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Committee of Experts on International Cooperation in Tax Matters
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Item 3(i) of the provisional agenda
Tax consequences of the digitalized economy

Changes to Article 23 A and its Commentary to reflect the inclusion of Article 12B in the United Nations Model Double Taxation Convention between Developed and Developing Countries

Note by the Secretariat

Summary

At the Committee's twenty-second session, it considered E/C.18/2021/CRP.15, which addressed changes consequential to the decision to include Article 12B in the United Nations Model Double Taxation Convention between Developed and Developing Countries. After some discussion of the correct approach to Article 23 A, particularly as it relates to paragraph 3 of Article 12B, the Co-Chair requested that a small group develop a proposal for the consideration of the full Committee.

This note reflects the outcome of those discussions with respect to both the drafting of Article 23 A and its Commentaries.

The Committee is invited to discuss and approve the proposed changes included in this note when it will resume its discussion of item 3(i) of its agenda (Tax consequences of the digitalized economy).

1. To ensure consistency between paragraphs 2 and 4 of Article 23A, they are proposed to read as follows:

> 2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10, 11, 12, ~~and~~ 12A ***and 12B*** may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income which may be taxed in that other State.
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> …
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> 4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10, 11, 12 or 12A ***or the provisions of Article 12B*** to such income; in the ~~latter~~ case ***where the other Contracting State does not exempt the income***, the first-mentioned State shall allow the deduction of tax provided for by paragraph 2.

Under this drafting, a residence State that generally provides for relief of double taxation through the exemption method would provide a credit, not an exemption, with respect to income taxed in the source State under either paragraph 2 or 3 of Article 12B.

2. If this approach is adopted, the changes originally proposed with respect to the Commentary on Article 23 in E/C.18/2021/CRP.15 would need to be modified as follows:

> 16. The OECD Commentary continues as follows (the modifications that appear in square brackets, which are not part of the Commentary on the OECD Model Convention, have been inserted in order to provide additional explanations or to reflect the differences between the provisions of the OECD Model Convention and those of this Model):
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> …47. In Articles 10 and 11 [and 12**,** 12A and 12B] the right to tax dividends and interest[, royalties, fees for technical services and income from automated digital services] 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.
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> 16.1 The Committee considers that the following Commentary on paragraph 4 of Article 23 A of the OECD Model Convention is applicable to paragraph 4 (the additional comments that appear in italics between square brackets, which are not part of the Commentary on the OECD Model, have been inserted in order to reflect the fact that paragraph 4 also applies where the State of source applies the provisions of paragraph 2

of Article 12***,*** paragraph 2 of Article 12A or ~~paragraph 2~~ ***the provisions*** of Article 12B, to an item of income):

…

> 56.2 The paragraph only applies to the extent that the State of source has applied the provisions of the Convention to exempt an item of income or capital or has applied the provisions of paragraph 2 of Article 10, *[…]* 11 *[, 12*~~,~~ ***or*** *12A* or ***the provisions of Article*** 12B*]* to an item of income. The paragraph would therefore not apply where the State of source considers that it may tax an item of income or capital in accordance with the provisions of the Convention but where no tax is actually payable on such income or capital under the provisions of the domestic laws of the State of source. In such a case, the State of residence must exempt that item of income under the provisions of paragraph 1 because the exemption in the State of source does not result from the application of the provisions of the Convention but, rather, from the domestic law of the State of source (see paragraph 34 above). Similarly, where the source and residence States disagree not only with respect to the qualification of the income but also with respect to the amount of such income, paragraph 4 applies only to that part of the income that the State of source exempts from tax through the application of the Convention or to which that State applies paragraph 2 of Article 10, *[…]* 11 *[,12*~~,~~ ***or*** *12A* or ***the provisions of Article*** 12B*]*.

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

16.4 Paragraph 4 also applies where the State of source interprets the facts of a case or the provisions of the Convention in such a way that an item of income falls under the provisions of paragraph 2 of Article 10, 11***,*** 12~~,~~ ***or*** 12A or ***the provisions of Article*** 12B that provides for limited taxation in the State of source while the State of residence adopts a different interpretation and considers that the item falls under a provision of the Convention that allows the State of source to tax the item without any limitation. For example, on the one hand, the State of source considers that royalties paid by one of its residents and beneficially owned by a resident of the other Contracting State are taxable at the limited rate provided for in paragraph 2 of Article 12. On the other hand, the State of residence of the beneficial owner considers that the right in respect of which the royalties are paid is

effectively connected with a permanent establishment situated in the State of source through which the beneficial owner carries on business. The State of residence considers therefore that the royalties are taxable in the State of source without any limitation in accordance with paragraph 4 of Article 12 and are exempted under the provisions of paragraph 1. In such case, to the extent that the difference of views is not solved through the mutual agreement procedure, paragraph 4 allows the State of residence not to apply paragraph 1.

16.5 Where the State of source applies the provisions of paragraph 2 of Article 10, 11**,** 12~~,~~ ***or*** 12A or ***the provisions of Article*** 12B, the State of residence, in order to eliminate double taxation, should grant a credit pursuant to paragraph 2 of Articles 23 A. This should be the case even if the State of residence has interpreted the facts of the case or the provisions of the Convention in such a way that would result in the State of source having an unlimited right to tax the income under the convention, which would mean that the State of residence should normally exempt that income under the provisions of paragraph 1. Applying the credit method in that case is more efficient than trying to determine, pursuant to the mutual agreement procedure how the treaty requires that double taxation be relieved. The last part of paragraph 4, which is not found in the OECD Model, has been added for the sake of clarity in order to make that point explicit. In paragraph 2, some States may require a credit for taxes payable in the other Contracting State to be granted subject to the provisions of their domestic law regarding the allocation of a credit for foreign taxes but without affecting the general principle provided in such paragraph. Such wording would generally allow the application of the credit resulting from paragraph 4. However, where the reference to domestic law is not so limited, the Contracting States should verify during the negotiations that no inconsistency between the domestic law and the treaty rules exist that could prevent the granting of the credit (e.g. the domestic law of the State of residence may not provide for a credit for foreign taxes where an item of income is taxed under its domestic law as a business profit attributable to a permanent establishment and not as a royalty).

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