E/C.18/2022/CRP.23

Distr.: General
03 October 2022

Original: English

Committee of Experts on International Cooperation in Tax Matters
Twenty-fifth session

Geneva, 18-21 October 2022
Item 3(c) of the provisional agenda
Issues related to the United Nations Model Double Taxation Convention between Developed and Developing Countries

Proposal for the inclusion of a general "subject to tax" rule in the United Nations Model Double Taxation Convention between Developed and Developing Countries

This note is provided to the Committee for ***discussion*** at its 25th Session.

At its 23rd Session, the Committee discussed several issues that could be addressed in the next update of the UN Model Double Taxation Convention between Developed and Developing Countries, including a proposal to include a subject-to-tax rule. There was general support for such a rule among Committee Members. At the 24th Session of the Committee, the Subcommittee on the Update of the UN Model presented its proposed work plan, which included the development of such a subject-to-tax rule as a priority item. The Committee approved the proposed work program and provided guidance to the Subcommittee regarding certain issues to be addressed in drafting the provision.

This note sets out the Subcommittee's initial draft of such a provision along with the Subcommittee's suggestions regarding how to address certain issues where there were different views within the Subcommittee.

The Committee is asked to:

1) consider and discuss the Subcommittee's draft proposal in paragraph 10 hereof and its suggestions regarding how to deal with the issues raised by participants during the discussions in the Subcommittee; and

2) provide guidance to the Subcommittee regarding whether to continue to develop a provision along the lines of that in paragraph 15.

I. Introduction

1. At its 23rd Session, the Committee of Experts on International Cooperation in Tax Matters considered note E/C.18/2021/CRP.22, on the work relating to the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model). That note described a number of issues that had been identified by the last Membership of the Committee but which that membership had not had a chance to address.

2. The Committee also considered several other issues raised by Members of the Committee, including a proposal by Rasmi Das to introduce a "subject to tax" rule into the UN Model. The Committee agreed that work on a subject-to-tax rule is a priority for the Subcommittee on the Update of the United Nations Model Double Taxation Convention between Developed and Developing Countries (the Subcommittee).

3. At its first meeting, held virtually on 10-12 January 2022, the Subcommittee considered how to proceed with respect to this subject, given the importance attached to it by the Committee. The Co-Coordinators' report to the Committee, E/C.18/2022/CRP.2, describes the conclusions of the Subcommittee with respect to pursuing this work:

> 6. Participants in the Subcommittee noted that, from a policy perspective, adding a subject-to-tax rule to the UN Model would be consistent with changes made in the 2017 UN Model in response to concerns about base erosion and profit shifting (BEPS). Some participants noted that some cases of double non-taxation of income (as a result of participation exemptions) or entities (such as pension funds) have been viewed as acceptable in the past and argued that they should continue to be accommodated by any subject-to-tax rule. A number of participants suggested that the rule should be simple for developing countries to administer. Before deciding on the scope and drafting options relating to a proposal to be made to the Committee, the Subcommittee will review a variety of provisions that address various aspects of the problem, including: the special tax regime rule found in the Commentaries on Article 1 of both the UN and OECD Models; the simpler subject-to-tax rule that was deleted from those Commentaries when they were substantially re-written in 2017; the remittance-basis taxation rule found in many treaties; and the fiscally transparent entities rule added as paragraph 2 of Article 1 of the UN and OECD Models. Participants in the Subcommittee have also been asked to inform the Secretariat of any similar provisions found in their own bilateral tax treaties.

4. The Committee considered the Co-Coordinators' report at its 24th Session in April 2022. The report of that session notes, in relation to this issue:

> 21. Comments were also made regarding the proposed work on a subject-to-tax rule. Some members and observers questioned the necessity of such a rule considering the development of a similar rule in connection with pillar 2 of the Organisation for Economic Co-operation and Development (OECD)/Group of 20 Inclusive Framework on Base Erosion and Profit Shifting. Other members and observers noted that the scope and context were quite different: there were States Members of the United Nations that did not participate in the Inclusive Framework or did so but had not agreed to some of the current proposals. Moreover, many developing countries believed that the scope of the subject-to-tax rule should be broader than the limited rule under discussion in the Inclusive Framework, in particular in the context of the Committee's mandate regarding the United Nations Model Convention. It was noted that the United Nations Model Convention

provided for much more source State taxation than did the OECD Model Tax Convention on Income and on Capital. Even those Member States that participate in the Inclusive Framework may find the approach eventually developed by the Committee easier to apply. Ms. Smith noted that the many different approaches to subject-to-tax rules that had been taken in the past would inform the work of the Subcommittee.

5. At its virtual meeting on 9-10 June 2022, the Subcommittee considered a series of questions regarding the desired scope of the provision, against the backdrop of the various approaches reflected in the provisions described in paragraph 6 of the Co-Coordinators' report and other provisions submitted by participants in accordance with the last sentence of that paragraph. The conclusions from that discussion and a further discussion at the Subcommittee's meeting held 12 September are set out in the following sections.

6. During the September meeting, some participants in the Subcommittee expressed their view that the subject-to-tax rule is so important to developing countries that there should be a mechanism to incorporate it into existing treaties in an expedited manner. Others pointed out that the provision in many cases would need to be customized to take into account provisions of existing treaties, limiting the extent to which implementation could be expedited. The Subcommittee concluded that the priority is for the Committee to agree on the principles and drafting with respect to a new provision for the UN Model before considering any mechanisms for expedited implementation.

II. Proposed Scope of a Subject-to-Tax Rule regarding Taxation by the Source State

7. During the Subcommittee meetings, the general outline of a provision became clear, although different views were expressed regarding certain aspects of the proposed rule.

8. For the reasons set out in paragraph 21 of the report on the 24th Session of the Committee, there was substantial support among participants for a broad rule that is not limited to addressing BEPS concerns but reflects increasing international consensus regarding minimum levels of taxation. Supporters of this approach believe that such a rule would be easier for developing countries to apply. They acknowledge that some potential exemptions or carve-outs, such as those described in paragraph 6 of E/C.18/2022/CRP.2, might be appropriate in certain cases but take the view that the drafting of such provisions could be set out in the Commentary for use in bilateral agreements.

9. Other participants argued that a broader provision was not supported by the BEPS concerns that were the basis for the Committee's support for work on this issue. In their view, if a country has significant concerns regarding the risk of double non-taxation with respect to a particular potential treaty partner, it should reconsider whether a tax treaty with that country is appropriate at all, applying the guidance found in paragraph 20 of the Introduction to the UN Model.[1] In addition, they viewed certain exemptions (such as one for recognized pension funds) as being so obviously necessary and consistent with policies already reflected within the UN Model, that they should be included in the provision itself.

[11] Quoting paragraphs 15.1 to 15.6 of the Introduction to the OECD Model Tax Convention on Income and on Capital.

10. The Subcommittee therefore requests the views of the Committee on the following provision that could be included in the UN Model:

> (a) This Convention shall not affect the taxation by a Contracting State of any income arising in that State and derived by a resident of the other Contracting State if that income:
>
> > (i) is not fully included in the taxable income of that resident in that other State; or
> >
> > (ii) is subject to a low level of taxation in that other State within the meaning of subparagraph (b).
>
> (b) Income is subject to a low level of taxation in that other State if:
>
> > (i) it is subject to a nominal tax rate of ___ per cent [the percentage is to be established through bilateral negotiations] or less; or
> >
> > (ii) it is subject to a nominal tax rate higher than the rate set out in subdivision (i) but the beneficial owner of the income is entitled to a special exemption, exclusion or reduction that is linked directly to the income or the entity receiving it so that the amount of tax paid in that other State with respect to such income is less than the amount of tax that would be imposed if the tax rate set out in (i) were applied to such income without regard to such exemption, exclusion or reduction.
>
> (c) Subparagraph (a) will not apply to income that: [exemptions, if any, appropriate in the context of the bilateral relationship between the Contracting States].

11. The Commentary on the provision in paragraph 10 would deal with various technical issues regarding the application of the provision. The Commentary also would make clear that the provision uses the term “income” to be consistent with the use of the term throughout the UN Model, but the provision is intended to apply to gains as well; those countries that need to do so could add the words “or capital gains” to clarify the point. In addition, the Commentary would discuss considerations that countries should take into account when establishing the nominal tax rate in subdivision (i) of subparagraph (b) (including how the rule would apply to subnational taxes in federal systems) and would address how relief from double taxation rules would apply in the situations described in subparagraph (b). The inclusion of a subject-to-tax rule might also require consequential changes to portions of the Commentary on Article 1 dealing with various anti-abuse rules.

12. Some participants in the Subcommittee argued that the subject-to-tax rule should apply only in situations of base erosion and profit shifting between related parties. That was not the prevailing view within the Subcommittee, however, so the provision set out in paragraph 10 applies to transactions between both related and unrelated parties. If the Committee agrees with the Subcommittee that the provision should apply broadly, but also that it is advisable to include an alternative limiting the provision to transactions between related parties, that could be done in the Commentary.

13. A number of participants in the Subcommittee were of the view that certain non-taxable entities, such as pension funds, charities and collective investment vehicles, should not be denied benefits as a result of the application of the provision. It was also argued that common exemptions by the residence State, such as a participation exemption for dividends, should not trigger the provision. Further, it would be necessary to clarify how the provision would apply in certain cases involving pension payments. However, the Subcommittee concluded that determining appropriate exemptions is a bilateral exercise that should take into account the situation in each of the treaty partners; therefore, including exemptions in the Model

provision itself would be inappropriate. Accordingly, the provision includes a placeholder[2] to encourage negotiators to consider whether any such exemptions would be appropriate. It is anticipated that the Commentary would include draft language for the exemptions likely to be most common.

14. The provision set out in paragraph 10 is self-executing; that is, it applies to any income that falls within its parameters regardless of whether the Contracting States have identified a regime as creating the conditions described in subparagraph (b). Moreover, the provision is not limited to regimes or conditions that arise after the date on which the treaty is signed. The Subcommittee felt that drafting the provision so that it would apply only after a change in law or practice would put developing countries at a disadvantage. Some countries may, however, wish to provide more certainty to taxpayers by applying the provision only when the two Contracting States have agreed that the conditions of subparagraph (b) have been met. Accordingly, in bilateral negotiations, the parties may agree to include additional language to that effect. The Subcommittee recommends that the Commentary provide the drafting for such language. The Subcommittee also discussed the way that such a provision would be implemented, including a suggestion that the provision should be applied on an *ex post* basis so as not to disrupt normal withholding obligations, but no conclusion on how to approach this issue was reached.

III. Proposed Scope of a Subject-to-Tax Rule regarding Taxation by the Residence State

15. The Subcommittee noted that the primary concerns justifying the introduction of a subject-to-tax rule related to the failure of a residence State to tax in circumstances where the source State had ceded the right to tax. However, the Subcommittee also agreed that concerns regarding double non-taxation could arise when the situation was reversed, and the residence State had agreed to exempt income but the source State failed to exercise its right to tax. The Subcommittee considered the following provision from Article 26(2) of the Nordic Convention to address that concern:

> Where the right to tax any income or property is attributed, in accordance with the Convention, to another State than the State of which the person deriving the income or owning the property is a resident, and that other State, pursuant to its laws, does not include such income or property in tax liability in its entirety, or takes the income or property into account for the purpose of computing progression or for some other tax computation only, the income or property shall, to the extent it is not included in tax liability in that other State and subject to the provisions below, be taxable only in the Contracting State of which the person concerned is a resident.

If the Committee agrees with the concept behind such a provision, the drafting might be modified to reflect the difference between its multilateral origin and the bilateral context.

16. The Subcommittee noted, however, that this provision could produce unintended consequences in some cases, particulaly where exclusive source State taxation is intended to ensure an exemption in both States. For example, many German treaties provide for exclusive source State taxation for “compensation for an injury or damage sustained as a result of hostilities or political persecution”. Such payments are exempt from taxation in Germany, so retaining source State taxing rights are a way to ensure that they are not taxable in either State. Another example involves mismatches between different pension systems. If the source State has what is referred to as a “T-E-E” pension system (where no deduction is allowed for

[2] This approach is similar to the addition in 2021 of paragraph 4 to Article 1 of the UN Model to encourage negotiators to address explicitly the treatment of collective investment vehicles.

contributions to a pension fund, but the fund itself and distributions from the fund are not taxable), and therefore does not tax pensions when paid, taxation in the residence State through application of the provision of the Nordic Convention could result in financial hardship.[3] If this provision were to be used in a bilateral setting, negotiators would have to consider whether exemptions should be added to preserve those and similar intended double exemptions.

IV. Questions for the Committee

17. The Committee is asked to consider and discuss the Subcommittee's draft proposal in paragraph 10 hereof and its suggestions regarding how to deal with the issues raised by participants during the discussions in the Subcommittee.

18. The Committee is also asked to provide guidance to the Subcommittee regarding whether to continue to develop a provision along the lines of that in paragraph 15.

[3] See paragraph 22 of the Commentary on Article 18 of the OECD Model, quoted in paragraph 6 of the Commentary on Article 18 of the UN Model.