph 63 below)**.~~" [para. 58]~~

59 ~~"It is to be noted that Article 23 B applies in a State R only to items of income or capital which, in accordance with the Convention, 'may be taxed' in the other State E (or S)~~ **The obligation imposed by Article 23 B on a State R to give credit for the tax levied in the other State E (or S) on an item of income or capital depends on whether this item may be taxed by the State E (or S) in accordance with the Convention […]** Items of income or capital which according to Article 8, to paragraph 3 of Article 13, to subparagraph (a) of paragraphs 1 and 2 of Article 19 and to paragraph 3 of Article 22, 'shall be taxable only' in the other State, are from the outset exempt from tax in State R **[**...**]**, and the Commentary on Article 23 A applies to such exempted income and capital. As regards progression, reference is made to paragraph 2 of the Article **[**...**]**" ~~[para. 59]~~

60. "Article 23 B sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the credit. This is consistent with the general pattern of the Convention. Experience has shown that many problems may arise. Some of them are dealt with in the following paragraphs. In many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of conventions, therefore, contain a reference to the domestic laws of the Contracting States and further provide that such domestic rules shall not affect the principle laid down in Article 23 B. Where the credit method is not used in the domestic laws of a Contracting State, this State should establish rules for the application of Article 23 B, if necessary after consultation with the competent authority of the other Contracting State (paragraph 3 of Article 25).~~" [para. 60]~~

61. "The amount of foreign tax for which a credit has to be allowed is the tax effectively paid in accordance with the Convention in the other Contracting State. Problems may arise, e.g.~~,~~ where such tax is not calculated on the income of the year for which it is levied but on the income of a preceding year or on the average income of two or more preceding years. Other problems may arise in connection with different methods of determining the income or in connection with changes in the currency rates (devaluation or revaluation). However, such problems could hardly be solved by an express provision in the Convention.~~" [para. 61]~~

62. "According to the provisions of the second sentence of paragraph 1 of Article 23 B, the deduction which the State of residence (R) is to allow is restricted to that part of the income tax which is appropriate to the income derived from the State S, or E (so-called ‘maximum deduction’). Such maximum deduction may be computed either by apportioning the total tax on total income according to the ratio between the income for which credit is to be given and the total income, or by applying the tax rate for total income to the income for which credit is to be given. In fact, in cases where the tax in State E (or S) equals or exceeds the appropriate tax of State R, the credit method will have the same effect as the exemption method with progression. Also under the credit method, similar problems as regards the amount of income, tax rate etc. may arise as are mentioned in the Commentary on Article 23 A . . . For the same reasons mentioned in paragraphs 42 and 43 above, it is preferable also for the credit method~~,~~ not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique. This is also true for some further problems which are dealt with below.” ~~[para. 62]~~

63. “The maximum deduction is normally computed as the tax on net income, i.e.~~,~~ on the income from State E (or S) less allowable deductions (specified or proportional) connected with such income . . . For such reason, the maximum deduction in many cases may be lower than the tax effectively paid in State E (or S). This may especially be true in the case where, for instance, a resident of State R deriving interest from State S has borrowed funds from a third person to finance the interest-producing loan. As the interest due on such borrowed money may be offset against the interest derived from State S, the amount of net income subject to tax in State R may be very small, or there may even be no net income at all. This problem could be solved by using the full credit method in State R as mentioned in paragraph 48 above. Another solution would be to exempt such income from tax in State S, as it is proposed in the Commentary in respect of interest on credit sales and on loans granted by banks . . .” ~~[para. 63]~~

64. “If a resident of State R derives income of different kinds from State S, and the latter State, according to its tax laws~~,~~ imposes tax only on one of these items, the maximum deduction which State R is to allow will normally be that part of its tax which is appropriate only to that item of income which is taxed in State S. However, other solutions are possible, especially in view of the following broader problem: the fact that credit has to be given, e.g.~~,~~ for several items of income on which tax at different rates is levied in State S, or for income from several States, with or without conventions, raises the question whether the maximum deduction or the credit has to be calculated separately for each item of income, or for each country, or for all foreign income qualifying for credit under domestic laws and under conventions. Under an ‘overall credit’ system, all foreign income is aggregated, and the total of foreign taxes is credited against the domestic tax appropriate to the total foreign income.” ~~[para. 64]~~

65. “Further problems may arise in case of losses. A resident of State R, deriving income from State E (or S), may have a loss in State R, or in State E (or S) or in a third State. For purposes of the tax credit, in general, a loss in a given State will be set off against other income from the same State. Whether a loss suffered outside State R (e.g.~~,~~ in a permanent establishment) may be deducted from other income, whether derived from State R or not~~,~~ depends on the domestic laws of State R. Here similar problems may arise, as mentioned in the Commentary on Article 23 A (paragraph 44 above). When the total income is derived from abroad, and no income but a loss not exceeding the income from abroad arises in State R, then the total tax charged in State R will be appropriate to the income from State S, and the maximum deduction which State R is to allow will consequently be the tax charged in State R. Other solutions are possible.” ~~[para. 65]~~

66. “The aforementioned problems depend very much on domestic laws and practice, and the solution must, therefore, be left to each State. In this context, it may be noted that some States are very liberal in applying the credit method. Some States are also considering or have already adopted the possibility of carrying over unused tax credits. Contracting States are, of course, free in bilateral negotiations to amend the Article to deal with any of the aforementioned problems.” ~~[para. 66]~~

67. “In so-called thin ‘capitali~~z~~sations’ situations, the Model Convention allows the State of the borrower company, under certain conditions, to treat an interest payment as a distribution of dividends in accordance with its domestic legislation; the essential condition is that the contributor of the loan should effectively share the risks run by the borrower company. This gives rise to two consequences:

— the taxing at source of such 'interest' at the rate for dividends (paragraph 2 of Article 10);

— the inclusion of such 'interest' in the taxable profits of the lender company.~~" [para. 67]~~

68. ~~"~~If the relevant conditions are met, the State of residence of the lender would be obliged to give relief for any juridical or economic double taxation of the interest as if the payment was in fact a dividend. It should then give credit for tax effectively withheld on this interest in the State of residence of the borrower at the rate applicable to dividends and, in addition, if the lender is the parent company of the borrower company, apply to such 'interest' any additional relief under its parent/subsidiary regime. This obligation may result:

~~(~~a) from the actual wording of Article 23 of the Convention, when it grants relief in respect of income defined as dividends in Article 10 or of items of income dealt with in Article 10;

~~(~~b) from the context of the Convention, i.e.~~,~~ from a combination of Articles 9, 10, 11, and 23 and~~,~~ if need be, by way of the mutual agreement procedure:

— where the interest has been treated in the country of residence of the borrower company as a dividend under rules which are in accordance with paragraph 1 of Article 9 or paragraph 6 of Article 11 and where the State of residence of the lender agrees that it has been properly so treated and is prepared to apply a corresponding adjustment;

— when the State of residence of the lender applies similar thin capitali~~z~~**s**ation rules and would treat the payment as a dividend in a reciprocal situation, i.e.~~,~~ if the payment were made by a company established in its territory to a resident in the other Contracting State;

— in all other cases where the State of residence of the lender recogni~~z~~**s**es that it was proper for the State of residence of the borrower to treat the interest as a dividend.~~" [para. 68].~~

69. As regards dividends from a substantial holding by a company, reference is made to paragraphs 49 to 54 above.

~~"~~**B. Remarks concerning capital tax**

70. As paragraph 1 is drafted, credit is to be allowed for income tax only against income tax and for capital tax only against capital tax. Consequently, credit for or against capital tax will be given only if there is a capital tax in both Contracting States.~~" [para. 70]~~

71. ~~"~~In bilateral negotiations, two Contracting States may agree that a tax called a capital tax is of a nature closely related to income tax and may, therefore, wish to allow credit for it against income tax and vice versa. There are cases where, because one State does not impose a capital tax or because both States impose capital taxes only on domestic assets, no double taxation of capital will arise. In such cases it is, of course, understood that the reference to capital taxation may be deleted. Furthermore, States may find it desirable, regardless of the nature of the taxes under the convention, to allow credit for the total amount of tax in the State of source or situs against the total amount of tax in the State of residence. Where, however, a convention includes both real capital taxes and capital taxes which are in their nature income taxes, the States may wish to allow credit against income tax only for the latter capital taxes. In such cases, States are free to alter the proposed Article so as to achieve the desired effect.~~" [para. 71]~~

~~"C. The relation in special cases between the taxation in the State of source and the ordinary credit method~~

~~In certain cases a State, especially a developing country, may for particular reasons give concessions to taxpayers, e.g., tax incentive reliefs to encourage industrial output. In a similar way,~~

~~a State may exempt from tax certain kinds of income, e.g., pensions to war-wounded soldiers." [para. 72]~~

~~"When such a State concludes a convention with a State which applies the exemption method, no restriction of the relief given to the taxpayers arises, because that other State must give exemption regardless of the amount of tax, if any, imposed in the State of source (see paragraph 34 above). But when the other State applies the credit method, the concession may be nullified to the extent that such other State will allow a deduction only of the tax paid in the State of source. By reason of the concessions, that other State secures what may be called an uncovenanted gain for its own Exchequer." [para. 73]~~

~~"Should the two States agree that the benefit of the concessions given to the taxpayers in the State of source are not to be nullified, a derogation from paragraph 2 of Article 23 A, or from Article 23 B will be necessary." [para. 74]~~

C. Tax sparing

72. Some States grant different kinds of tax incentives to foreign investors for the purpose of attracting foreign investment. When the State of residence of a foreign investor applies the credit method, the benefit of the incentive granted by a State of source may be reduced to the extent that the State of residence, when taxing income that has benefited from the incentive, will allow a deduction only for the tax actually paid in the State of source. Similarly, if the State of residence applies the exemption method but subject the application of that method to a certain level of taxation by the State of source, the granting of a tax reduction by the State of source may have the effect of denying the investor the application of the exemption method in his State of residence.

73. To avoid any such effect in the State of residence, some States that have adopted tax incentive programmes wish to include provisions, usually referred to as "tax sparing" provisions, in their conventions. The purpose of these provisions is to allow non-residents to obtain a foreign tax credit for the taxes that have been "spared" under the incentive programme of the source State or to ensure that these taxes will be taken into account for the purposes of applying certain conditions that may be attached to exemption systems.

74. Tax sparing provisions constitute a departure from the provisions of Articles 23 A and 23 B. Tax sparing provisions may take different forms, as for example:

~~"Various formulae can be used to this effect as for example:~~

a) the State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general legislation or such amount as limited by the Convention (*e.g.* limitations of rates provided for dividends and interest in Articles 10 and 11) even if the State of source~~, as a developing country,~~ has waived all or part of that tax under special provisions for the promotion of its economic development;

b) as a counterpart for the tax ~~sacrifice which the developing country makes b reducing in a general way its tax at the source,~~ **reduction by the State of [source]** the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate;

c) the State of residence exempts the income which has benefited from tax incentives in the **State of source** ~~developing country~~. ~~Contracting States are free to devise other formulae in the course of bilateral negotiations.” [para 75]~~

17. Contracting States are free to devise other formulae in the course of bilateral negotiations. The following paragraphs of the OECD Commentary before the 2000 update of that Commentary, are still relevant:

17.1 “If a Contracting State agrees to stimulate especially investments in the other State being a developing country, the above provisions will generally be accompanied by guarantees for the investors, that is to say, the convention will limit the rate of tax which can be imposed in the State of source on dividends, interest and royalties.” [para. 76]

17.2 “Moreover, time restrictions or time limits can be provided for the application of the advantages referred to in formula (a), and possibly (c), above: the extended credit (or the exemption) may be granted only in respect of incentives applied temporarily in developing countries, or only for investments made or contracts concluded in the future (for instance, from the date of entry into force of the convention) or for a determined period of time.” [para. 77]

17.3 “Thus, there exist a considerable number of solutions to this problem. In fact, the concrete effects of the provisions concerned can also vary as a result of other factors such as the amount to be included in the taxable income in the State of residence (formulae (a) and (b) above); it may be the net income derived (after deduction of the tax effectively paid in the State of source), or the net income grossed-up by an amount equal to the tax effectively paid in the State of source, or to the tax which could have been levied in accordance with the convention (rates provided for in Articles 10 and 11) or to the tax which the State of residence agrees to allow as a deduction.” [para. 78]

18. The following extracts from the Commentary on Article 23 A and 23 B of the OECD Model Convention ~~(as it read on 22 July 2010)~~ are also applicable:

75. A 1998 report by the Committee of Fiscal Affairs, entitled “Tax Sparing a Reconsideration”,1 analyses the tax policy considerations that underlie tax sparing provisions as well as their drafting. The report identifies a number of concerns that put into question the overall usefulness of the granting of tax sparing relief. These concerns relate in particular to:

- **— the potential for abuse offered by tax sparing;**
- **— the effectiveness of tax sparing as an instrument of foreign aid to promote economic development of the source country; and**
- **— general concerns with the way in which tax sparing may encourage States to use tax incentives.**

~~“~~Paragraph 2

79. This paragraph has been added to enable the State of residence to retain the right to take the amount of income or capital exempted in that State into consideration when determining the tax to be imposed on the rest of the income or capital. The right so retained extends to income or capital which ‘shall be taxable only’ in the other State. The principle of progression is thus safeguarded for the State of residence, not only in relation to income or capital which ‘may be taxed’ in the other State, but also for income or capital which ‘shall be taxable only’ in that other State. The Commentary on paragraph 3 of Article 23 A in relation to the State of source also applies to paragraph 2 of Article 23 B.~~”. [para. 79]~~

Commentary on chapter VI

SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

1. Article 24 of the United Nations Model Convention**, except for reference to a different paragraph of Article 12 in paragraph,** reproduces Article 24 of the OECD Model Convention. **The Committee considers that the following extracts from the Commentary on paragraphs 1 to 4 of Article 24 of the OECD Model Convention ~~(as it read on 22nd July 2010)~~ are applicable to corresponding paragraphs of Article 24 (the additional comments that appear in italics between square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to reflect the differences between the provisions of the OECD Model Convention and those of this Model as also to specify the applicable paragraph/subparagraph of this Model):** ~~In 1999, the definition of the term "national" which had previously been included in this article was moved to article 3 as was also done in the OECD Model Convention. (Cf. paragraph 9 of the Commentary on article 3 above).~~

Paragraph 1

2. Since this paragraph reproduces Article 24, paragraph 1, of the OECD Model Convention, the Commentary on that paragraph is fully relevant:

> **5.** ~~"~~This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.~~" [para. 1]~~
>
> **6.** ~~"~~It is noteworthy that the principle of non-discrimination, under various descriptions and with a more or less wide scope, was applied in international fiscal relations well before the appearance, at the end of the 19th ~~c~~**C**entury, of the classic type of double taxation conventions. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of friendship or commerce, etc.) concluded by States, especially in the 19th ~~c~~**C**entury, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other State equality of treatment with ~~their~~ **its** own nationals. The fact that such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope. The text of paragraph 1 provides that the application of this paragraph is not restricted by Article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State.~~" [para. 2]~~
>
> **7.** ~~"~~The expression 'in the same circumstances' refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in

fact. The expression ‘in particular with respect to residence’ makes clear that the residence of the taxpayer is one of the factors that are relevant in determining whether taxpayers are placed in similar circumstances. The expression ‘in the same circumstances’ would be sufficient by itself to establish that a taxpayer who is a resident of a Contracting State and one who is not a resident of that State are not in the same circumstances. In fact, whilst the expression ‘in particular with respect to residence’ did not appear in the 1963 Draft Convention or in the 1977 Model Convention, the Member countries have consistently held, in applying and interpreting the expression ‘in the same circumstances’, that the residence of the taxpayer must be taken into account. However, in revising the Model Convention, the Committee on Fiscal Affairs felt that a specific reference to the residence of the taxpayers would be a useful clarification as it would avoid any possible doubt as to the interpretation to be given to the expression ‘in the same circumstances’ in this respect.~~” [para. 3]~~

8. “In applying paragraph 1, therefore, the underlying question is whether two persons who are residents of the same State are being treated differently solely by reason of having a different nationality. Consequently~~,~~ if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its nationals who reside in the other State. Similarly, paragraph 1 does not apply where a national of a Contracting State (State R) who is also a resident of State R is taxed less favourably in the other Contracting State (State S) than a national of State S residing in a third State (for instance, as a result of the application of provisions aimed at discouraging the use of tax havens) as the two persons are not in the same circumstances with respect to their residence.~~” [para. 4]~~

9. The expression “in the same circumstances” can in some cases refer to a person’s tax situation. This would be the case, for example, where a country would subject its nationals, or some of them, to a more comprehensive tax liability than non-nationals (this, for example, is a feature of the United States tax system). As long as such treatment is not itself a violation of paragraph 1, it could not be argued that persons who are not nationals of that State are in the same circumstances as its nationals for the purposes of the application of the other provisions of the domestic tax law of that State with respect to which the comprehensive or limited liability to tax of a taxpayer would be relevant (*e.g.* the granting of personal allowances).

10. “Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.” [para. 5]

11. “Neither are they to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State, to extend the same privileges to similar institutions whose activities are not for its benefit.” [para. 6]

12. “To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private ~~industrial and commercial~~ **business** undertakings, the provisions of paragraph 1 will apply to them.~~” [para. 7]~~

13. “As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions’ activities and by the benefit which that State and its nationals will derive from those activities.~~" [para. 8]~~

14. ~~"~~Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed ~~on the basis of separate accounts~~ **in accordance with Article 7 [of the United Nations Model Convnetion]**, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.~~" [para. 9]~~

15. ~~"~~Subject to the foregoing observation, the words '. . . shall not be subjected . . . to any taxation or any requirement connected therewith which is other or more burdensome . . .' mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals.~~" [para. 10~~]

16. ~~"~~In view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under paragraph 1. This result is achieved through the definition of the term 'national' in subparagraph ~~(f)~~ **[f]** of paragraph 1 of Article 3.~~" [para. 11]~~

17. By virtue of that definition, in the case of a legal person such as a company, "national of a Contracting State" means a legal person "deriving its status as such from the laws in force in that Contracting State". A company will usually derive its status as such from the laws in force in the State in which it has been incorporated or registered. Under the domestic law of many countries, however, incorporation or registration constitutes the criterion, or one of the criteria, to determine the residence of companies for the purposes of Article 4. Since paragraph 1 of Article 24 prevents different treatment based on nationality but only with respect to persons or entities "in the same circumstances, in particular with respect to residence", it is therefore important to distinguish, for purposes of that paragraph, a different treatment that is solely based on nationality from a different treatment that relates to other circumstances and, in particular, residence. As explained in paragraphs 7 and 8 above, paragraph 1 only prohibits discrimination based on a different nationality and requires that all other relevant factors, including the residence of the entity, be the same. The different treatment of residents and non-residents is a crucial feature of domestic tax systems and of tax treaties; when Article 24 is read in the context of the other Articles of the Convention, most of which provide for a different treatment of residents and non-residents, it is clear that two companies that are not residents of the same State for purposes of the Convention (under the rules of Article 4) are usually not in the same circumstances for purposes of paragraph 1.

18. Whilst residents and non-residents are usually not in the same circumstances for the purposes of paragraph 1, it is clear, however, that this is not the case where residence has no relevance whatsoever with respect to the different treatment under consideration.

19. The following examples illustrate these principles.

20. Example 1: Under the domestic income tax law of State A, companies incorporated in that State or having their place of effective management in that State are residents thereof. The State A - State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Since a company incorporated in State B that would have its place of effective management in State A would be a resident of State A for purposes of the State A - State B Convention, the fact that dividends paid to such a company by a company incorporated in State A would not be eligible for this exemption, even though the recipient company is in the same circumstances as a company incorporated in State A with respect to its residence, would constitute a breach of paragraph 1 absent other relevant different circumstances.

21. Example 2: Under the domestic income tax law of State A, companies incorporated in that State are residents thereof and companies incorporated abroad are non-residents. The State A - State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. The domestic tax law of State A provides that dividends paid to a company incorporated in that country by another company incorporated in that country are exempt from tax. Paragraph 1 does not extend that treatment to dividends paid to a company incorporated in State B. Even if a company incorporated in State A and a company incorporated in State B that receive such dividends are treated differently, these companies are not in the same circumstances with regards to their residence and residence is a relevant factor in this case (as can be concluded, for example, from paragraph 5 of Article 10, which would prevent the subsequent taxation of dividends paid by a non-resident company but not those paid by a resident company).

22. Example 3: Under the domestic income tax law of State A, companies that are incorporated in that State are residents thereof. Under the domestic tax law of State B, companies that have their place of effective management in that State are residents thereof. The State A - State B tax convention is identical to this Model Tax Convention. The domestic tax law of State A provides that a non-resident company that is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information is subject to an annual tax equal to 3 per cent of the value of its immovable property instead of a tax on the net income derived from that property. A company incorporated in State B but which is a resident of a State with which State A does not have a tax treaty that allows for the exchange of tax information cannot claim that paragraph 1 prevents the application of the 3 per cent tax levied by State A because it is treated differently from a company incorporated in State A. In that case, such a company would not be in the same circumstances, with respect to its residence, as a company incorporated in State A and the residence of the company would be relevant (*e.g.* for purposes of accessing the information necessary to verify the net income from immovable property derived by a non-resident taxpayer).

23. Example 4: Under the domestic income tax law of State A, companies

incorporated in that State are residents of State A and companies incorporated abroad are non-residents. The State A - State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident of the State in which it has been incorporated. Under State A's payroll tax law, all companies that employ resident employees are subject to a payroll tax that does not make any distinction based on the residence of the employer but that provides that only companies incorporated in State A shall benefit from a lower rate of payroll tax. In that case, the fact that a company incorporated in State B will not have the same residence as a company incorporated in State A for the purposes of the A-B convention has no relevance at all with respect to the different tax treatment under the payroll tax and that different treatment would therefore be in violation of paragraph 1 absent other relevant different circumstances.

24. Example 5: Under the domestic income tax law of State A, companies incorporated in that State or which have their place of effective management in that State are residents of the State and companies that do not meet one of these two conditions are non-residents. Under the domestic income tax law of State B, companies incorporated in that State are residents of that State. The State A - State B tax convention is identical to this Model Tax Convention except that paragraph 3 of Article 4 provides that if a legal person is a resident of both States under paragraph 1 of that Article, that legal person shall be deemed to be a resident only of the State in which it has been incorporated. The domestic tax law of State A further provides that companies that have been incorporated and that have their place of effective management in that State are entitled to consolidate their income for tax purposes if they are part of a group of companies that have common shareholders. Company X, which was incorporated in State B, belongs to the same group as two companies incorporated in State A and all these companies are effectively managed in State A. Since it was not incorporated in State A, company X is not allowed to consolidate its income with that of the two other companies.

25. In that case, even if company X is a resident of State A under the domestic law of that State, it is not a resident of State A for purposes of the Convention by virtue of paragraph 3 of Article 4. It will therefore not be in the same circumstances as the other companies of the group as regards residence and paragraph 1 will not allow it to obtain the benefits of consolidation even if the different treatment results from the fact that company X has not been incorporated in State A. The residence of company X is clearly relevant with respect to the benefits of consolidation since certain provisions of the Convention, such as Articles 7 and 10, would prevent State A from taxing certain types of income derived by company X.

Paragraph 2

~~3. Since this paragraph reproduces Article 24, paragraph 2, of the OECD Model Convention, the Commentary on the latter paragraph, which reads as follows, is fully relevant:~~

26. On 28~~th~~ September~~,~~ 1954, a number of States concluded in New York a Convention relating to the status of stateless persons, under ~~a~~**A**rticle 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD Member countries." [para. 12]

27. It should, however, be recogni~~z~~**s**ed that the provisions of paragraph 2 will, in a bilateral convention, enable national treatment to be extended to stateless persons who, because they are in one of the situations enumerated in paragraph 2 of ~~a~~**A**rticle 1 of the above-mentioned Convention of 28~~ th~~ September~~,~~ 1954, are not covered by that Convention. This is mainly the case, on the one hand, of persons receiving at the time of signature of that Convention, protection or assistance from organs or agencies of the United Nations other than the United Nations High Commissioner for Refugees, and, on the other hand, of persons who are residents of a country and who there enjoy and are subject to the rights and obligations attaching to the possession of that country's nationality.~~" [para. 13]~~

28. The purpose of paragraph 2 is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to stateless persons who are residents of that or **of** the other Contracting State." [para. 14]

29. By thus excluding stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other State.~~" [para. 15]~~

30. However, if States were to consider it desirable in their bilateral relations~~,~~ to extend the application of paragraph 2 to all stateless persons, whether residents of a Contracting State or not, so that in all cases they enjoy the most favourable treatment accorded to nationals of the State concerned, in order to do this they would need only to adopt the following text which contains no condition as to residence in a Contracting State:

> 'Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that State in the same circumstances, **in particular with respect to residence,** are or may be subjected.' ~~"[para. 16]~~

31. It is possible that in the future certain States will take exception to the provisions of paragraph 2 as being too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. If such States wished to avoid this latter consequence, they would have to modify paragraph ~~3~~2 as follows:

> 'Stateless persons who are residents of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected.' ~~"[para. 17~~]

32. Finally, it should be understood that the definition of the term 'stateless person' to be used for the purposes of such a clause can only be that laid down in paragraph 1 of Article 1 of the Convention of 28~~ th~~ September~~,~~ 1954, which defines a stateless person as 'a person who is not considered as a national by any State under the operation of its law'.~~" [para. 18]~~

Paragraph 3

~~4. Since this paragraph reproduces Article 24, paragraph 3, of the OECD Model Convention, the Commentary on that paragraph is fully relevant~~:

33. Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.~~" [para. 19]~~

34. It appears necessary first to make it clear that the wording of the first sentence of paragraph 3 must be interpreted in the sense that it does not constitute discrimination to tax nonresident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied. **For example, paragraph 3 does not prevent the application of specific mechanisms that apply only for the purposes of determining the profits that are attributable to a permanent establishment. The paragraph must be read in the context of the Convention and, in particular, of paragraph 2 of Article 7 [of the United Nations Model Convention] […] Clearly, rules or administrative practices that seek to determine the profits that are attributable to a permanent establishment on the basis required by paragraph 2 of Article 7[of the UN Model] cannot be considered to violate paragraph 3, which is based on the same principle since it requires that the taxation on the permanent establishment be not less favourable than that levied on a domestic enterprise carrying on similar activities.**~~" [para. 20]~~

35. By the terms of the first sentence of paragraph 3, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on ~~industrial and commercial~~ **business** activities, and especially taxes on business profits.~~" [para. 21]~~

36. However, the second sentence of paragraph 3 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.~~" [para. 22]~~

37. It is also clear that, for purposes of paragraph 3, the tax treatment in one Contracting State of the permanent establishment of an enterprise of the other Contracting State should be compared to that of an enterprise of the first-mentioned State that has a legal structure that is similar to that of the enterprise to which the permanent establishment belongs. Thus, for example, paragraph 3 does not require a State to apply to the profits of the permanent establishment of an enterprise carried on by a non-resident individual the same rate of tax as is applicable to an enterprise of that State that is carried on by a resident company.

38. Similarly, regulated and unregulated activities would generally not constitute the "same activities" for the purposes of paragraph 3. Thus, for instance, paragraph 3 would not require that the taxation on a permanent establishment whose activities include the borrowing and lending of money but which is not registered as a bank be not less favourably levied than that of domestic banks since the permanent establishment does not carry on the same activities. Another example would be that of activities carried on by a State or its public bodies, which, since they are controlled by the State, could not be considered, for the purposes of paragraph 3, to be similar to activities that an enterprise of the other State performs through a permanent establishment.

39. As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment, which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.~~" [para. 23]~~

~~"~~A. Assessment of tax

40. With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

~~(~~a) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authori~~z~~sed by the taxation law to be deducted from taxable profits ~~in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise.~~ Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises **[…]**.

~~(~~b) Permanent establishments must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries ('wholesale' writing down, accelerated depreciation etc.). As regards reserves, it should be noted that these are sometimes authori~~z~~sed for purposes other than the offsetting—in accordance with commercial accounting principles—of depreciation on assets, expenses or losses which have not yet occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit, provisions or 'reserves' for investment. When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises~~,~~ with respect to their permanent establishments situated in the State concerned, insofar, that is, as the activities to which such provisions or reserves would pertain are taxable in that State.

~~(~~c) Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g.~~,~~ 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, as shown in the separate accounts for these activities, which will qualify for such carry-forward.

~~(~~d) Permanent establishments should further have the same rules applied to resident enterprises, with regard to the taxation of capital gains reali~~z~~sed on the alienation of assets, whether during or on the cessation of business.~~" [para. 24~~]

41. As clearly stated in subparagraph *c)* above, the equal treatment principle of paragraph 3 only applies to the taxation of the permanent establishment's own activities. That principle, therefore, is restricted to a comparison between the rules governing the taxation of the permanent establishment's own activities and those applicable to similar

business activities carried on by an independent resident enterprise. It does not extend to rules that take account of the relationship between an enterprise and other enterprises (*e.g.* rules that allow consolidation, transfer of losses or tax-free transfers of property between companies under common ownership) since the latter rules do not focus on the taxation of an enterprise's own business activities similar to those of the permanent establishment but, instead, on the taxation of a resident enterprise as part of a group of associated enterprises. Such rules will often operate to ensure or facilitate tax compliance and administration within a domestic group. It therefore follows that the equal treatment principle has no application. For the same reasons, rules related to the distribution of the profits of a resident enterprise cannot be extended to a permanent establishment under paragraph 3 as they do not relate to the business activities of the permanent establishment (see paragraph 59 below).

42. Also, it is clear that the application of transfer pricing rules based on the arm's length standard in the case of transfers from a permanent establishment to its head office (or vice versa) cannot be considered to be a violation of paragraph 3 even if such rules do not apply to transfers within an enterprise of the Contracting State where the permanent establishment is located. Indeed, the application of the arm's length standard to the determination of the profits attributable to a permanent establishment is mandated by paragraph 2 of Article 7[of the United Nations Model Convention] and that paragraph forms part of the context in which paragraph 3 of Article 24 must be read; also, since Article 9 would authorise the application of the arm's length standard to a transfer between a domestic enterprise and a foreign related enterprise, one cannot consider that its application in the case of a permanent establishment results in less favourable taxation than that levied on an enterprise of the Contracting State where the permanent establishment is located.

43. Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of non-discrimination, **they do not constitute an exhaustive list of the possible consequences of that principle with respect to the determination of the tax base. The application of that principle may be less clear** ~~the same does not always hold good for~~ **in** the tax incentive measures which most countries, faced with such problems as decentrali~~z~~**s**ation of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.~~" [para. 25]~~

44. As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in ~~industrial or commercial~~ **business** activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States."~~[para. 26]~~

45. It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.~~" [para. 27]~~

46. ~~Finally,~~ **Also** it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.~~" [para. 28]~~

47. Finally, the provisions of paragraph 3 should not be construed as obliging a State which accords special taxation privileges to non-profit institutions whose activities are performed for purposes of public benefit that are specific to that State, to extend the same privileges to permanent establishments of similar institutions of the other State whose activities are not exclusively for the first-mentioned State's public benefit.

~~"~~B. Special treatment of dividends received in respect of holdings owned by permanent establishments

48. In many countries special rules exist for the taxation of dividends distributed between companies (parent company subsidiary treatment, the '*Schachtelprivileg'*, the rule ~~'~~*non bis in idem*~~'~~). The question arises whether such treatment, should by effect of the provisions of paragraph 3, also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets.~~" [para. 29]~~

49. On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle, profits tax should be levied once, in the hands of the subsidiary performing the profit-generating activities. The parent company should be exempted from tax on such profits when received from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the head office of the parent company is situated to give relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The State of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (i.e.~~,~~ for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.~~" [para. 30]~~

50. Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward relates to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends, its extension to permanent establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 3 does not entail any obligation to extend such treatment to permanent establishments argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.~~” [para. 31]~~

51. The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, viz.,

— reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;

— or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;

— or simple reasons of practical convenience, in line with the present tendency towards decentrali~~z~~sation of management functions in large enterprises.~~” [para. 32]~~

52. In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 3. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.~~” [para. 33]~~

53. A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B) results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5 or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions of paragraphs 2 and 4 of Article 10, so as to enable withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent establishments of companies which are residents of State B in the same way as if they are received directly, i.e.~~,~~ by the head offices of the latter companies, viz., at the rate of:

— 5 per cent in the case of a holding of at least 25 per cent;

— 15 per cent in all other cases.~~” [para. 34]~~

[It is to be noted that paragraph 2 of Article 10 in the United Nations Model Convention differs from the terms quoted above.]

54. Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned, to levy a withholding tax there on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.~~” [para. 35]~~

~~“~~C. Structure and rate of tax

55. In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 3 raise, with regard to the rate applicable in the case of permanent establishments, ~~especially difficult and delicate problems~~ **some specific issues related to**~~, which here too arise from~~ the fact that the permanent establishment is only a part of a legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.~~” [para. 36]~~

56. When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way **[**. . .**]** States that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.~~” [para. 37]~~

57. When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed a priori that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 3 are not observed only if the minimum rate is higher.~~” [para. 38]~~

58. However, even if the profits of the whole enterprise to which the permanent establishment belongs ~~is~~**are** taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the **[…] [**distinct and separate enterprise**]**, according to which the profits of the permanent establishment must be determined under paragraph 2 of Article 7 **[of the United Nations Model Convention]**. The minimum amount of the tax levied in the State where the permanent establishment is situated is, therefore, the amount which would be due if it were a **[…] [**distinct and separate enterprise**]**, without reference to the profits of the whole enterprise to which it belongs. The State where the permanent establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment, leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.~~” [para. 39]~~

~~“As regards the split-rate system of company tax, it should first be pointed out as being a fact central to the issue here that most OECD Member countries which have adopted this system do not consider themselves bound by the provisions of paragraph 3 to extend it to permanent establishments of non-resident companies. This attitude is based, in particular, on the view that the split-rate is only one element amongst others (in particular a withholding tax on distributed income) in a system of taxing company profits and dividends which must be considered as a whole and is therefore, both for legal and technical reasons, of domestic application only. The State where the permanent establishment is situated could claim the right not to tax such profits at the reduced rate, as, generally, it does not tax the dividends distributed by the company to which the permanent establishment belongs. Moreover, a State which has adopted a split-rate system usually has other economic policy objectives, such as the promotion of the capital market, by encouraging resident companies to distribute dividends. The extension of the reduced rate to the profits of the permanent establishment would not serve such a purpose at all, as the company distributing the dividends is not a resident of the State concerned.” [para. 40]~~

~~“This view is, however, disputed. The States in favour of extending the split-rate system~~

~~to permanent establishments urge that as the essential feature of this system is a special technique of taxing profits which enterprises in a corporate form derive from their activities, and is designed to afford immediate relief from the double taxation levied on the profits distributed, it should be applied to permanent establishments in bilateral conventions against double taxation. It is generally recognizsed that, by the effects of their provisions, such conventions necessarily result in some integration of the taxation systems of the Contracting States. On this account, it is perfectly conceivable that profits made in a State (A) by a permanent establishment of a company resident in another State (B) should be taxed in State A according to the split-rate system. As a practical rule, the tax could in such case be calculated at the reduced rate (applicable to distributed profits) on that proportion of an establishment's profits which corresponds to the ratio between the profit distributed by the company to which it belongs and the latter's total profit; the remaining profit could be taxed at the higher rate. Of course, the two Contracting States would have to consult together and exchange all information necessary for giving practical effect to this solution. Similar considerations apply to systems where distributions of profits made can be deducted from the taxable income of a company." [para. 41]~~

~~"As regards the imputation system ('avoir fiscal' or 'tax credit'), it seems doubtful, at least on a literal interpretation of the provisions of paragraph 3, whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishments. In fact, it has identical effects to those of the split-rate system but these effects are not immediate as they occur only at the time of the shareholder's personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a distinct company in State A where the permanent establishment of a company which is a resident of State B is situated, and, to the extent that they are distributed, carry the 'avoir fiscal' or 'tax credit'. But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions and procedures for allowing the 'avoir fiscal' or 'tax credit' to shareholders who are themselves residents of either State, of the companies concerned that are residents of State B." [para. 42]~~

~~"Contracting States which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances." [para. 43]~~

59. Since a permanent establishment, by its very nature, does not distribute dividends, the tax treatment of distributions made by the enterprise to which the permanent establishment belongs is therefore outside the scope of paragraph 3. Paragraph 3 is restricted to the taxation of the profits from the activities of the permanent establishment itself and does not extend to the taxation of the enterprise as a whole. This is confirmed by the second sentence of the paragraph, which confirms that tax aspects related to the taxpayer that owns the permanent establishment, such as personal allowances and deductions, are outside the scope of the paragraph. Thus, issues related to various systems for the integration of the corporate and shareholder's taxes (*e.g.* advance corporate tax, *précompte mobilier*, computation of franked income and related dividend tax credits) are outside the scope of the paragraph.

~~"~~D. Withholding tax on dividends, interest and royalties received by a permanent establishment

62. When permanent establishments receive dividends, interest or royalties such income, by virtue of paragraph ~~4~~ **[3]** of Articles 10 and 11 and paragraph [4] of Article 12, respectively, comes under the provisions of Article 7 and consequently—subject to the observations made in paragraph ~~34~~**53** above as regards dividends received on holdings of permanent establishment—falls to be included in the taxable profits of such permanent establishments~~. (Ccf.~~

~~paragraph 35 of the Commentary on Article 7.).” [para. 44]~~

63. According to the respective Commentaries on the above-mentioned provisions of Articles 10, 11 and 12 **[...]** these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any limitation provided for in those Articles, which means—and this is the generally accepted interpretation—that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.” ~~[para. 45]~~

64. While this approach does not create any problems with regard to the provisions of paragraph 3 of Article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.~~” [para. 46]~~

65. In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 3 that for the purpose of taxing the income which is derived from their activity, or which is normally connected with it—as is recogni~~z~~sed to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph [4] of Article 12—permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.~~” [para. 47]~~

66. In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.~~” [para. 48]~~

~~“~~E. Credit for foreign tax

67. In a related context, **when foreign income is included in the profits attributable to a permanent establishment,** ~~–when a permanent establishment receives foreign income which is included in its taxable profits,~~ it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.~~” [para. 49]~~

68. If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises~~,~~ as to the extension to permanent establishments of the benefit of **credit provisions included in tax** conventions concluded with third States **[. . .] Whilst the permanent establishment is not itself a person and is therefore not entitled to the benefits of these tax conventions, this issue is relevant to the taxation on the permanent establishment. This question is examined below in the particular case of dividends and interest.** ~~” [para. 50]~~

~~“~~F. Extension to permanent establishments of the benefit of **the credit provisions of** double taxation conventions concluded with third States

69. When the permanent establishment in a Contracting State of a resident enterprise of another Contracting State receives dividends **[…],** interest **[**or royalties**]** from a third State, then the question arises as to whether and to what extent the Contracting State in which the permanent establishment is situated should credit the tax that cannot be recovered from the third State.~~” [para. 51]~~

70. There is agreement that double taxation arises in these situations and that some method of relief should be found. The majority of Member countries are able to grant credit in these cases on the basis of their domestic law or under paragraph 3. States that cannot give credit in such a way or that wish to clarify the situation may wish to supplement the provision in their convention with the Contracting State in which the enterprise is resident by wording that allows the State in which the permanent establishment is situated to credit the tax liability in the State in which the income originates to an amount that does not exceed the amount that resident enterprises in the Contracting State in which the permanent establishment is situated can claim on the basis of the Contracting State's convention with the third State. If the tax that cannot be recovered under the convention between the third State and the State of residence of the enterprise which has a permanent establishment in the other Contracting State is lower than that under the convention between the third State and the Contracting State in which the permanent establishment is situated, then only the lower tax collected in the third State shall be credited. This result would be achieved by adding the following words after the first sentence of paragraph 3:

'When a permanent establishment in a Contracting State of an enterprise of the other Contracting State receives dividends, interest or royalties from a third State and the ~~right or the asset~~ **holding or debt-claim** in respect of which the dividends, interest or royalties are paid is effectively connected with that permanent establishment, the first-mentioned State shall grant a tax credit in respect of the tax paid in the third State on the dividends, interest or royalties, as the case may be, by applying the rate of tax provided in the convention with respect to taxes on income and capital between the State of which the enterprise is a resident and the third State. However, the amount of the credit shall not exceed the amount that an enterprise that is a resident of the first-mentioned State can claim under that State's convention on income and capital with the third State. **If the convention also provides for other categories of income that may be taxed in the State in which they arise and for which credit should be given (*e.g.* royalties, in some conventions), the above provision should be amended to also cover these.**' ~~" [para. 52]~~

71. Where a permanent establishment situated in a Contracting State of an enterprise resident of another Contracting State (the State of residence) receives dividends, interest or royalties from a third State (the State of source) and, according to the procedure agreed to between the State of residence and the State of source, a certificate of domicile is requested by the State of source for the application of the withholding tax at the rate provided for in the convention between the State of source and the State of residence, this certificate must be issued by the latter State. While this procedure may be useful where the State of residence employs the credit method, it seems to serve no purposes where that State uses the exemption method as the income from the third State is not liable to tax in the State of residence of the enterprise. On the other hand, the State in which the permanent establishment is located could benefit from being involved in the certification procedure as this procedure would provide useful information for audit purposes. Another question that arises with triangular cases is that of abuses. 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.~~" [para. 53]~~

72. In addition to the typical triangular case considered here, other triangular cases arise, particularly that in which the State of the enterprise is also the State from which the income ascribable to the permanent establishment in the other State originates (see also paragraph 5 of the Commentary on Article 21). States can settle these matters in bilateral negotiations.~~” [para. 54]~~

Paragraph 4

~~5. Since this paragraph reproduces Article 24, paragraph 4, of the OECD Model Convention, the Commentary on that paragraph is fully relevant:~~

73. This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes.~~” [para. 55]~~

74. Paragraph 4 does not prohibit the country of the borrower from ~~treating interest as a dividend under~~ **applying** its domestic rules on thin capitali~~z~~sation 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 creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.~~” [para. 56]~~

75. Also, paragraph 4 does not prohibit additional information requirements with respect to payments made to non-residents since these requirements are intended to ensure similar levels of compliance and verification in the case of payments to residents and non-residents.

~~6~~**2**. In the course of the discussion by the **former** Group of Experts ~~of~~ **in regard to** paragraph 4, **when the United Nations Model Convention was revised in 1999,** a question was raised whether such a paragraph was suitable for inclusion in a tax treaty between developed and developing countries. It was suggested that the paragraph would not be acceptable to those countries that made deductibility of disbursements made abroad by foreign-owned corporations conditional on the recipient being taxed in such countries. After substantial discussion, the feeling of the Group was that the special circumstances mentioned above ought not to be the basis for treaty articles of broad application but that in cases where they were likely to create a problem they should be raised in bilateral negotiations.

Paragraph 5

~~7~~**3**. Since this paragraph reproduces **paragraph 5 of** Article 24~~, paragraph 5,~~ of the OECD Model Convention, the **Committee considers that the following extracts from the commentary on the said paragraph of the OECD Model Convention are applicable**~~Commentary on that paragraph is fully relevant~~:

76. This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital.~~” [para. 57]~~

~~“Paragraph 5, though relevant in principle to thin capitalizsation, is worded in such general terms that it must take second place to more specific provisions in the Convention. Thus~~

~~paragraph 4 (referring to paragraph 1 of Article 9 and paragraph 6 of Article 11) takes precedence over this paragraph in relation to the deduction of interest." [para. 58]~~

77. Since the paragraph relates only to the taxation of resident enterprises and not to that of the persons owning or controlling their capital, it follows that it cannot be interpreted to extend the benefits of rules that take account of the relationship between a resident enterprise and other resident enterprises (*e.g.* rules that allow consolidation, transfer of losses or tax-free transfer of property between companies under common ownership). For example, if the domestic tax law of one State allows a resident company to consolidate its income with that of a resident parent company, paragraph 5 cannot have the effect to force the State to allow such consolidation between a resident company and a non-resident parent company. This would require comparing the combined treatment of a resident enterprise and the non-resident that owns its capital with that of a resident enterprise of the same State and the resident that owns its capital, something that clearly goes beyond the taxation of the resident enterprise alone.

78. Also, because paragraph 5 is aimed at ensuring that all resident companies are treated equally regardless of who owns or control their capital and does not seek to ensure that distributions to residents and non-residents are treated in the same way (see paragraph 76 above), it follows that withholding tax obligations that are imposed on a resident company with respect to dividends paid to non-resident shareholders but not with respect to dividends paid to resident shareholders cannot be considered to violate paragraph 5. In that case, the different treatment is not dependent on the fact that the capital of the company is owned or controlled by non-residents but, rather, on the fact that dividends paid to non-residents are taxed differently. A similar example would be that of a State that levies a tax on resident companies that make distributions to their shareholders regardless of whether or not they are residents or non-residents, but which, in order to avoid a multiple application of that tax, would not apply it to distributions made to related resident companies that are themselves subject to the tax upon their own distributions. The fact that the latter exemption would not apply to distributions to non-resident companies should not be considered to violate paragraph 5. In that case, it is not because the capital of the resident company is owned or controlled by non-residents that it is treated differently; it is because it makes distributions to companies that, under the provisions of the treaty, cannot be subjected to the same tax when they re-distribute the dividends received from that resident company. In this example, all resident companies are treated the same way regardless of who owns or controls their capital and the different treatment is restricted to cases where distributions are made in circumstances where the distribution tax could be avoided.

79. Since the paragraph prevents the discrimination of a resident enterprise that is solely based on who owns or controls the capital of that enterprise, it would not *prima facie* be relevant with respect to rules that provide for a different treatment of an enterprise based on whether it pays interest to resident or non-resident creditors. The paragraph is not concerned with rules based on a debtor-creditor relationship as long as the different treatment resulting from the rules is not based on whether or not non-residents own or control, wholly or partly, directly or indirectly, the capital of the enterprise. For example, if under a State's domestic thin capitalisation rules, a resident enterprise is not allowed to deduct interest paid to a non-resident associated enterprise, that rule would not be in violation of paragraph 5 even where it would be applied to payments of interest made to a creditor that would own or control the capital of the

enterprise, provided that the treatment would be the same if the interest had been paid to a non-resident associated enterprise that did not itself own or control any of the capital of the payer. Clearly, however, such a domestic law rule could be in violation of paragraph 4 to the extent that different conditions would apply for the deduction of interest paid to residents and non-residents and it will therefore be important to determine, for purposes of that paragraph, whether the application of the rule is compatible with the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 (see paragraph 74 above). This would also be important for purposes of paragraph 5 in the case of thin capitalisation rules that would apply only to enterprises of a Contracting State the capital of which is wholly or partly owned or controlled, directly or indirectly, by non-residents. Indeed, since the provisions of paragraph 1 of Article 9 or paragraph 6 of Article 11 form part of the context in which paragraph 5 must be read (as required by Article 31 of the *Vienna Convention on the Law of Treaties*), adjustments which are compatible with these provisions could not be considered to violate the provisions of paragraph 5.

80 ~~"~~In the case of transfer pricing enquiries, almost all Member 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 the Article.~~" [para. 59]~~

~~8~~**4**. ~~In the course of the Group's discussion of paragraph 5,~~ **When the Model was last revised in 1999,** some members from developing countries proposed that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises are treated alike; they said that change represented a notable departure from the general principle of taxing foreign persons on the same basis as nationals but that the problems of tax compliance in cases in which foreign ownership was involved and the politically sensitive position of foreign-owned enterprises in developing countries warranted the change. Therefore, they proposed that Article 24, paragraph 5, of the OECD Model Convention be amended to read as follows:

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

They further pointed out that the proposed change in paragraph 5 had been included in several tax treaties to which developed countries were parties. Some members from developed countries noted that such a proposal would limit the effect of the non-discrimination ~~a~~**A**rticle to the prevention of discrimination between enterprises owned by non-residents, thus leaving the door open to discrimination against enterprises owned by non-residents as a class.

~~9~~**5**. Several members from developed countries expressed reservations concerning the proposed change and said that they considered the OECD non-discrimination Article as the backbone of the Convention. They recalled that the antecedents of the non-discrimination Article in the present OECD Model Convention dated from the nineteenth century. They felt that if such a fundamental principle were to be altered, it would have a significant effect on international tax relations generally. Further, since the proposed change was motivated in part by problems with tax compliance where foreign ownership was involved—essentially, problems with transfer pricing—it was suggested that the problem might be dealt with more properly in other parts of the Model Convention, such as in ~~a~~**A**rticle 9 dealing with associated enterprises.

~~10~~**6** Some members from developing countries indicated that, while recognizing the essential importance of and need for the ~~a~~**A**rticle on non-discrimination, some countries might wish to modify certain paragraphs of that ~~a~~**A**rticle in bilateral negotiations. It was suggested for example that, because of the difficulties involved in determining what constituted reasonable amounts in the case of transfer payments on account of royalties, technical assistance fees, head office expenses and so on, a country might desire to deny deductions for such payments or compute the amount of deduction in accordance with the domestic law of the country when such payments were made by an enterprise situated within its territory to a foreign controlling company, whether the latter was resident in another Contracting State or in a third country. Another example cited was that of a country which granted tax preferences with a view to the attainment of certain national objectives which might wish to make a given percentage of local ownership of the enterprise involved a condition for the granting of such tax preferences. The Group recognized that special situations such as those mentioned as examples should be resolved in bilateral negotiations.

Paragraph 6

~~11~~**7**. Since this paragraph reproduces **paragraph 6 of** Article 24~~, paragraph 6,~~ of the OECD Model Convention, the **Committee considers that the following** ~~C~~commentary on that paragraph **of the OECD Model Convention** is ~~fully relevant~~ **applicable**:

> **81** ~~"~~This paragraph states that the scope of the Article is not restricted by the provisions of Article 2. The Article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities.~~" [para. 60]~~

Article 25

MUTUAL AGREEMENT PROCEDURE

NOTE BY THE SECRETARIAT: A REVISED ARTICLE 25 WITH NEW COMMENTARY IS PRESENTED IN A SEPARATE CONFERENCE ROOM PAPER (CRP.3) AS PREPARED BY THE SUBCOMITTEE ON DISPUTE RESOLUTION FOR INCLUSION IN THE 2011 REVISION OF THE UN MODEL

Article 26

EXCHANGE OF INFORMATION

NOTE BY THE SECRETARIAT: COMMENTARY BELOW REFLECTS THE REVISED COMMENTARY ON ARTICLE 26, AS ADOPTED BY THE COMMITTEE OF EXPERTS IN 2008[5].

A. GENERAL CONSIDERATIONS

1. Article 26 embodies rules under which information may be exchanged to the widest possible extent, both to facilitate the proper application of the treaty and to assist the Contracting States in the enforcement of their domestic tax laws. Consequently, the obligation to exchange information under this ~~a~~Article should be interpreted broadly, and the limitations on that obligation should not be extended by analogy beyond their specific meaning. In particular, the ~~a~~Article should be understood to require the Contracting States to promote an effective exchange of information.

1.1. In a global economy, cooperation among nations on fiscal matters has become increasingly important, and the former reluctance of nations to concern themselves with the revenue laws of other countries ~~mostly~~ has mostly disappeared. Article 26 provides a basis for the effective exchange of information between the Contracting States, whereas ~~a~~Article 27 provides for assistance in collection. From the perspective of many developing countries, ~~a~~Article 26 is particularly important not only for curtailing cross-border tax evasion and avoidance, but also to curtail the capital flight that is often accomplished through such evasion and avoidance.

1.2. Much of the language of ~~a~~Article 26 is also found in the comparable ~~a~~Article of the OECD Model Convention. Consequently, the OECD commentary to that ~~a~~Article generally is relevant in interpreting ~~a~~Article 26 of the United Nations Model Convention. It should be understood, nevertheless, that ~~a~~Article 26 is intended to be broader in a number of respects than the comparable provision in the OECD Model Convention.

1.3. Although ~~a~~Article 26 imposes reciprocal obligations on the Contracting States, it does not allow a developed country to refuse to provide information to a developing country on the ground that the developing country does not have an administrative capacity comparable to the developed country. Reciprocity has to be measured by reference to the overall effects of a treaty, not with respect to the effects of a single article.

2. The text of paragraph 1 of ~~a~~Article 26 makes clear that the exchange of information is not restricted by ~~a~~Article 1 (Persons covered) or ~~a~~Article 2 (Taxes covered). Consequently, the information exchanged may relate to persons who are not resident in either Contracting State and to the administration or enforcement of taxes not mentioned in ~~a~~Article 2. Some countries may object to the extension of paragraph 1 to all taxes, for constitutional reasons or other reasons. Those concerns are addressed in section B below.

[5] Paragraphs 1 to 5 of the old Commentary on Article 26 (cf. 1999 UN Model) which was deleted in 2008 has not been reproduced here. Paragraphs 6-25 of the 1999 Commentary is reproduced under UN paragraph 30 of this Commentary.

3. Following the pattern of the 2005 OECD revisions, paragraph 1 of ~~a~~Article 26 was broken up into three separate paragraphs, now paragraphs 1, 2 and 6. This paragraphing change was made for clarity and has no substantive significance.

4. Article 26 was modified substantially in 20~~08~~11, with a view to clarifying certain issues, expanding the scope of the article, and limiting exceptions to the obligation to exchange information. In some cases, the changes made were not intended to be substantive, but rather were intended to remove doubts as to the proper interpretation of the ~~a~~Article. For example, the term "necessary" in paragraph 1 was changed to "foreseeably relevant" to clarify the intended meaning of the prior language. In contrast, the change in that paragraph providing for an exchange of information with respect to taxes not mentioned in ~~a~~Article 2 was intended to be a substantive change. Another example of substantive change is the addition of paragraph 4, which removes the requirement for a domestic tax interest.

4.1. In some cases, the issue of whether a change made to ~~a~~Article 26 is intended as substantive or interpretative depends on the prior practices of the Contracting States. For example, in some cases, the addition of paragraph 5, which removes, inter alia, domestic bank secrecy laws as a basis for refusing to exchange information, may simply clarify the meaning of the limitations on the exchange of information contained in paragraph 3. In other cases, it may modify that paragraph substantively. The effect of the change depends in part on the particular prior practices of the Contracting States. The position taken in the OECD commentary is that paragraph 5 is primarily interpretative with respect to treaties between its member States. This issue may be of particular importance in interpreting treaties that entered into force prior to the adoption of the 20~~08~~11 changes to ~~a~~Article 26.

4.2. One difference in the wording of ~~a~~Article 26 and the comparable provision of the OECD Model Convention is that ~~a~~Article 26 includes in paragraph 1 the following sentence: "In particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes." The phrase "that would be helpful to a Contracting State in preventing avoidance or evasion" was inserted in 20~~08~~11. That change was thought to be useful by members of the Committee, especially members from developing countries, to make clear in the text of ~~a~~Article 26 a point that already was clear in the commentary and was implicit in the language of the last sentence of prior paragraph 1, now revised and moved to paragraph 6. The statement of the purposes of information exchanges in the text of ~~a~~Article 26 is intended to provide guidance to the Contracting States on the proper interpretation of the article.

4.3. Although tax evasion is illegal and tax avoidance is not, both result in loss of revenue to the government, and, by definition, both defeat the intent of the government in enacting its taxing statutes. Consequently, mutual assistance in combating tax avoidance is an important aspect of mutual cooperation on tax matters. In addition, some forms of aggressive tax avoidance are so close to the line between avoidance and evasion that a Contracting State is unlikely to know for sure whether the information it is requesting deals with avoidance or evasion until after it obtains the requested information. Information on tax avoidance may be extremely useful to a Contracting State in its efforts to close possible loopholes in its taxing statutes.

5. The term "exchange of information" should be understood broadly to include an exchange of documents and an exchange of information unrelated to specific taxpayers and the

provision of information by one Contracting State whether or not information is also being provided at that time by the other Contracting State.

5.1. If specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State should provide information under ~~a~~Article 26 in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts or writings), to the extent feasible. Under paragraph 3, the requested State may decline to provide the information in the specific form requested if, for instance, the requested form is not known or permitted under its law or administrative practice. A refusal to provide the information in the form requested does not affect the obligation to provide the information.

5.2. Contracting States may wish to use electronic or other communication and information technologies, including appropriate security systems, to improve the timeliness and quality of exchanges of information. Indeed, the Contracting States may be obligated to provide requested information in electronic form if such action is necessary for an effective exchange of information. Contracting States which are required, according to their law, to observe data protection laws may wish to include provisions in their bilateral conventions concerning the protection of personal data exchanged. Data protection concerns the rights and fundamental freedoms of an individual, and in particular, the right to privacy, with regard to automatic processing of personal data. In no event is a Contracting State relieved of its obligation to exchange information simply because its domestic laws do not allow it to provide the information in the form requested.

5.3. The scope of exchange of information covers all tax matters without prejudice to the general rules and legal provisions governing the rights of defendants and witnesses in judicial proceedings. Exchange of information for criminal tax matters can also be based on bilateral or multilateral treaties on mutual legal assistance (to the extent that they also apply to tax crimes).

5.4. Article 26 provides in paragraph 6 that "the competent authorities shall, through consultation, develop appropriate methods and techniques concerning the matters in respect of which exchanges of information under paragraph 1 shall be made". This language authorizes the competent authorities to exchange information in at least three modes: exchange by specific request, automatic exchange, and other exchanges, understood to include spontaneous exchanges.

5.5. Nothing in the United Nations Model Convention prevents the application of the provisions of ~~a~~Article 26 to the exchange of information that existed prior to the entry into force of the Convention, as long as the assistance with respect to this information is provided after the Convention has entered into force and the provisions of the article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the article are applicable to such information, in particular when the provisions of that Convention will have effect with respect to taxes arising or levied from a certain time.

6. The Committee of Experts has suggested some guidelines for arrangements regarding the implementation of appropriate exchanges of information. (See E/C.18/2008/3/Add.1, sect. C.) Those guidelines are in the form of an inventory of options available to the competent authorities. The inventory is not intended to be exhaustive or to impose any procedural obligations on a Contracting State. Instead, the inventory is a listing of suggestions to be

examined by competent authorities in developing procedures for an effective exchange of information.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 26

Paragraph 1

7. The first sentence of paragraph 1 sets forth the basic obligation of the Contracting States concerning the exchange of information. It requires, subject to the limitations of paragraph 3, that the competent authorities exchange such information as is "foreseeably relevant" for the proper application of the Convention or for the administration or enforcement of their domestic tax laws, as long as taxation under those laws is not inconsistent with the Convention.

7.1. Prior to the 20~~08~~11 changes to ~~a~~Article 26, the term "necessary" was used instead of the term "foreseeably relevant". The view of the Committee and the OECD commentary has been that these terms have similar, if not identical, meanings. That is, the term "necessary" is understood to mean "appropriate and helpful", not "essential". In any event, whatever the phrase chosen, the requesting State is not obliged to demonstrate its need for the requested information before the obligation to provide that information arises.

7.2. The standard of "foreseeably relevant" is intended to provide for exchange of information in tax matters to the widest possible extent and, at the same time, to clarify that Contracting States are not at liberty to request information about a particular taxpayer that is highly unlikely to be relevant to the tax affairs of that taxpayer. Contracting States may agree to an alternative formulation of this standard that is consistent with the scope of the ~~a~~Article. For example, they might replace "foreseeably relevant" with "necessary" or "relevant" or "may be relevant" if those terms are understood to require an effective exchange of information. In the interest of conformity with the OECD usage, the Committee decided to adopt the term "foreseeably relevant", although some members of the Committee preferred the term "may be relevant" on the ground that its meaning was clearer.

7.3. The information covered by paragraph 1 is not limited to taxpayer-specific information. The competent authorities may also exchange other sensitive information related to tax administration and compliance improvement; for example, they might provide information about risk analysis techniques or tax avoidance or evasion schemes. They may also share information they have obtained about aggressive or abusive tax avoidance schemes, such as those promoted by some international accounting firms. In addition, the competent authorities may exchange information relating to a whole economic sector (e.g., the oil, fishing or pharmaceutical industry, the banking sector, etc.) and not to particular taxpayers.

8. The scope of the obligation to exchange information is not limited by ~~a~~Articles 1 or 2. That is, the obligation applies not only with respect to information relevant to the proper application of the Convention or to the administration or enforcement of domestic taxes mentioned in ~~a~~Article 2, but also to all other domestic taxes, including subnational taxes. In this respect, the United Nations Model Convention and the OECD Model Convention~~, as amended in 2005,~~ are identical.

8.1. Some members of the Committee expressed concern that sharing of information with respect to all taxes, particularly subnational taxes, might prove burdensome or might raise constitutional and political issues for them. They suggested that the obligation to provide

information might be limited to taxes covered by the Convention, plus one or two important taxes, such as the value added tax (VAT). To accomplish that outcome, the following language might be substituted for paragraph 1:

> **"1. The competent authorities of the Contracting States shall exchange such information as is foreseeably relevant for carrying out the provisions of this Convention or to the administration or enforcement of the domestic laws of the Contracting States *concerning taxes covered by the Convention and [insert specific taxes] of a Contracting State*, in so far as the taxation thereunder is not contrary to the Convention."**

8.2. The obligation to provide requested information applies whether or not the person, with respect to whom the information is requested, is a resident of either Contracting State or is engaged in economic activity in either Contracting State. For example, a Contracting State may request information about the bank deposits of an individual who is resident in some third State.

9. The obligation imposed under paragraph 1 is for an *effective* exchange of information. A Contracting State may not avoid its obligations under paragraph 1 through unreasonable time delays, by imposing unreasonable or burdensome procedural barriers, or by intentionally taking steps that prevent it from having certain information otherwise subject to exchange under paragraph 1.

10. The examples provided in paragraphs 10.1 and 10.2 below illustrate the application of paragraph 1 of ~~a~~Article 26 of the Convention in particular cases. Some of these examples are drawn from, but are not identical to, the examples provided in paragraphs 6 and 7 of the OECD commentary on ~~a~~Article 26. In all of these examples, the requested State (the Contracting State that has been asked for information) has the obligation under paragraph 1 of ~~a~~Article 26 of the Convention to provide the requested information.

10.1. Application of the Convention between State A and State B (information must be provided):

(a) State A, where the recipient of royalties under a royalty contract is resident, is attempting to apply ~~a~~Article 12 (Royalties). It asks State B, where the payer of the royalty is resident, for information concerning the amount of royalty transmitted;

(b) In deciding whether it is proper to grant to the recipient of a royalty the relief claimed under ~~a~~Article 12, State B asks State A whether the recipient is in fact a resident of State A and whether State A considers the recipient to be ~~is~~ the beneficial owner of the royalties;

(c) In computing the taxable profits of a permanent establishment that is located in State A and has its head office in State B, State A may request information from State B about the expenses and profits of the head office and the dealings of the head office with other permanent establishments and associated companies;

Comment [MB36]: A participant of the EGM in June suggested to replace dealings with transactions.

(d) Similarly, if an associated company, within the meaning of ~~a~~Article 9, is located in State A and another associated company is located in State B, then State A may request information from State B about the profits and expenses of the associated company located in State B and about the dealings of that associated company with any other associated companies and permanent establishments;

(e) State A or State B may request information that may be relevant for the purposes of applying ~~a~~Article 25 (Mutual agreement procedure);

(f) State B is attempting to tax an employee resident in State A in accordance with ~~a~~Article 15 (Dependent personal services). The employment has been exercised for more than 183 days in State B. That State may request that State A provide it with information on the amount of the income exempted from taxation in State A in accordance with ~~a~~Article 23 A (exemption method for relieving double taxation);

(g) State A is attempting to impose a corporate income tax on an entity claiming to be a partnership. State A may request information from State B that would be helpful to it in properly classifying the entity for tax purposes, including information about the way the entity is classified for tax purposes by State B;

(h) State A is being asked to provide to one of its residents a tax credit under ~~a~~Article 23 B for income taxes allegedly paid to State B. State A may request from State B information about whether the alleged payment of the tax actually occurred.

10.2. Implementation of domestic laws:

(a) A company in State A supplies goods to an independent company in State B. State A wishes to know from State B what price the company in State B paid for the goods supplied, with a view to a correct application of the provisions of its domestic value added tax;

(b) A company in State A sells goods through a company in State C (possibly a low-tax country) to a company in State B. The companies may or may not be associated. There is no convention between State A and State C, nor between State B and State C. Under the convention between State A and State B, State A, with a view to ensuring the correct application of the provisions of its domestic laws to the profits made by the company situated in its territory, asks State B what price the company in State B paid for the goods;

(c) State A, for the purpose of taxing a company situated in its territory, asks State B, under the convention between A and B, for information about the prices charged by a company in State B, or a group of companies in State B with which the company in State A has no business contacts in order to enable State A to check the prices charged by the company in that State by direct comparison (e.g., prices charged by a company or a group of companies in a dominant position);

(d) A resident of State A holds a bank account in State B, and the income from that account is exempt from tax under the domestic laws of State B. State A may request that State B provide information on the amount of interest income earned on that account;

(e) A financial intermediary invests money of its account holders in State A, earning therein dividends and interest. State A requires that the financial intermediary keep records of the beneficial owners of the accounts but does not routinely request those records in enforcing its domestic laws. State B suspects that some of the beneficiaries of the account holders of the financial intermediary are its residents and are properly taxable under its domestic laws. State B may request that State A obtain for it information on identified taxpayers from the financial intermediary;

(f) A corporation resident in State A has companies located in State B and State C. State B believes that the company doing business in its territory has been skimming profits into the

company located in State C. State B may request that State A provide it with information about the profits and expenses of the company located in State C. Domestic law of State A obliges the parent company to keep records of transactions of its foreign subsidiaries.

***Paragraph* 2**

11. A Contracting State cannot be expected to provide confidential financial information to another Contracting State unless it has confidence that the information will not be disclosed to unauthorized persons. To provide the assurance of secrecy required for effective information exchange, paragraph 2 provides that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.

12. Of course, the information received under ~~a~~Article 26 would be useless, or nearly so, to the requesting State (the Contracting State requesting the information) if the prohibition against disclosure were absolute. Paragraph 2 provides that information received under ~~a~~Article 26 can be disclosed to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes mentioned in paragraph 1. In addition, it is understood that the information may also be communicated to the taxpayer, his proxy or witnesses in a civil or criminal proceeding.

12.1. As stated in paragraph 12, the information obtained can be communicated to the persons and authorities mentioned and, on the basis of the last sentence of paragraph 2 of the ~~a~~Article, can be disclosed by them in court sessions held in public or in decisions which reveal the name of the taxpayer. Once information is used in public court proceedings or in court decisions and thus rendered public, it is clear that from that moment such information can be quoted from the court files or decisions for other purposes even as possible evidence. But this disclosure to the public does not mean that the persons and authorities mentioned in paragraph 2 are allowed to provide on request additional information received.

12.2. If either or both of the Contracting States object to information obtained under ~~a~~Article 26 being made public by courts, or, once the information has been made public in this way, to the information being used for other purposes, they should state this objection expressly in their Convention.

13. In general, the information received by a Contracting State may be used only for the purposes mentioned in paragraph 1. If the information appears to be of value to the receiving State for purposes other than those referred to in that paragraph, that State may not use the information for such other purposes without the authorization of the competent authority of the supplying State. That authorization should not be unreasonably withheld.

13.1. In some cases, a Contracting State may prosecute a taxpayer for tax evasion and also for an additional crime, such as money-laundering, that arises out of the same set of facts. In such circumstances, the receiving State may want to use the information provided for both purposes.

13.2. Similarly, the information received by a Contracting State may not be disclosed to a third country unless there is an express provision in the bilateral treaty between the Contracting States allowing such disclosure.

13.3. Contracting States wishing to broaden the purposes for which they may use information exchanged under this ~~a~~Article may do so by adding the following text to the end of paragraph 2:

> **"Notwithstanding the foregoing, information received by a Contracting State may be used for other purposes when such information may be used for such other purposes under the laws of both States and the competent authority of the supplying State authorizes such use."**

14. The OECD Model Convention, as amended in 2005, includes a provision that would allow the sharing of information obtained under ~~a~~Article 26 with persons charged with the oversight of the persons allowed to obtain such information. This provision is also included in paragraph 2 of the United Nations Model Convention.

14.1. The disclosure should be limited to information necessary for those bodies to fulfil their oversight duties. Such oversight bodies include authorities that supervise tax administration and enforcement authorities as part of the general administration of the Government of a Contracting State. Such sharing is permitted only if the persons engaged in oversight activities are subject to confidentiality requirements at least as strict as those applicable to tax administration and enforcement officials. The competent authorities may want to agree as to the bodies that constitute an oversight body within the meaning of this paragraph.

Paragraph 3

15. Paragraph 3 of ~~a~~Article 26 contains provisions that limit the obligation of the requested State under paragraph 1. The limitations provided in paragraph 3, however, may be superseded by the provisions contained in paragraphs 4 and 5. The provisions of paragraph 3, read in conjunction with the provisions of paragraphs 4 and 5, should not be read in a way that would prevent an effective exchange of information between the Contracting States. In addition, a Contracting State should disclose to the other Contracting State before it enters into a convention any specific provisions of its laws and administrative practice that it believes entitle it to avoid an obligation otherwise imposed by paragraph 1.

16. Paragraph 3 (a), subject to the limitations provided in paragraphs 4 and 5, contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. For example, if a requested State is not permitted under its laws or administrative practice to seize private papers from a taxpayer without court authorization, it is not required to make such a seizure without court authorization on behalf of a requesting State even if the requesting State could make such a seizure without court authorization under its own laws or administrative practice. The purpose of this rule is to prevent ~~a~~Article 26 from creating an unintentional conflict between a Contracting State's obligation under ~~a~~Article 26 and its obligations under domestic law.

16.1. Domestic provisions requiring that information obtained by the tax authorities be kept secret should not be interpreted as constituting an obstacle to the exchange of information under paragraph 3 (a) because the tax authorities of the requesting State are obligated under paragraph 2 to observe secrecy with regard to information received under this ~~a~~Article.

16.2. Paragraph 1 obligates a requested State to provide information with respect to all of the taxes of the requesting State, even if the requested State does not have a comparable tax.

Paragraph 3 (a) does not remove the obligation to provide information relating to taxes that the requested State does not impose. For instance, a requested State cannot avoid its obligation to provide information helpful to the requesting State in the enforcement of its value added tax merely because the requested State does not have a value added tax. Of course, the requested State may avoid the obligation to supply such information if it cannot obtain that information under its normal administrative procedures, within the meaning of paragraph 3 (b).

16.3. The purpose of paragraph 3 (a) is to avoid traps for the unwary, not to create such traps. A Contracting State that believes that it is not required to obtain certain types of information on behalf of the other Contracting State because of its own laws or administrative practice (including the laws and administrative practice of its subnational governments) should disclose that position in writing prior to entering into a convention containing ~~a~~Article 26. It should also disclose the likely effects of that position on its ability to provide an effective exchange of information. For instance, if a Contracting State believes that one of its laws prevents it from providing the other Contracting State with information as to the beneficial owners of its resident companies or other juridical persons, it should give written notice of that position during the negotiation of the convention, with an explanation of the impact of that law on its obligations in relation to mutual assistance. Depending on the facts and circumstances of the particular case, a failure to disclose may eliminate the right of a Contracting State to invoke paragraph 3 (a) to avoid its obligations under paragraph 1.

16.4. A Contracting State that changes its laws or administrative practice after entering into a convention containing paragraph 3 (a) must disclose that change to the other Contracting State in timely fashion. Depending on the facts and circumstances of the case, such a change may constitute a material breach of the convention. In any event, a failure to provide timely notice of such a change may eliminate the right of a Contracting State to invoke paragraph 3 (a) to avoid its obligations arising under paragraph 1.

16.5. A Contracting State that wishes to expand the scope of the limitation currently provided in paragraph 3 (a) might modify that paragraph as follows (new language in italics):

> **"(a) To carry out administrative measures at variance with the laws and administrative practice of that *Contracting State* or of the other Contracting State *even if that Contracting State knows and fails to disclose that specific provisions of its laws or administrative practice are likely to prevent an effective exchange of information*;"**

17. Some countries are required by law to notify the person supplying information and/or the taxpayer subject to an enquiry prior to the release of that information to another country. Such notification procedures may be an important aspect of the rights provided under domestic law. In some cases, notification should help prevent mistakes (e.g., in cases of mistaken identity) and should facilitate exchange (by allowing taxpayers who are notified to cooperate voluntarily with the tax authorities in the requesting State). Notification procedures may not be applied, however, in a manner that, in the particular circumstances of the request, would frustrate the efforts of the requesting State to prevent avoidance or evasion of taxes. That is, they should not prevent or unduly delay an effective exchange of information. For instance, notification procedures should permit exceptions from prior notification in cases in which the information request is of a very urgent nature or the notification is likely to undermine the chance of success of the investigation conducted by the requesting State.

17.1. A Contracting State that under its domestic law is required to notify the person who provided the information and/or the taxpayer that an exchange of information is proposed should inform its treaty partners in writing that it has this requirement and what the consequences are for its obligations in relation to mutual assistance. Such information should be provided to the other Contracting State before a convention is concluded and thereafter whenever the relevant rules are modified. Depending on the facts and circumstances of the particular case, a failure to disclose may eliminate the right of a Contracting State to invoke paragraph 3 (a) to avoid its obligations under paragraph 1.

18. In general, the requested State is not obligated to carry out administrative measures on behalf of the requesting State that are not permitted under the laws or administrative practice of the requesting State. The purpose of this rule is to prevent a requesting State from using the administrative measures of the requested State to avoid limitations imposed on the requesting State by its own government.

18.1. Different countries will necessarily have different mechanisms for obtaining and providing information. Variations in laws and administrative practice may not be used as a basis for the requested State to deny a request for information unless the effect of these variations would be to limit in a significant way the requesting State's legal authority to obtain and provide the information if the requesting State itself received a legitimate request from the requested State.

18.2. The general rule of paragraph 18 has no application when the legal system or administrative practice of only one country provides for a specific procedure. For instance, a Contracting State requested to provide information about an administrative ruling or advance pricing agreement (APA) it has granted cannot point to the absence of a ruling or APA regime in the requesting State to avoid its obligation under paragraph 1 to provide such information.

19. Most countries recognize under their domestic laws that information cannot be obtained from a person to the extent that such person can claim the privilege against self-incrimination. A requested State, therefore, may decline to provide information if its self-incrimination rules preclude it from obtaining that information or if the self-incrimination rules of the requesting State would preclude it from obtaining such information under similar circumstances. In practice, however, the privilege against self-incrimination should have little, if any, application in connection with most information requests. The privilege against self-incrimination is personal and cannot be claimed by an individual who himself is not at risk of criminal prosecution. In the overwhelming majority of information requests, the objective is to obtain information from third parties such as banks, intermediaries, or the other party to a contract, and not from the individual under investigation. Furthermore, the privilege against self-incrimination generally does not attach to persons other than natural persons.

20. Paragraph 3 (b) allows a requested State to avoid an obligation otherwise imposed by paragraph 1 when it cannot obtain the requested items of information in the normal course of its administration or when the other Contracting State could not have obtained that information in the normal course of its administration. The purpose of this rule is to prevent the requesting State from imposing unreasonable burdens on the requested State.

20.1. Information is deemed to be obtainable in the normal course of administration if the information is in the possession of the tax authorities or can be obtained by them in the normal

procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons. For instance, if the requested State, as part of its audit policies, obtains information about the appropriateness of the transfer prices used by its taxpayers in dealings with associated companies, it is deemed to be able to obtain similar information about its taxpayers and associated companies on behalf of a requesting State.

20.2. Unless otherwise agreed to by the Contracting States, it should be assumed that the information requested by a Contracting State could be obtained by that State in a similar situation unless that State has informed the other Contracting State to the contrary.

20.3. It is often presumed, when a convention is entered into between a developed country and a developing country, that the developed country will have a greater administrative capacity than the developing country. Such a difference in administrative capacity does not provide a basis under paragraph 3 (b) for either Contracting State to avoid an obligation to supply information under paragraph 1. That is, paragraph 3 does not require that each of the Contracting States receive reciprocal benefits under ~~a~~Article 26. In freely adopting a convention, the Contracting States presumably have concluded that the convention, viewed as a whole, provides each of them with reciprocal benefits. There is no necessary presumption that each of the articles, or each paragraph of each article, provides a reciprocal benefit. On the contrary, it is commonplace for a Contracting State to give up some benefit in one article in order to obtain a benefit in another article.

20.4. Although paragraphs 3 (a) and 3 (b) do not explicitly provide for reciprocity in benefits, the OECD commentary to ~~a~~Article 26 has taken the position that a reciprocity requirement can be inferred from the language of paragraph 3 (b), which, inter alia, limits the obligation of a Contracting State to supply information obtainable in the normal course of administration of that other Contracting State. In effect, the OECD commentary is reading the term "obtainable" to mean that the other Contracting State has the actual administrative capacity to obtain that information. The alternative reading is that "obtainable" means that the tax administration has the authority to obtain the information, whether or not it has the capacity to exercise that authority. Countries may wish to make clear in their treaty that the Contracting States are obligated to exchange information even if one of the Contracting States has a significantly less advanced capacity for obtaining information about taxpayers. To achieve that result, they might amend paragraph (b) to read as follows:

> **"(b) To supply information that cannot be obtained in the normal course of the administration of that Contracting State or is not obtainable under the laws of that Contracting State or of the other Contracting State;"**

21. In general, a requested State may decline, under paragraph 3 (c), to disclose information that constitutes a confidential communication between an attorney, solicitor, or other admitted legal representative in his role as such and his client to the extent that the communication is protected from disclosure under domestic law.

21.1. The scope of protected confidential communications should be narrowly defined. Such protection does not attach to documents or records delivered to an attorney, solicitor, or other admitted legal representative in an attempt to protect such documents or records from disclosure required by law. Also, information on the identity of a person such as a director or beneficial owner of a company is not protected from disclosure. Although the scope of protection

afforded under domestic law to confidential communications may differ among States, the protection provided under paragraph 3 (c) does not extend so broadly so as to hamper the effective exchange of information.

21.2. Notwithstanding the provisions of domestic law in the requested State, that State may decline to supply requested communications between attorneys, solicitors or other admitted legal representatives and their clients only if, and to the extent that, such representatives act in their capacity as attorneys, solicitors or other admitted legal representatives and not in a different capacity, such as nominee shareholders, trustees, settlors, company directors, or accountants, or under a power of attorney to represent a company in its business affairs. More specifically, the communication must have been produced in good faith for the purpose of seeking or providing legal advice or for use in existing or contemplated legal proceedings.

21.3. In no event may a requested State decline to disclose communications between attorneys, solicitors or other admitted legal representatives and their clients if those persons have themselves participated with their clients in a plan to commit tax evasion or avoidance.

21.4. A claim that information is protected as a confidential communication between an attorney, solicitor or other admitted legal representative and its client should be adjudicated exclusively in the Contracting State under the laws of which the claim arises. Thus, it is not intended that the courts of the requested State should adjudicate claims based on the laws of the requesting State.

22. Paragraph 3 (c) also permits a requested State to decline to provide information if the disclosure of that information would reveal any trade, business, industrial, commercial or professional secret or trade process. Before invoking this provision, a Contracting State should carefully weigh if the interests of the taxpayer really justify its application. Secrets mentioned in this paragraph should not be taken in too wide a sense. A wide interpretation of the provision in many cases would be inconsistent with the purpose of ~~a~~Article 26 because it would render ineffective the exchange of information provided for in that ~~a~~Article.

22.1. A trade or business secret or trade process is generally understood to mean information which has considerable economic importance and which can be exploited practically and the unauthorized use of which may lead to serious damage (e.g., may lead to severe financial hardship). The purpose of the secrecy exception is to prevent an exchange of information from imposing unfair hardship on taxpayers by revealing to their competitors or potential competitors valuable secret information and thereby significantly diminishing the commercial value of that information. Secret information that once had substantial commercial value may be disclosed if that information does not have substantial commercial value at the time the information is requested. Information is not secret within the meaning of paragraph 3 (c) simply because the disclosure of it would embarrass the taxpayer or a third party or may result in the taxpayer having to pay additional taxes or losing income on account of bad publicity. A Contracting State may decide to supply requested information when it finds that there is no reasonable basis for assuming that the taxpayer involved may suffer adverse consequences incompatible with information exchange.

22.2. Secret information may be disclosed to the requesting State if the requested State determines that the risk of disclosure to the public or to competitors is unlikely due to the confidentiality requirements set forth in paragraph 2. A document that is protected from full

disclosure because it contains protected secret information may be disclosed if the secret information is removed.

22.3. Financial information, including books and records, does not by its nature constitute a trade, business or other secret. In certain limited cases, however, the disclosure of financial information might reveal a trade, business or other secret. For instance, a request for information on certain purchase records may raise such an issue if the disclosure of such information would reveal the proprietary formula used in the manufacture of a product. The protection of such information may also extend to information in the possession of third persons. For instance, a bank might hold a pending patent application for safe keeping, or a secret trade process or formula might be described in a loan application or in a contract held by a bank. In such circumstances, details of the trade, business or other secret should be excised from the documents and the remaining financial information exchanged accordingly.

23. Paragraph 3 (c) includes a limitation with regard to information that concerns the vital interests of the State itself. Under that limitation, Contracting States do not have to supply information the disclosure of which would be contrary to public policy (*ordre public*). This limitation should become relevant only in extreme cases. For instance, such a case could arise if a tax investigation in the requesting State were motivated by political, racial or religious persecution. The limitation may also be invoked when the information constitutes a State secret. For instance, there is no disclosure requirement when sensitive information is held by secret services, the disclosure of which would be contrary to the vital interests of the requested State. Thus, issues of public policy (*ordre public*) rarely arise in the context of information exchange between treaty partners.

24. As discussed above, paragraph 3 may give a requested State the right to refuse to supply information under some circumstances. It is not required, however, to invoke any of the limitations of that paragraph. If the requested State declines to exercise its right under paragraph 3 and supplies the requested information, the information exchanged remains within the framework of ~~a~~Article 26. Consequently, the information is subject to the confidentiality rules of paragraph 2. In addition, the affected taxpayer or other third party has no ground for contending that the tax authorities in the requested State have failed to observe the obligation to secrecy imposed on them by domestic law.

25. Article 26 does not require the existence of criminal activity in either of the Contracting States for the obligation to exchange information to arise. Some treaties, nevertheless, do require such criminal activity. In such treaties, it may be important to provide that criminality in the requesting State is sufficient for the obligation to exchange information to arise. As a cautionary measure, some States that do not limit their exchange of information to criminal matters may wish to state specifically in their treaty that dual criminality is not required. To eliminate the possibility of a dual criminality requirement being read into a treaty, the following paragraph might be added as paragraph 6, with the current paragraph 6 renumbered as paragraph 7. "6. The obligation to exchange information arises under paragraph 1 whether or not a person under investigation is suspected of criminal activity. In no case shall the provisions of this ~~a~~Article be construed to permit a Contracting State to decline to supply information solely because the conduct being investigated would not constitute a crime under the laws of that Contracting State if such conduct occurred in that Contracting State."

Paragraph 4

26. Paragraph 4 was added to the United Nations Model Convention in 20~~08~~11. It is taken directly from the comparable provision ~~added to~~ in the OECD Model Convention~~ in 2005~~. As a result, the OECD commentary to paragraph 4 is fully applicable in interpreting paragraph 4 of ~~a~~Article 26. The position taken in the OECD commentary is that the addition of this paragraph was intended to assist in the interpretation of ~~a~~Article 26 and does not result in a substantive change in the obligations implicit in the prior version of ~~a~~Aticle 26.

26.1. According to paragraph 4, a requested State must use its information gathering measures to obtain requested information even though those measures are invoked solely to provide information to the other Contracting State. The term "information gathering measures" means laws and administrative or judicial procedures that enable a Contracting State to obtain and provide the requested information. That is, a requested State does not need to have a domestic tax interest in obtaining the requested information for the obligation to supply information under paragraph 1 to apply.

26.2. As stated in the second sentence of paragraph 4, the obligation imposed by that paragraph generally is subject to the limitations contained in paragraph 3. An exception applies, however, that prevents a requested State from avoiding an obligation to supply information due to domestic laws or practices that include a domestic tax interest requirement. Thus, a requested State cannot avoid an obligation to supply information on the ground that its domestic laws or practices only permit it to supply information in which it has an interest for its own tax purposes.

26.3. For many countries, the combination of paragraph 4 and their domestic law provides a sufficient basis for using their information gathering measures to obtain the requested information even in the absence of a domestic tax interest in the information. Other countries, however, may wish to clarify expressly in the Convention that Contracting States must ensure that their competent authorities have the necessary powers to do so. Contracting States wishing to clarify this point may replace paragraph 4 with the following text: "4. In order to effectuate the exchange of information as provided in paragraph 1, each Contracting State shall take the necessary measures, including legislation, rulemaking, or administrative arrangements, to ensure that its competent authority has sufficient powers under its domestic law to obtain information for the exchange of information, regardless of whether that Contracting State may need such information for its own tax purposes."

Paragraph 5

27. Paragraph 5 was added to the United Nations Model Convention in 20~~08~~11. It is taken directly from the comparable provision ~~added to~~ in the OECD Model Convention~~ in 2005~~. As a result, the OECD commentary to paragraph 5 is fully applicable in interpreting paragraph 5 of ~~a~~Article 26. The discussion below of secrecy limitations draws heavily from the OECD commentary. The position taken in the OECD commentary is that the addition of this paragraph was intended to assist in the interpretation of ~~a~~Article 26 and does not result in a substantive change in the obligations implicit in the prior version of ~~a~~Article 26.

27.1. Paragraph 1 imposes a positive obligation on a Contracting State to exchange all types of information. Paragraph 5 is intended to ensure that the limitations of paragraph 3 cannot be

used to prevent the exchange of information held by banks, other financial institutions, nominees, agents and fiduciaries, as well as ownership information.

27.2. Paragraph 5 states that a requested State shall not decline to supply information to a requesting State solely because the information requested is held by a bank or other financial institution. Thus, paragraph 5 overrides paragraph 3 to the extent that paragraph 3 would otherwise permit a requested Contracting State to decline to supply information on grounds of domestic bank secrecy laws. Access to information held by banks or other financial institutions may be by direct means or indirectly through a judicial or administrative process. The procedure for indirect access should not be so burdensome and time-consuming as to act as an impediment to access to bank information.

27.3. Paragraph 5 also provides that a Contracting State shall not decline to supply information solely because the information is held by persons acting in an agency or fiduciary capacity. For instance, if a Contracting State has a law under which all information held by a fiduciary is treated as a "professional secret" merely because it was held by a fiduciary, such State could not use such law as a basis for declining to provide the information held by the fiduciary to the other Contracting State. A person acts in a "fiduciary capacity" when the business which the person transacts, or the money or property which the person handles, is not its own or for its own benefit but is held for the benefit of another person and when the fiduciary stands in a relationship to that other person implying and necessitating confidence and trust on the one part and good faith on the other part. A trustee is a common example of a person acting in a fiduciary capacity. The term "agency" is very broad and includes all forms of corporate service providers (e.g., company formation agents, trust companies, registered agents, lawyers).

27.4. Paragraph 5 states that a Contracting State shall not decline to supply information solely because the requested information relates to an ownership interest in a person, which includes companies and partnerships, foundations or similar organizational structures. Information requests cannot be declined merely because domestic laws or practices may treat ownership information as a trade or other secret.

27.5. Although paragraph 5 limits the ability of a requested State to rely on paragraph 3 to refuse to supply information held by a bank, financial institution, a person acting in an agency or fiduciary capacity or to refuse to supply information relating to ownership interests, that paragraph does not eliminate all protection under paragraph 3. The requested State may continue to refuse to supply such information if that refusal is based on substantial reasons unrelated to the status of the holder of the requested information as a bank, financial institution, agent, fiduciary or nominee, or to the fact that the information relates to ownership interests.

27.6. A requested State is not necessarily prevented by paragraph 5 from declining under paragraph 3 (b) to supply information constituting a confidential communication between an attorney, solicitor, or other admitted legal representative and his client even if that person is acting in an agency capacity. To qualify for protection under paragraph 3 (b), however, a requested State must demonstrate that the communication between the attorney, solicitor, or other admitted legal representative and his client meets all the requirements of that paragraph, including that the communication is protected from disclosure under domestic law, that the refusal is unrelated to the status of the legal representative as an agent, fiduciary, or nominee, that any documents at issue were not delivered to the legal representative to avoid disclosure, and that non-disclosure would not frustrate an effective exchange of information.

27.7. Contracting States wishing to refer expressly to the protection afforded to confidential communications between a client and an attorney, solicitor or other admitted legal representative may do so by adding the following text at the end of paragraph 5: "Nothing in the above sentence shall prevent a Contracting State from declining to obtain or provide information which would reveal confidential communications between a client and an attorney, solicitor or other admitted legal representative where such communications are protected from disclosure under paragraph 3 (b) and when the claim for protection under that paragraph is unrelated to the status of the legal representative as an agent, fiduciary, or nominee."

28. The following examples illustrate the application of paragraph 5:

(a) Company X owns a majority of the stock in a subsidiary company Y, and both companies are incorporated under the laws of State A. State B is conducting a tax examination of business operations of company Y in State B. In the course of this examination the question of both direct and indirect ownership in company Y becomes relevant, and State B makes a request to State A for ownership information of any person in company Y's chain of ownership. In its reply, State A should provide to State B ownership information for both company X and company Y;

(b) An individual subject to tax in State A maintains a bank account with Bank B in State B. State A is examining the income tax return of the individual and makes a request to State B for all bank account income and asset information held by Bank B in order to determine whether there were deposits of untaxed earned income. State B should provide the requested bank information to State A;

(c) Bank A in State A is suspected of entering into secret letters of agreement with some of its depositors that direct the bank to pay interest earned by those depositors to an unrelated offshore bank. State B requests that State A provide it with copies of those secret letters of agreement. Bank A asserts that the letters of agreement are legal documents protected from disclosure under the lawyer-client privilege. State A should provide the requested documents.

Paragraph 6

29. The language of paragraph 6 was taken, with some changes, from the last sentence of paragraph 1 of the United Nations Model Convention before its amendment in 20~~08~~11. Paragraph 6 specifically grants to the competent authorities the authority to establish procedures for an effective exchange of information. The OECD Model Convention does not contain paragraph 6 or an equivalent. The position taken in the OECD commentary is that this authority is implicit in ~~a~~Article 26.

29.1 To carry out the exchange of information in accordance with the preceding paragraphs of this ~~a~~Article, paragraph 6 provides that the competent authorities of the Contracting States shall work together to establish procedures for the exchange of information, including routine exchanges, typically in electronic form. Although paragraph 6 does not require them to make such arrangements in advance of the need for particular exchanges of information, this is strongly advisable to achieve an effective exchange of information.

29.2. Some States may wish to make explicit in their treaty that the competent authorities are obligated not only to exchange information on request but also to establish measures for automatic and spontaneous exchanges of information. Those countries may wish to add the following language to the end of paragraph 6:

> **"In addition to responding to specific requests for information, the competent authorities shall exchange information on a routine and spontaneous basis. They shall agree from time to time on the types of information or documents which shall be furnished on a routine basis."**

29.3 Some members of the Committee have expressed a concern that information requests from a developed country to a developing country could place excessive burdens on the tax department in the developing country, due to the different capacity of their tax administrations to obtain and provide information. That concern might be alleviated by making the requesting State responsible for material extraordinary costs associated with a request for information. In this context, the question of whether an extraordinary cost of obtaining requested information is material could be determined not by reference to some absolute amount but by reference to the cost relative to the total budget of the tax department being asked to provide information. For example, a small absolute cost might be material for a tax department with very limited resources, whereas a larger absolute cost might not be material for a well-funded department.

29.4. Countries concerned about imposing substantial costs on developing countries might include the following language at the end of paragraph 6:

> **"Extraordinary costs incurred in providing information shall be borne by the Contracting Party which requests the information. The competent authorities of the Contracting Parties shall consult with each other in advance if the costs of providing information with respect to a specific request are expected to be extraordinary."**

C. INVENTORY OF EXCHANGE MECHANISMS

30. Paragraphs 6-25 of the former ~~a~~Article 26 commentary of the United Nations Model Convention, as set out below with some editorial changes, could be included in a handbook that deals with exchange mechanisms.

Routine transmittal of information

6. A method of exchange of information is that of the routine or automatic flow of information from one treaty country to another[6]. ~~The term "transmitting country" refers to the country transmitting information, and the term "receiving country" refers to the country receiving information.~~ The following are various aspects that the competent authorities should focus on in developing a structure for such routine exchange. In considering routine exchanges of information, it should be recognized that some countries not desiring to receive such information in a routine fashion (or unable to receive it routinely because the transmitting countries do not routinely collect such information) may desire to obtain information of this type under a specific request. Hence, in these situations, items mentioned in the present section should be considered as available for coverage under the next section, **entitled** "Transmittal on specific request".

Items covered

[6] The term "transmitting country" refers to the country transmitting information, and the term "receiving country" refers to the country receiving information.

7. *Regular sources of income*. The items covered under a routine transmittal or exchange of information may extend to regular sources of income flowing between countries, such as dividends, interest, compensation (including wages, salaries, fees and commissions), royalties, rents and other possible items whose regular flow between the two countries is significant. It should be recognized that at present a few countries are not in a position to supply routine information of this type because their tax collection procedures do not provide the needed data.

Transactions involving taxpayer activity. A routine exchange of information may cover certain significant transactions involving taxpayer activity**:**

(a) Transactions relevant to the treaty itself:

- **(i)** Claims for refund of transmitting country tax made by residents of receiving country;
- **(ii)** Claims for exemption or particular relief from transmitting country tax made by residents of receiving country;

(b) Transactions relevant to special aspects of the legislation of the transmitting country: ~~I~~items of income derived by residents of the receiving country that receive exemption or partial relief under special provisions of the national law of the transmitting country;

(c) Transactions relating to activities in the transmitting country of residents of the receiving country:

- **(i)** Opening and closing by receiving country residents of a branch, office**,** etc. in the transmitting country;
- **(ii)** Creation or termination by receiving country residents of a corporation in the transmitting country;
- **(iii)** Creation or termination by receiving country residents of a trust in the transmitting country;
- **(iv)** Opening and closing by receiving country residents of bank accounts in the transmitting country;
- **(v)** Property in the transmitting country acquired by residents of the receiving country by inheritance, bequest or gift;
- **(vi)** Ancillary probate proceedings in the transmitting country concerning receiving country residents;

(d) General information:

- **(i)** Tax laws, administrative procedures**,** etc. of the transmitting country;
- **(ii)** Changes in regular sources of income flowing between countries, especially as they affect the treaty, including administrative interpretations of and court decisions on treaty provisions and administrative practices or developments affecting application of the treaty;
- **(iii)** Activities that affect or distort application of the treaty, including new patterns or techniques of evasion or avoidance used by residents of the transmitting or receiving country;
- **(iv)** Activities that have repercussions regarding the tax system of the receiving country, including new patterns or techniques of evasion or avoidance used by

residents of either country that significantly affect the receiving country's tax system.

General operational aspects to be considered

8. The competent authorities should consider various factors that may have a bearing on the operational character of the routine exchange, including its effectiveness. For example:

(*a*) Countries that are more interested in receiving information on a specific request basis than on a routine basis, in their consideration of the specific request area, should keep in mind items mentioned in this inventory under the heading of routine information;

(*b*) A minimum floor amount may be fixed to limit minor data;

(*c*) The routine source of income items may be rotated from year to year, for example, dividends only in one year, interest in another, etc;

(*d*) The information to be exchanged routinely need not be ~~strictly~~ reciprocal in all items. Country A may be interested in receiving information on some items but not others; the preferences of country B may extend to different items; it is not necessary for either country to receive items in which it is not interested, nor should either country refuse to transmit information on certain items simply because it is not interested in receiving information on those items;

(*e*) While the information to be exchanged on income items may not always be significant in itself as regards the income flows escaping tax, the routine exchange may provide indications respecting the degree to which the capital or other assets producing the income flows are escaping tax;

(*f*) Whether the information on items of income should cover the payee only or also the payer is a further point to be taken into account;

(*g*) Another factor to be considered is whether the information should cover only residents of the receiving country or also those domiciled therein or citizens thereof, or be limited to any of these categories;

(*h*) The degree of detail involved in the reporting, e.g., name of taxpayer or recipient, profession, address, etc., may need to be taken into account;

(*i*) The form and the language in which the information should be provided is a further point to be considered.

Factors to be considered by the transmitting country

9. The transmitting country may wish to give consideration to factors affecting its ability to fulfil the requirements of a routine exchange of information. Such a consideration would presumably lead to a more careful selection of the information to be routinely exchanged rather than to a decision not to exchange information that could be of practical use.

10. Among the factors to be considered are the administrative ability of the transmitting country to obtain the information involved. This, in turn, is governed by the general effectiveness of its administrative procedures, its use of withholding taxes, its use of information returns from payers or others, and the overall costs of obtaining the information involved.

Factors to be considered by receiving country

11. The receiving country may wish to give consideration to factors affecting its ability to use the information that could be received under a routine exchange of information, such as the administrative ability of the receiving country to use the information on a reasonably current basis and effectively to

associate such information with its own taxpayers, either routinely or on a sufficient scale to justify the routine receipt of the information.

Transmittal on specific request

12. A method of exchange of information that is in current use is that of a request for specific information made by one treaty country to another. The specific information may relate to a particular taxpayer and certain facets of his situation, or to particular types of transactions or activities, or to information of a more general character. The following are various aspects of the question that the competent authorities should focus on in developing a structure for such exchange of information pursuant to specific requests.

Items covered

13. *Particular taxpayers.* The information that may be desired from a transmitting country with respect to a receiving country taxpayer is essentially open-ended and depends on the factors involved in the situation of the taxpayer under the tax system of the receiving country and the relationship of the taxpayer and his activities to the transmitting country. A specific enumeration in advance of the type of information that may be within the scope of an exchange pursuant to specific request does not seem to be a fruitful or necessary task. The agreement to provide information pursuant to specific request may, thus, be open-ended as to the range, scope and type of information, subject to the overall constraints to be discussed herein.

14. The request for specific information may arise in a variety of ways. For example:

(*a*) Information needed to complete the determination of a taxpayer's liability in the receiving country when that liability depends on the taxpayer's worldwide income or assets; the nature of the stock ownership in the transmitting country of the receiving country corporation; the amount or type of expense incurred in the transmitting country; and the fiscal domicile of an individual or corporation;

(*b*) Information needed to determine the accuracy of a taxpayer's tax return to the tax administration of the receiving country or the accuracy of the claims or proof asserted by the taxpayer in defence of the tax return when the return is regarded as suspect or is under actual investigation;

(*c*) Information needed to determine the true liability of a taxpayer in the receiving country when it is suspected that his reported liability is wrong.

Particular types of transactions or activities. The exchange on specific request need not be confined to requests regarding particular taxpayers but may extend to requests for information on particular types of transactions or activities. For example:

(*a*) Information on price, cost, commission or other such patterns in the transmitting country necessary to enable the tax administration of the receiving country either to determine tax liability in a particular situation or to develop standards for investigation of its taxpayers in situations involving possible under-or over-invoicing of exported or imported goods, the payment of commissions on international transactions and the like;

(*b*) Information on the typical methods by which particular transactions or activities are customarily conducted in the transmitting country;

(*c*) Information on whether a particular type of activity is being carried on in the transmitting country that may have effects on taxpayers or tax liabilities in the receiving country.

15. *Economic relationships between the countries.* The specific request may extend to requests for information regarding certain economic relationships between the countries which may be useful to a country as a check on the effectiveness of its tax administration activities, for example:

(*a*) The volume of exports from the transmitting country to the receiving country;

(*b*) The volume of imports into the transmitting country from the receiving country;

(*c*) Names of banks dealing in the transmitting country with branches, subsidiaries etc. of residents of the receiving country.

It should be noted that since items in this category, such as the volume of exports between the countries, are presumably not regarded as secret to the tax authorities in the transmitting country, they may be disclosed generally in the receiving country, as provided in article 26.

Rules applicable to the specific request

16. The competent authorities should develop rules applicable to the transmission of specific requests by the receiving country and to the response by the transmitting country. These rules should be designed to facilitate a systematic operational procedure regarding such exchange that is both efficient and orderly. While the rules may be general in character in the sense that they set standards or guidelines governing the specific request procedures, the rules should also permit discussion between the competent authorities of special situations that either country believes require special handling.

The rules should pertain to:

(*a*) The specificity of detail required in the request by the receiving country, the form of such request and the language of the request and reply;

(*b*) The extent to which the receiving country must pursue or exhaust its own administrative processes and possibilities before making a specific request; presumably the receiving country should make a bona fide effort to obtain the information for itself before resorting to the specific request procedure;

(*c*) The conditions affecting the nature and extent of the response by the transmitting country. This aspect should cover the ability of the transmitting country to provide documentary material when the receiving country needs material in that form for use in judicial or other proceedings, including the appropriate authentication of the documents.

Transmittal of information on discretionary initiative of transmitting country (spontaneous exchange)

17. The competent authorities should determine whether, in addition to the routine and specific request methods of exchange of information under which a transmitting country is automatically transmitting information or systematically responding to specific requests by the receiving country, they desire a transmittal of information on the discretionary initiative of the transmitting country itself. Such a transmittal could occur when, in the course of its own activities, the tax administration of the transmitting country obtains information that it considers would be of importance to the receiving country. The information may relate to facets of a particular taxpayer's situation and the relationship of that situation to his liability in the receiving country or to the liability of other taxpayers in the receiving country. Or the information may relate to a pattern of transactions or conduct by various taxpayers or groups of taxpayers occurring in either country that is likely to affect the tax liabilities or tax administration of the receiving country in relation either to its national laws or to the treaty

provisions.

18. The competent authorities will have to determine, under the standards governing the exchange of information developed pursuant to the treaty, whether it is the duty of a transmitting country affirmatively to develop a procedure and guidelines governing when such information is to be transmitted, whether such transmittal is to be considered by the transmitting country but is fully discretionary, or whether such transmittal need not even be considered by the transmitting country. Even if it is agreed that it is the duty of the transmitting country to develop a system for such transmittal, presumably the decision on when the conditions under that system have been met will rest on the discretionary judgement of the latter country.

Use of information received

19. The competent authorities will have to decide on the permissible use of the information received. The decisions on this matter basically depend on the legal requirements set forth in article 26 itself. ~~Under the guideline,~~ ~~the~~**The** extent of the use of information depends primarily on the requirements of national law regarding the disclosure of tax information or on other "security requirements" regarding tax information. This being so, it is possible that the extent of the disclosure or the restrictions on disclosure may vary between the two countries. However, such possible variance need not be regarded as inappropriate or as negating exchanges of information that would otherwise occur if the countries involved are satisfied with such a consequence under article 26 as adopted in their convention.

Recipients of information received through exchange

20. The competent authorities will have to specify, either in detail or by reference to existing comparable rules in the receiving country, who the qualifying recipients of information in that country are. Under article 26 the information can be disclosed, for example:

(*a*) To administrators of the taxes covered in the ~~c~~**C**onvention;
(*b*) To enforcement officials and prosecutors for such taxes;
(*c*) To administrative tribunals for such taxes;
(*d*) To judicial tribunals for such taxes;
(*e*) In public court proceedings or in judicial decisions where it may become available to the public if considered appropriate;
(*f*) To the competent authority of another country (see the section below entitled "Consultation among several competent au thorities").

The form in which information is provided

21. The permissible extent of the disclosure may affect the form in which the information is to be provided if it is to be useful to the receiving country. Thus, if the information may be used in judicial tribunals and if, to be so used, it must be of a particular character or form, then the competent

authorities will have to consider how to provide for a transmittal that meets this need. (See also the comment on documents in the section above dealing with rules applicable to the specific request.)

Consultation among several competent authorities

22. Countries may wish to give consideration to procedures developed by the competent authorities for consultations covering more than the two competent authorities under a particular treaty. Thus, if countries A, B and C are joined in a network of treaties, the competent authorities of A, B and C might desire to hold a joint consultation. **A joint meeting** ~~This~~ could be desired whether **or not** all three countries are directly intertwined **by their treaty network. For** ~~for~~ example, **the joint meeting might be desirable** where there are A-B, A-C and B-C treaties, or where ~~one country is a link in a chain but not fully joined, for example, where~~ there are A-B and B-C treaties but not an A-C treaty. Countries desiring to have their competent authorities engage in such consultations should provide the legal basis for the consultations by adding the necessary authority in their treaties. Some countries may feel that article 26 permits joint consultation where all three countries are directly linked by bilateral treaties. However, the guideline does not cover joint consultation where a link in the chain is not fully joined, as in the second situation described above. In such a case, it would be necessary to add a treaty provision allowing the competent authority of country B to provide information received from country A to the competent authority of country C. Such a treaty provision could include a safeguard that the competent authority of country A must consent to the action of the competent authority of country B. Presumably, it would so consent only where it was satisfied as to the provisions regarding protection of secrecy in the B-C treaty.

Overall factors

23. There are a variety of overall factors affecting the exchanges of information that the competent authorities will have to consider and decide upon, either as to their specific operational handling in the implementation of the exchange of information or as to their effect on the entire exchange process itself. ~~Among s~~**S**uch overall factors ~~are~~ **include those set out below**:

Factors affecting implementation of exchange of information

These include the following:

Comment [MB37]: This is not a separate paragraph in the UN Commentary, but paragraph 23 was divided into two separate paragraphs in the Committee document called "Revised article 26".

(*a*) The competent authorities should decide on the channels of communication for the different types of exchanges of information. One method of communication that may be provided for is to permit an official of one country to go in person to the other country to receive the information from the competent authority and discuss it so as to expedite the process of exchange of information**;**

(*b*) Some countries may have decided that it is useful and appropriate for a country to have representatives of its own tax administration stationed in the other treaty country. Such an arrangement would presumably rest on authority, treaty or agreements other than that in the article on exchange of information of the envisaged double taxation treaty (**al**though, if national laws of both countries permit, this article would be treated as covering this topic) and the arrangement would determine the conditions governing the presence of such representatives and their duties. In this regard, it should be noted that it would not seem necessary that the process be reciprocal, so that it would be appropriate for country A to have its representatives in country B but not vice**-**versa if country A considered the process to be useful and country B did not. If arrangements do exist for such representatives, then the competent authorities may want to coordinate with those representatives where such coordination would make the exchange of information process more effective and where such coordination is otherwise appropriate**;**

(*c*) Some countries may decide it is appropriate to have a tax official of one country participate directly with tax officials of the other country in a joint or “team” investigation of a particular taxpayer or activity. The existence of the arrangement for most countries would presumably rest on authority, treaty or agreements other than that in the envisaged treaty article on exchange of information, although, if national laws of both countries permit, this article could be treated by the countries as authorizing the competent authorities to sanction this arrangement. In either event, if the arrangement is made, it would be appropriate to extend to such an investigation the safeguards and procedures developed under the envisaged treaty article on exchange of information**;**

(*d*) The process of exchange of information should be developed so that it has the needed relevance to the effective implementation of the substantive treaty provisions. Thus, treaty provisions regarding intercompany pricing and the allocation of income and expenses produce their own informational requirements for effective implementation. The exchange of information process should be responsive to those requirements**;**

(*e*) The substantive provisions of the treaty should take account of and be responsive to the exchange of information process. Thus, if there is an adequate informational base for the exchange of information process to support allowing one country to deduct expenses incurred in another country, then the treaty should be developed on the basis of the substantive appropriateness of such deduction**;**

(*f*) The competent authorities will have to determine to what extent there should be cost**-**sharing or cost reimbursement with respect to the process of exchange of information.

Factors affecting structure of exchange of information process

24. **These include the following:**

(*a*) It should be recognized that the arrangements regarding exchange of information worked out by country A with country B need not parallel those worked out between country A and country C or between country B and country C. The arrangements should in the first instance be responsive to the needs of the two countries directly involved and need not be fully parallel in every case just for the sake of formal uniformity. However, it should be observed that prevention of international tax evasion and avoidance will often require international cooperation of tax authorities in a number of countries. As a consequence, some countries may consider it appropriate to devise procedures and treaty provisions that are sufficiently flexible to enable them to extend their cooperation to multi**-**country consultation and exchange arrangements**;**

(*b*) The competent authorities will have to weigh the effect of a domestic legal restriction on obtaining information in a country that requests information from another country not under a similar domestic legal restriction. Thus, suppose country A requests information from country B, and the tax authorities in country B are able to go to their financial institutions to obtain such information, whereas the tax authorities in country A are generally not able to go to their own financial institutions to obtain information for tax purposes. How should the matter be regarded in country B? It should be noted that article 26 here permits country B to obtain the information from its financial institutions and transmit it to country A. Thus, country B is not barred by its domestic laws regarding tax secrecy if it decides to obtain and transmit the information. ~~It thus~~**Thus, it** becomes a matter of discretion in country B as to whether it should respond, and may perhaps become a matter for negotiation between the competent authorities. It should be noted that many countries in practice do respond in this situation and that such a course is indeed useful in achieving effective exchange of information to prevent tax avoidance. However, it should also be noted that country A, being anxious to obtain information in such cases from other countries, should also recognize its responsibility to try to change its domestic laws to strengthen the domestic authority of its own tax administration and to enable it to respond to requests from other countries. **It should be noted that countries that have entered into a tax convention that includes paragraph 5 of Article 26 of the United Nations Model Convention are required to provide information to its treaty partner notwithstanding its domestic bank secrecy laws;**

Comment [MB38]: Note by a member of the Subcommittee: This clarification should be in parenthesis as it is missing from former Commentary and not merely editorial change. A foot note reference can be made indicating that this was added in 2011.

(*c*) In addition to situations involving the legal imbalance discussed above, the competent authorities will have to weigh the effects of a possible imbalance growing out of a divergence in other aspects of tax administration. Thus, if country A cannot respond as fully to a request as country B can because of practical problems of tax administration in country A, then might the level of the process of exchange of information be geared to the position of country A? Or, ~~on the other hand,~~ in general or in particular aspects, should country B be willing to respond to requests of country A even when country A would not be able to respond to requests of country B? This matter is similar to that discussed in the preceding paragraph and a similar response should be noted**;**

(*d*) It should be noted that article 26 authorizes a transmitting country to use its administrative procedures solely to provide information to the requesting country, even when the person about whom information is sought is not involved in a tax proceeding in the transmitting country. Moreover, the transmitting country should, for the purpose of exchange of information, use its own administrative authority in the same way as if its own taxation were involved**;**

(*e*) The competent authorities will have to weigh the effect on the process of exchange of information of one country's belief that the tax system or tax administration of the other country, either in general or in particular situations, is discriminatory or confiscatory. It may be that further exploration of such a belief could lead to substantive provisions in the treaty or in national law that would eliminate the problems perceived by the first country and thereby facilitate a process of exchange of information. One possible example of this is the treatment of non-permanent residents**;**

(*f*) The competent authorities will have to weigh the effects that the process of exchange of information may have on the competitive position of taxpayers of the countries involved. Thus, if country A has a treaty with country B providing for exchange of information, country A will have to weigh the effect on the structure or process of that exchange of the fact that country C does not have a treaty with country B, so that firms of country C doing business in country B may be subject to a different tax posture in country B than firms of country A. Similarly, even if a treaty with an exchange of information article exists between countries C and B, if the tax administration of country A has more authority to obtain information (to be exchanged with country B) than does the tax administration of country C, or is otherwise more effective in its administration**,** and therefore**,** has more information, then a similar difference in tax posture may result. As a corollary, it seems clear that the adequate implementation of exchange of information provisions requires a universal effort of tax administrations to obtain and develop under national laws a capacity for securing information and a competence in utilizing information that is appropriate to a high level of efficient and equitable tax administration.

Periodic consultation and review

25. Since differences in interpretation and application, specific difficulties and unforeseen problems and situations are bound to arise, provision must be made for efficient and expeditious

consultation between the competent authorities. Such consultation should extend both to particular situations and problems and to periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.

NOTE BY THE SECRETARIAT: THE NEW COMMENTARY ON ARTICLE 27 WAS ADOPTED BY THE COMMITTEE OF EXPERTS AT THE SECOND ANNUAL SESSION IN 2007.

Article 27

~~CONSERNING THE~~ ASSISTANCE IN THE COLLECTION OF TAXES

1. This Article provides the rules under which Contracting States[7] may agree to provide each other assistance in the collection of taxes. In some States, national law or policy may prevent this form of assistance or set limitations to it. Also, in some cases, administrative considerations may not justify providing assistance in the collection of taxes to another State or may similarly limit it. During the negotiations each Contracting State will therefore need to decide whether and to what extent assistance should be given to the other State based on various factors, including:

- **the stance taken in national law to providing assistance in the collection of other States' taxes;**
- **whether and to what extent the tax systems, tax administrations and legal standards of the two States are similar, particularly as concerns the protection of fundamental taxpayers' rights (e.g. timely and adequate notice of claims against the taxpayer, the right to confidentiality of taxpayer information, the right to appeal, the right to be heard and present argument and evidence, the right to be assisted by a counsel of the taxpayer's choice, the right to a fair trial, etc.);**
- **whether assistance in the collection of taxes will provide balanced and reciprocal benefits to both States;**
- **whether each State's tax administration will be able to effectively provide such assistance;**
- **whether the cost of assistance is not too high for the requested State with regard to the money at stake;**
- **whether trade and investment flows between the two States are sufficient to justify this form of assistance; or**

[7] Throughout this Commentary on Article 27, the State making a request for assistance is referred to as the "requesting State" whilst the State from which assistance is requested is referred to as the "requested State".

- **whether, for constitutional or other reasons, the taxes to which the Article applies should be limited.**

The Article should only be included in the Convention where each State concludes that, based on these factors, they can agree to provide assistance in the collection of taxes levied by the other State.

2. The Article provides for comprehensive collection assistance. Some States may prefer to provide a more limited type of collection assistance. This may be the only form of collection assistance that they are generally able to provide or that they may agree to in a particular convention. For instance, a State may want to limit assistance to cases where the benefits of the Convention (e.g. a reduction of taxes in the State where income such as interest arises) have been claimed by persons not entitled to them. States wishing to provide such limited collection assistance are free to adopt bilaterally an alternative Article drafted along the following lines:

"Article 27
Assistance in the collection of taxes

1. The Contracting States shall lend assistance to each other in the collection of tax to the extent needed to ensure that any exemption or reduced rate of tax granted under this Convention shall not be enjoyed by persons not entitled to such benefits. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.

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

a) **to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;**
b) **to carry out measures which would be contrary to public policy (ordre public)."**

Paragraph 1

3. This paragraph contains the principle that a Contracting State is obliged to assist the other State in the collection of taxes owed to it, provided that the conditions of the Article are met. Paragraphs 3 and 4 provide the two forms that this assistance will take.

4. The paragraph also provides that assistance under the Article is not restricted by Articles 1 and 2. Assistance must therefore be provided as regards a revenue claim owed to a Contracting State by any person, whether or not a resident of a Contracting State. Some Contracting States may, however, wish to limit assistance to taxes owed by residents of either Contracting State. Such States are free to restrict the scope of the Article by omitting the reference to Article 1 from the paragraph.

5. Paragraph 1 of the Article applies to the exchange of information for purposes of the provisions of this Article. The confidentiality of information exchanged for purposes of assistance in collection is thus ensured.

6. The paragraph finally provides that the competent authorities of the Contracting States may, by mutual agreement, decide the details of the practical application of the provisions of the Article.

7. Such agreement should, in particular, deal with the documentation that should accompany a request made pursuant to paragraph 3 or 4. It is common practice to agree that a request for assistance will be accompanied by such documentation as is required by the law of the requested State, or has been agreed to by the competent authorities of the Contracting States, and that is necessary to undertake, as the case may be, collection of the revenue claim or measures of conservancy. Such documentation may include, for example, a declaration that the revenue claim is enforceable and is owed by a person who cannot, under the law of the requesting State, prevent its collection or an official copy of the instrument permitting enforcement in the requesting State. An official translation of the documentation in the language of the requested State should also be provided. It could also be agreed, where appropriate, that the instrument permitting enforcement in the requesting State shall, where appropriate and in accordance with the provisions in force in the requested State, be accepted, recognised, supplemented or replaced as soon as possible after the date of the receipt of the request for assistance, by an instrument permitting enforcement in the latter State.

8. The agreement should also deal with the issue of the costs that will be incurred by the requested State in satisfying a request made under paragraph 3 or 4. In general, the costs of collecting a revenue claim are charged to the debtor but it is necessary to determine which State will bear costs that cannot be recovered from that person. The usual practice, in this respect, is to provide that in the absence of an agreement specific to a particular case, ordinary costs incurred by a State in providing assistance to the other State will not be reimbursed by that other State. Ordinary costs are those directly and normally related to the collection, i.e. those expected in normal domestic collection proceedings. In the case of extraordinary costs, however, the practice is to provide that these will be borne by the requesting State, unless otherwise agreed bilaterally. Such costs would cover, for instance, costs incurred when a particular type of procedure has been used at the request of the other State or supplementary costs of experts, interpreters or translators. Most States also consider as extraordinary costs the costs of judicial and bankruptcy proceedings. The agreement should provide a definition of extraordinary costs and consultation between the Contracting States should take place in any particular case where extraordinary costs are likely to be involved. It should also be agreed that, as soon as a Contracting State anticipates that extraordinary costs may be incurred, it will inform the other Contracting State and indicate the estimated amount of such costs so that the other State may decide whether such costs should be incurred. It is, of course, also possible for the Contracting States to provide that costs will be allocated on a basis different from what is described above; this may be necessary, for instance, where a request for assistance in collection is suspended or withdrawn under paragraph 7 or where the issue of costs incurred in providing assistance in collection is already dealt with in another legal instrument applicable to these States. Finally, the agreement shall take into account the differences in development of Contracting States. It could therefore be agreed that all costs, including ordinary costs, will be borne by one State only. In such a case, the Contracting States will have to agree on the costs. These could for instance be determined on the basis of a fixed amount.

9. In the agreement, the competent authorities may also deal with other practical issues such as:

- whether there should be a limit of time after which a request for assistance could no longer be made as regards a particular revenue claim;
- what should be the applicable exchange rate when a revenue claim is collected in a currency that differs from the one which is used in the requesting State;
- how should any amount collected pursuant to a request under paragraph 3 be remitted to the requesting State; or
- whether there should be minimum threshold below which assistance will not be provided.

Paragraph 2

10. Paragraph 2 defines the term "revenue claim" for the purposes of the Article. The definition applies to any amount owed in respect of all taxes that are imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, but only insofar as the imposition of such taxes is not contrary to the Convention or other instrument in force between the Contracting States. It also applies to the interest, administrative penalties and costs of collection or conservancy that are related to such an amount. Assistance is therefore not restricted to taxes to which the Convention generally applies pursuant to Article 2, as is confirmed in paragraph 1.

11. Some Contracting States may prefer to limit the application of the Article to taxes that are covered by the Convention under the general rules of Article 2. States wishing to do so should replace paragraphs 1 and 2 by the following:

> **"1. The Contracting States shall lend assistance to each other in the collection of revenue claims. This assistance is not restricted by Article 1. The competent authorities of the Contracting States may by mutual agreement settle the mode of application of this Article.**
>
> **2. The term 'revenue claim' as used in this Article means any amount owed in respect of taxes covered by the Convention together with interest, administrative penalties and costs of collection or conservancy related to such amount."**

12. Similarly, some Contracting States may wish to limit the types of tax to which the provisions of the Article will apply or to clarify the scope of application of these provisions by including in the definition a detailed list of the taxes. States wishing to do so are free to adopt bilaterally the following definition:

> **"The term 'revenue claim' as used in this Article means any amount owed in respect of the following taxes imposed by the Contracting States, together with interest, administrative penalties and costs of collection or conservancy related to such amount:**
>
> ***a)* (in State A): __**
> ***b)* (in State B): __"**

13. In order to make sure that the competent authorities can freely communicate information for purposes of the Article, Contracting States should ensure that the Article is drafted in a way that allows exchanges of information with respect to any tax to which this Article applies.

14. Nothing in the Convention prevents the application of the provisions of the Article to revenue claims that arise before the Convention enters into force, as long as assistance with respect to these claims is provided after the treaty has entered into force and the provisions of the Article have become effective. Contracting States may find it useful, however, to clarify the extent to which the provisions of the Article are applicable to such revenue claims, in particular when the provisions concerning the entry into force of their convention provide that the provisions of that convention will have effect with respect to taxes arising or levied from a certain time. States wishing to restrict the application of the Article to claims arising after the Convention enters into force are also free to do so in the course of bilateral negotiations.

Paragraph 3

15. This paragraph stipulates the conditions under which a request for assistance in collection can be made. The revenue claim has to be enforceable under the law of the requesting State and be owed by a person who, at that time, cannot, under the law of that State, prevent its collection. This will be the case where the requesting State has the right, under its internal law, to collect the revenue claim and the person owing the amount has no administrative or judicial rights to prevent such collection.

16. In many States, a revenue claim can be collected even though there is still a right to appeal to an administrative body or a court as regards the validity or the amount of the claim. If, however, the internal law of the requested State does not allow it to collect its own revenue claims when appeals are still pending, the paragraph does not authorise it to do so in the case of revenue claims of the other State in respect of which such appeal rights still exist even if this does not prevent collection in that other State. Indeed, the phrase "collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State" has the effect of making that requested State's internal law restriction applicable to the collection of the revenue claim of the other State. Many States, however, may wish to allow collection assistance where a revenue claim may be collected in the requesting State notwithstanding the existence of appeal rights, even though the requested State's own law prevents collection in that case. States wishing to do so are free to modify paragraph 3 to read as follows:

> **"When a revenue claim of a Contracting State is enforceable under the laws of that State and is owed by a person who, at that time, cannot, under the laws of that State, prevent its collection, that revenue claim shall, at the request of the competent authority of that State, be accepted for purposes of collection by the competent authority of the other Contracting State. That revenue claim shall be collected by that other State in accordance with the provisions of its laws applicable to the enforcement and collection of its own taxes as if the revenue claim were a revenue claim of that other State that met the conditions allowing that other State to make a request under this paragraph."**

17. Paragraph 3 also regulates the way in which the revenue claim of the requesting State is to be collected by the requested State. Except with respect to time limits and priority (see the Commentary on paragraph 5), the requested State is obliged to collect the revenue claim of the requesting State as though it were the requested State's own revenue claim, even if, at the time, it has no need to undertake collection actions related to that taxpayer for its own purposes. As already mentioned, the phrase "in accordance with the provisions of its law applicable to the enforcement and collection of its own taxes" has the effect of limiting collection assistance to

claims with respect to which no further appeal rights exist if, under the requested State's internal law, collection of that State's own revenue claims are not permitted as long as such rights still exist.

18. It is possible that the request may concern a tax that does not exist in the requested State. The requesting State shall indicate where appropriate the nature of the revenue claim, the components of the revenue claim, the date of expiry of the claim and the assets from which the revenue claim may be recovered. The requested State will then follow the procedure applicable to a claim for a tax of its own which is similar to that of the requesting State or any other appropriate procedure if no similar tax exists.

Paragraph 4

19. In order to safeguard the collection rights of a Contracting State, this paragraph enables it to request the other State to take measures of conservancy even where it cannot yet ask for assistance in collection, e.g. when the revenue claim is not yet enforceable or when the debtor still has the right to prevent its collection. This paragraph should only be included in conventions between States that are able to take measures of conservancy under their own laws. Also, States that consider that it is not appropriate to take measures of conservancy in respect of taxes owed to another State may decide not to include the paragraph in their conventions or to restrict its scope. In some States, measures of conservancy are referred to as "interim measures" and such States are free to add these words to the paragraph to clarify its scope in relation to their own terminology.

20. One example of measures to which the paragraph applies is the seizure or the freezing of assets before final judgement to guarantee that these assets will still be available when collection can subsequently take place. The conditions required for the taking of measures of conservancy may vary from one State to another but in all cases the amount of the revenue claim should be determined beforehand, if only provisionally or partially. A request for measures of conservancy as regards a particular revenue claim cannot be made unless the requesting State can itself take such measures with respect to that claim (see the Commentary on paragraph 8).

21. In making a request for measures of conservancy the requesting State should indicate in each case what stage in the process of assessment or collection has been reached. The requested State will then have to consider whether in such a case its own laws and administrative practice permit it to take measures of conservancy.

Paragraph 5

22. Paragraph 5 first provides that the time limits of the requested State, i.e. time limitations beyond which a revenue claim cannot be enforced or collected, shall not apply to a revenue claim in respect of which the other State has made a request under paragraph 3 or 4. Since paragraph 3 refers to revenue claims that are enforceable in the requesting State and paragraph 4 to revenue claims in respect of which the requesting State can take measures of conservancy, it follows that it is the time limits of the requesting State that are solely applicable.

23. Thus, as long as a revenue claim can still be enforced or collected (paragraph 3) or give rise to measures of conservancy (paragraph 4) in the requesting State, no objection based on the time limits provided under the laws of the requested State may be made to the application of

paragraph 3 or 4 to that revenue claim. States which cannot agree to disregard their own domestic time limits should amend paragraph 5 accordingly.

24. The Contracting States may agree that after a certain period of time the obligation to assist in the collection of the revenue claim no longer exists. The period should run from the date of the original instrument permitting enforcement. Legislation in some States requires renewal of the enforcement instrument, in which case the first instrument is the one that counts for purposes of calculating the time period after which the obligation to provide assistance ends.

25. Paragraph 5 also provides that the rules of both the requested (first sentence) and requesting (second sentence) States giving their own revenue claims priority over the claims of other creditors shall not apply to a revenue claim in respect of which a request has been made under paragraph 3 or 4. Such rules are often included in domestic laws to ensure that tax authorities can collect taxes to the fullest possible extent.

26. The rule according to which the priority rules of the requested State do not apply to a revenue claim of the other State in respect of which a request for assistance has been made applies even if the requested State must generally treat that claim as its own revenue claim pursuant to paragraphs 3 and 4. States wishing to provide that revenue claims of the other State should have the same priority as is applicable to their own revenue claims are free to amend the paragraph by deleting the words "or accorded any priority" in the first sentence.

27. The words "by reason of their nature as such", which are found at the end of the first sentence, indicate that the time limits and priority rules of the requested State to which the paragraph applies are only those that are specific to unpaid taxes. Thus, the paragraph does not prevent the application of general rules concerning time limits or priority which would apply to all debts (e.g. rules giving priority to a claim by reason of that claim having arisen or having been registered before another one).

Paragraph 6

28. This paragraph ensures that any legal or administrative objection concerning the existence, validity or the amount of a revenue claim of the requesting State shall not be dealt with by the requested State's courts or administrative bodies. Thus, no legal or administrative proceedings, such as a request for judicial review, shall be undertaken in the requested State with respect to these matters. The main purpose of this rule is to prevent administrative or judicial bodies of the requested State from being asked to decide matters which concern whether an amount, or part thereof, is owed under the internal law of the other State. Any legal actions contesting the recovery measures taken by the requested State can, of course, be brought before the competent judicial authorities of that State. States in which the paragraph may raise constitutional or legal difficulties may amend or omit it in the course of bilateral negotiations.

Paragraph 7

29. This paragraph provides that if, after a request has been made under paragraph 3 or 4, the conditions that applied when such request was made cease to apply (e.g. a revenue claim ceases to be enforceable in the requesting State), the State that made the request must promptly notify the other State of this change of situation. Following the receipt of such a notice, the requested State has the option to ask the requesting State to either suspend or withdraw the request. If the request is suspended, the suspension should apply until such time as the State that

made the request informs the other State that the conditions necessary for making a request as regards the relevant revenue claim are again satisfied, or that it withdraws its request.

Paragraph 8

30. This paragraph contains certain limitations to the obligations imposed on the State which receives a request for assistance.

31. The requested State is at liberty to refuse to provide assistance in the cases referred to in the paragraph. However, if it does provide assistance in these cases, it remains within the framework of the Article and it cannot be objected that this State has failed to observe the provisions of the Article.

32. In the first place, the paragraph contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice or those of the other State in fulfilling its obligations under the Article. Thus, if the requesting State has no domestic power to take measures of conservancy, the requested State could decline to take such measures on behalf of the requesting State. Similarly, if the seizure of assets to satisfy a revenue claim is not permitted in the requested State, that State is not obliged to seize assets when providing assistance in collection under the provisions of the Article. However, types of administrative measures authorised for the purpose of the requested State's tax must be utilised, even though invoked solely to provide assistance in the collection of taxes owed to the requesting State.

33. Paragraph 5 of the Article provides that a Contracting State's time limits will not apply to a revenue claim in respect of which the other State has requested assistance. Subparagraph (a) is not intended to defeat that principle. Providing assistance with respect to a revenue claim after the requested State's time limits have expired will not, therefore, be considered to be at variance with the laws and administrative practice of that or of the other Contracting State in cases where the time limits applicable to that claim have not expired in the requesting State.

34. Subparagraph (b) includes a limitation to carrying out measures contrary to public policy (ordre public). As is the case under Article 26 (see paragraph 19 of the Commentary on Article 26), it has been felt necessary to prescribe a limitation with regard to assistance which may affect the vital interests of the State itself.

35. Under subparagraph (c), a Contracting State is not obliged to satisfy the request if the other State has not pursued all reasonable measures of collection or conservancy, as the case may be, available under its laws or administrative practice.

36. Finally, under subparagraph (d), the requested State may also reject the request for practical considerations, for instance if the costs that it would incur in collecting a revenue claim of the requesting State would exceed the amount of the revenue claim.

37. Some States may wish to add to the paragraph a further limitation, already found in the joint Council of Europe OECD multilateral Convention on Mutual Administrative Assistance in Tax Matters, which would allow a State not to provide assistance if it considers that the taxes, with respect to which assistance is requested, are imposed contrary to generally accepted taxation principles.

Article ~~27~~**28**

MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Article ~~27~~**28** of the United Nations Model Convention reproduces Article ~~27~~**28** of the OECD Model Convention. The Commentary of that Article is therefore relevant:

"The aim of the provision is to secure that members of diplomatic missions and consular posts shall, under the provisions of a double taxation convention, receive no less favourable treatment than that to which they are entitled under international law or under special international agreements." [para. 1]

"The simultaneous application of the provisions of a double taxation convention and of diplomatic and consular privileges conferred by virtue of the general rules of international law, or under a special international agreement~~,~~ may, under certain circumstances, have the result of discharging, in both Contracting States, tax that would otherwise have been due. As an illustration, it may be mentioned that~~,~~ e.g.~~,~~ a diplomatic agent who is accredited by State A to State B and derives royalties, or dividends from sources in State A will not, owing to international law, be subject to tax in State B in respect of this income and may also, depending upon the provisions of the bilateral convention between the two States, be entitled as a resident of State B to an exemption from, or a reduction of, the tax imposed on the income in State A. In order to avoid tax reliefs that are not intended, the Contracting States are free to adopt bilaterally an additional provision which may be drafted on the following lines:

"Insofar as, due to fiscal privileges granted to members of diplomatic missions and consular posts under the general rules of international law or under the provisions of special international agreements, income or capital are not subject to tax in the receiving State, the right to tax shall be reserved to the sending State."[para. 2]

"In many OECD ~~M~~**m**ember countries, the domestic laws contain provisions to the effect that members of diplomatic missions and consular posts whil**est** abroad shall for tax purposes be deemed to be residents of the sending State. In the bilateral relations between ~~M~~**m**ember countries in which provisions of this kind are operative internally, a further step may be taken by including in the Convention specific rules that establish, for purposes of the Convention, the sending State as the State of residence of the members of the diplomatic missions and consular posts of the Contracting States. The special provision suggested here could be drafted as follows:

> ~~'~~Notwithstanding the provisions of Article 4**,** an individual who is a member of a diplomatic mission or a consular post of a Contracting State which is situated in the other Contracting State or in a third State shall be deemed for the purposes of the Convention to be a resident of the sending State if:
>
> ~~(~~a) in accordance with international law he is not liable to tax in the receiving State in respect of income from sources outside that State or on capital situated outside that State, and
>
> ~~(~~b) he is liable in the sending State to the same obligations in relation to tax on his total income or on capital as are residents of that State.~~'~~ " [para. 3]

"By virtue of paragraph 1 of Article 4~~,~~[24] the members of diplomatic missions and consular posts of a third State accredited to a Contracting State**,** are not deemed to be residents of the receiving

[24] This paragraph will not apply to those bilateral agreements which omit the second sentence of paragraph 1 of article 4.

State if they are only subject to a limited taxation in that State . . . This consideration also holds true of the international organi~~z~~**s**ations established in a Contracting State and their officials as they usually benefit from certain fiscal privileges either under the convention or treaty establishing the organi~~z~~**s**ation or under a treaty between the organi~~z~~**s**ation and the State in which it is established. Contracting States wishing to settle expressly this question, or to prevent undesirable tax reliefs, may add the following provision to this Article:

> ‘The Convention shall not apply to international organi~~z~~**s**ations, to organs or officials thereof and to persons who are members of a diplomatic mission or a consular post of a third State, being present in a Contracting State and not treated in either Contracting State as residents in respect of taxes on income or on capital.’

This means that international organi~~z~~**s**ations, organs or officials who are liable in a Contracting State in respect only of income from sources therein should not have the benefit of the Convention.” [para. 4]

“Although honorary consular officers cannot derive from the provisions of the Article any privileges to which they are not entitled under the general rules of international law (there commonly exists only tax exemption for payments received as consideration for expenses honorary consuls have on behalf of the sending State), the Contracting States are free to exclude, by bilateral agreement, expressly honorary consular officers from the application of the Article.” [para. 5]

Commentary on chapter VII

FINAL PROVISIONS

Articles ~~28~~**29** and ~~29~~**30**

ENTRY INTO FORCE AND TERMINATION

Articles ~~28~~**29** and ~~29~~**30** of the United Nations Model Convention reproduce Articles ~~29~~**30** and ~~30~~**31** of the OECD Model Convention. The Commentary on the latter Articles is therefore relevant:

“The present provisions on the procedure for entry into force, ratification and termination are drafted for bilateral conventions and correspond to the rules usually contained in international treaties.” [para. 1]

“Some Contracting States may need an additional provision in the first paragraph of Article ~~29~~**30** indicating the authorities which have to give their consent to the ratification. Other Contracting States may agree that the Article should indicate that the entry into force takes place after an exchange of notes confirming that each State has completed the procedures required for such entry into force.” [para. 2]

“It is open to Contracting States to agree that the Convention shall enter into force when a specified period has elapsed after the exchange of the instruments of ratification or after the confirmation that each State has completed the procedures required for such entry into force.” [para. 3]

“No provisions have been drafted as to the date on which the Convention shall have effect or cease to have effect, since such provisions would largely depend on the domestic laws of the Contracting States concerned. Some of the States assess tax on the income received during the current year, others on the income received during the previous year, others again have a fiscal year which differs from the calendar year. Furthermore, some conventions provide, as regards taxes levied by deduction at the source, a date for the application or termination which differs from the date applying to taxes levied by assessment." [para. 4]

"As it is of advantage that the Convention should remain in force at least for a certain period, the Article on termination **provides that notice of termination** can only be given after a certain year**,** to be fixed by bilateral agreement. It is open to the Contracting States to decide upon the earliest year during which such notice can be given or even to agree not to fix any such year, if they so desire." [para. 5]

* * * * *