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Update of the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries

Proposed Substantive Changes to the Manual for Negotiation of Bilateral Tax Treaties between Developed and Developing Countries

Summary

This note is provided for ***discussion*** at the 25th Session of the Committee of Experts on International Cooperation in Tax Matters.

At its 24th Session, the Committee approved the work plan of the Subcommittee, including the proposal that "during the first half of this membership of the Committee, its focus should be on an update of the Manual to reflect the changes made in the 2021 version of the UN Model."

This document includes the substantive changes proposed as necessary as a result of changes made to the text of the 2021 UN Model, including the Commentaries thereon. Existing paragraphs that have been modified retain their numbering from the 2019 version of the Manual for ease of reference. New paragraphs have been assigned temporary reference numbers to aid in the Committee's discussions.

The Subcommittee hopes to provide a draft of the entire Manual, with editorial changes consisting primarily of updated cross-references, before the 26th Session of the Committee.

The Committee is requested to provide comments to the Subcommittee on the proposed drafting of these substantive changes so that such comments can be taken into account in the complete draft of the Manual to be provided before the 26th Session of the Committee.

[Article 1 – Changes dealing with CIVS and pension funds]

[177.] In addition to the situations dealt with by paragraph 2, there are a number of issues that may arise as regards the application of tax treaties to different types of entities and arrangements, in particular where such entities or arrangements do not pay tax. Such issues may arise, for instance, in relation to pension funds, sovereign wealth funds and collective investment vehicles. Since these constitute some of ***the*** most important cross-border investors in developing countries, it is important for these countries to have a clear understanding of how tax treaties will apply to income derived through such entities and, where necessary, to make the necessary adaptations. For instance, even though in some cases paragraph 2 of Article 1 might theoretically apply to income derived through a widely-held collective investment vehicle, the practical application of that paragraph might be extremely difficult because that collective investment vehicle may have thousands of members resident of different countries and that membership may change on a daily basis. ***In 2021, Article 1 of the UN Model was amended to include a placeholder provision, paragraph 4, to encourage negotiators to address the treatment of collective investment vehicles under their tax treaties.[1] At the same time, paragraph 1(g), defining "recognized pension funds", was added to Article 3[2] and paragraph 1 of Article 4 was amended to refer to "recognized pension funds."[3]*** ~~The Commentary on the OECD Model addresses some of the treaty issues raised by pension funds,[4] sovereign wealth funds;[5]~~ ~~***the Committee has not yet considered these issues***~~~~and collective investment vehicles.~~[6]

[Article 2 – No change, just two paragraphs (194 and 196) that say the same thing – suggest deleting paragraph 194]

~~[194.] The competent authorities are required under this paragraph to notify each other of significant changes to their tax laws. Negotiators should discuss when and how notification will take place, and whether other important changes, for example, judicial decisions, significant changes to regulations or procedures, and so forth, should also be notified. Some countries provide annual updates to their treaty partners, while others prefer that changes, especially important ones, be notified immediately.~~

[195.] A tax treaty will normally apply to new taxes introduced after the entry into force of that treaty if those taxes are taxes on income or on a capital. Paragraph 4 clarifies that taxes that are "identical or substantially similar" to the taxes that existed at the time of the signature of the treaty and were expressly listed in paragraph 3 will be covered.[7] It is sometimes unclear whether a new tax is a tax on income or capital or if it "identical or substantially similar" to a tax expressly listed in the treaty. In case of doubt, a country could ask its treaty partners if they agree that a new tax is of an identical or substantially similar nature.

[196.] When, after the entry into force of a treaty, a country makes significant changes in its domestic

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[1] ***Paragraphs 12 to 29 of the Commentary on Article 1 describe different possible approaches to CIVs and the relevant considerations in deciding among those approaches.***

[2] ***See paragraphs 15 to 19 of the Commentary on Article 3 of the UN Model. See also paragraph [ ] below.***

[3] ***The Commentary on the OECD Model also addresses some of the treaty issues raised by sovereign wealth funds; the Committee has not yet considered these issues.***

[4] ~~Definition of "recognized pension funds" in paragraph 1 i) of Article 3 of the OECD Model as well as paragraphs 10.3 to 10.18 of the Commentary on that Article. See also paragraph 209 below.~~

[5] Paragraphs 49 to 53 of the Commentary on Article 1 of the OECD Model.

[6] ~~Paragraphs 22 to 48 of the Commentary on Article 1 of the OECD Model.~~

[7] ***Article 2(4) of the*** UN Model~~, Article 2(4)~~. As noted above, however, some treaties do not include paragraphs 1 and 2 of Article 2 and therefore only apply to listed taxes and to "identical or substantially similar" taxes imposed after the signature of the treaty.

tax legislation, paragraph 4 also requires it to inform its treaty partners of such changes.[8] The competent authority should inform its counterpart in the other country of important new legislation; some countries might inform its treaty partners also about significant judicial decisions, administrative rulings, and so forth. Negotiators should discuss when and how ***that requirement*** ~~notification~~ will ***be fulfilled***~~take place~~. Some countries provide annual updates to their treaty partners, while others prefer to ~~***provide notification***~~ ~~notify only~~ ***inform them of*** important changes when they occur.

[Article 4—Changes dealing with CIVs and pension funds]

[209.] ***In 2021, paragraph 1 was modified to refer specifically to "recognized pension funds" to provide certainty with respect to*** ~~As pension funds now represent~~ ~~one of the largest categories of cross-border investors,~~ the application of the provisions of tax treaties to the income derived by ***one of the largest categories of cross-border investors***. ~~pension funds (for instance, the provisions of Article 10 that limit the amount of tax imposed on dividends beneficially owned by pension funds) is an important question.~~ ***Prior to this change, d***~~D~~epending on how a pension fund ~~is~~***was*** structured and on how it ~~is~~***was*** treated for tax purposes, there may ~~be~~ ***have been*** doubts as to whether a particular pension fund ***was*** ~~is~~ a person "liable to tax" in a state as required by paragraph 1. Most countries are of the view that it is appropriate policy to consider pension funds as residents for treaty purposes and wish to clarify that issue in Article 4.[9] ~~If it is decided to provide expressly in a treaty that pension funds are entitled to treaty benefits, it is important to include in that treaty a definition of pension funds that would ensure that the application of the relevant provisions is restricted to funds that do in fact provide retirement benefits. Paragraph 1 of Article 4 of the OECD Model as well as the accompanying definition of "recognized pension fund" in paragraph 1 *f*) of Article may be used for that purpose.~~ ***However, because some states prefer a more restrictive approach, the Commentary on Article 3 includes an alternative definition of "recognized pension fund" that addresses potential treaty-shopping with respect to pension funds without the need to apply the anti-abuse rule of paragraph 9 of Article 29.[10] The Commentary also briefly discusses the possibility, and consequences, of leaving out the definition of "recognized pension fund" entirely.[11]***

[Article 4 – Adoption of clarifications on dual-residence test]

[213.] Treaty negotiators may wish to discuss the tie-breaker rules ~~(and in particular the "permanent home available" and "habitual abode" tests)~~ during negotiations to ensure that both sides share the same understanding of their operation. The Commentaries on Article 4 of the UN and OECD models will assist negotiators in reaching a shared understanding, ***as the Commentary on Article 4 of the UN Model addressing the meaning of the "permanent home available" and "habitual abode" tests was updated in 2021 to adopt additional explanations that had been included in the Commentary on the OECD Model.[12]***

[Article 5 – Additions to Commentary]

[221.] The term "enterprise" itself is not defined in the UN Model and the non-exhaustive definition of "enterprise" found in the OECD Model[13] is merely intended to clarify that Article 7 applies to the carrying

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[8] ~~Ibid.~~

[9] See the explanations in ***paragraph 15 of the Commentary on Article 3 of the UN Model, quoting*** paragraphs 10.3 to 10.18 of the Commentary on Article 3 of the OECD Model and ***paragraph 5 of the Commentary on Article 4 of the UN Model***, ***quoting*** paragraphs 8.6 to 8.10 of the Commentary on Article 4 of the OECD Model.

[10] See paragraph 17 of the Commentary on Article 3 of the UN Model.

[11] See paragraph 6 of the Commentary on Article 4 of the UN Model.

[12] ~~While p~~***Paragraph*** ~~7~~ ***10*** of the Commentary on Article 4 of the UN Model***,*** quot~~es~~***ing*** paragraphs 9–20 of the Commentary on Article 4 of the ~~2014~~ OECD Model***.***~~, the Commentary of the 2017 OECD Model includes additional explanations on the concept of "permanent home available" and "habitual abode".~~

[13] Paragraph 1 (*c*) of Article 3 of the OECD Model.

on of professional and other independent activities (which are covered by Article 14 in the UN Model). ~~Paragraph 42 of the~~ ***The*** Commentary ~~on Article 5 of the OECD Model, which was added in 2017,~~ clarifies, however, that the term “enterprise” as used in Article 5 “refer[s] to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form”.[14]

…

[223.] Since the definition in paragraph 1 is the same in the UN and OECD models, paragraph 3 of the Commentary o~~f~~***n*** Article 5 of the UN Model quotes, with a few adaptations, the guidance on the interpretation and application of paragraph 1 ~~that was~~ found in the Commentary o~~f~~***n*** Article 5 of the ~~2014~~ OECD Model. ~~In 2017, however, a number of additional clarifications were added to the Commentary on paragraph 1 of the OECD Model and these changes have not yet been considered for inclusion in the UN Model.~~

[Article 5 – No change to Model or Commentary, but clarification of paragraph on insurance]

[260.] The Commentary[15] explains the reason for paragraph 6. It also indicates[16] that some countries prefer to delete the exception that relates to activities performed by an independent agent. Some countries take a broader approach and simply exclude~~s~~ the profits of insurance enterprises***s***[17] from the application of the treaty, leaving these profits to be taxed in accordance with domestic law.

[Introduction to Chapter III – Taxation of Income – clarification of “may be taxed”]

[274.] Generally, the phrase “shall be taxable only” in a state signifies that that state has been allocated exclusive taxing rights, while the phrase “may be taxed” in a state is used where that state is allocated a non-exclusive taxing right. The fact that income “may be taxed” in one state under a provision of the treaty does not affect the other country’s right to tax that income (except as regards to the application of Article 23, under which the state of residence ~~of~~***is*** obliged to eliminate double taxation of income which “may be taxed” in the other state in accordance with the treaty).[18]

[Article 7 – Changes as a result of the deletion of the note regarding purchases by PEs]

[311.] ***Until 2021, the UN Model included in Article 7 a note that referred to a long-standing rule from former OECD Article 7[19] that had prevented the attribution of profits*** ~~Article 7 of the UN Model includes a note indicating that the question of whether profits should be attributed~~ to a permanent establishment by reason of the mere purchase, by that permanent establishment, of goods and merchandise for the enterprise ~~has not been resolved and should be settled in bilateral negotiations~~. ***The*** ~~This~~ note ~~reflects~~***reflected*** the fact that the ***original*** drafters of the UN Model could not reach agreement on the inclusion of ***that*** ~~a~~ provision. ~~(paragraph 5) that was included in the former OECD Article 7 and according to which no profits should be attributed to the permanent establishment in these circumstances. That paragraph, however, was not included in the new OECD Article 7.~~ Since the paragraph ***has been***~~was~~ deleted from the OECD Model***, the***

[14] Paragraph 15 of the Commentary on Article 5 of the UN Model, quoting paragraph 42 of the Commentary on Article 5 of the OECD Model.

[15] Paragraph ~~28~~ ***72*** of the Commentary on Article 5 of the UN Model.

[16] Paragraph ~~29~~ ***73*** of the Commentary on Article 5 of the UN Model.

[17] See paragraph ***6 of the protocol to the treaty between Chile and New Zealand signed on 10 December 2003.*** ~~7 of Article 7 of the treaty between Mexico and New Zealand signed on 16 November 2006.~~

[18] As explained in ***paragraph 15 of the Introduction to the UN Model, quoting*** paragraph 25.1 of the Introduction of the OECD Model.

[19] Paragraph 5 of the former OECD Article 7.

note was no longer necessary and was deleted from the UN Model in 2021.~~because there was broad consensus that is was not consistent with the arm's length standard and was not justified,[20] treaty negotiators from developing countries may prefer to avoid the inclusion of that paragraph in their treaties~~.

[Article 10 – Changes to deal with pension funds, REITs, deletion of reference to partnership, beneficial ownership]

[342.] Paragraph 2(a), which deals with direct investment dividends, specifies a minimum holding of ~~10~~ ***25*** per cent of capital in the paying company as the threshold for that holding to be regarded as direct investment. ***This threshold was raised in 2017 from 10 per cent of capital although, as the Commentary noted,*** ~~*t*The Commentary notes, however, that this~~ ***the previous 10 per cent*** level ~~is~~ ***was intended to be*** illustrative only.[21] ***The 2017 change aligns the ownership threshold with*** ~~In~~ the OECD Model~~, the minimum holding is 25 per cent of capital~~. ***Although the Commentary notes[22] that the Committee of Experts viewed the new threshold as "more appropriate", it also indicates that countries may agree to a different threshold in their bilateral negotiations.[23]***

[342.A] ***The Commentary provides guidance regarding the interpretation of the term "capital".[24]*** In some treaties, the threshold for determining direct investment dividends is expressed as a percentage of the voting stock or voting power, as opposed to capital, in order to reflect the degree of influence the shareholder may have over the company rather than the amount of capital owned.

[343.] ***Prior to 2021, paragraph 2(a) of the UN Model included the words "other than a partnership", with the intention of ensuring that fiscally transparent partnerships could not benefit from lower rates of taxation applicable to direct investment dividends. These words were deleted in 2021 because the Committee determined that there was no reason for the exclusion. A fiscally transparent partnership cannot qualify as a resident and therefore is not entitled to treaty benefits. On the other hand, a partnership that is treated as a body corporate for tax purposes in its state of residence should be given the benefit of the lower rate.[25]*** Other issues that may arise in the application of the lower limit applicable to direct investment dividends are addressed in the Commentary on Article 10 of the UN Model.[26] ~~In addition, the Commentary on Article 10 of the OECD Model was amended in 2017 to address the issue of the application of that lower limit where shares are held through an entity or arrangement (such as a partnership in many countries) that is not treated as a taxpayer under domestic law.[27]~~

[344.] A change made in 2017 to paragraph 2(a) of both the UN and OECD models requires that the minimum shareholding be maintained for a period of at least 365 days which includes the day the dividend

~~[20] Paragraph 299 of the OECD *Report on the Attribution of Profits to Permanent Establishments,* available at https://www.oecd.org/ctp/transfer-pricing/41031455.pdf~~.

[21] Paragraph 6 of the Commentary on Article 10 of the UN Model and paragraph 1~~3~~***5*** of the Commentary on Article 10 of the UN Model, quoting paragraph 14 of the Commentary on Article 10 of the OECD Model.

[22] Paragraph 6 of the Commentary on Article 10 of the UN Model.

[23] Paragraph 16 of the Commentary on Article 10 of the UN Model, quoting paragraph 14 of the Commentary on Article 10 of the OECD Model.

[24] See paragraph 16 of the Commentary on Article 10 of the UN Model, quoting paragraph 15 of the Commentary on Article 10 of the OECD Model.

[25] See paragraph 16 of the Commentary on Article 10 of the UN Model, quoting paragraphs 11 and 11.1 of the Commentary on Article 10 of the OECD Model.

[26] Paragraph 16 of the Commentary on Article 10 of the UN Model, quoting paragraphs 19 to 22 of the Commentary on Article 10 of the OECD Model.

~~[27] Paragraph 11 and 11.1 of the Commentary on Article 10 of the 2017 OECD Model.~~

is paid. This change, which was made as a result of the report on Action 6 of the OECD/G20 BEPS project,[28] was intended to prevent abusive transactions in which the holder of shares that did not meet the required threshold for the lower limit applicable to direct investment dividends would, shortly before the payment of dividends, ***temporarily acquires additional shares for the purpose of meeting*** ~~temporarily transfer his shares to a shareholder that met~~ the threshold. The 365-day minimum holding period does not need to be met before the dividend is paid; it can also be met after that payment. Changes of ownership that result from corporate reorganizations should be disregarded for the purposes of the computation of that minimum holding period.

[345.] Some countries seek an exemption from source-country taxation in respect of certain categories of dividends, in particular where the dividend recipient is exempt from tax on such income in the recipient's country of residence. The Commentary discusses the cases of dividends paid to pension funds and to a state or state-owned entities (including sovereign wealth funds).[29] On the one hand, a withholding tax imposed by the source state on dividends received by such entities may have the effect of making it more advantageous for these entities to invest in other countries that grant them an exemption similar to the one to which they are entitled in the state in which they are established. On the other hand, the source state may be concerned that granting an exemption to such entities will give the***m***~~n~~ an unfair advantage over other taxpayers deriving similar income and it may also be concerned that if no equivalent exempt entities of a similar size exist~~s~~ under its own law, the exemption would primarily benefit entities of the other state. The application of paragraph 2 in these circumstances could be discussed during the negotiations.

[346.] ~~A few~~ ***An increasing number of*** ~~(mainly developed)~~ countries ***provide, in their domestic laws, for special investment entities that are treated as companies but that qualify for concessionary treatment. These include***, in particular, ~~may wish to include special rules to deal with the particular case of dividends paid by companies that qualify as~~ real estate investment trusts. ***Such countries may wish to include special rules in Article 10 to deal with dividends paid by such entities.*** The issues that these raise and possible solutions are discussed in the Commentary ~~on Article 10 of the OECD Model~~.[30]

[347.] Dividends to which Article 10 applies are mostly paid by companies resident of developing countries since there is substantially more investment in equity capital from developed to developing countries than in the opposite direction. Accordingly, the immediate impact of revenue reductions as a consequence of treaty limits on source taxation ***frequently*** will fall on the developing country (although there may be long-term revenue gains as a result of increased capital flows). Developing countries will need to decide what limits they can accept in their treaties bearing in mind that high rates of withholding taxes may deter investment.[31]

[348.] ~~All~~ ***Every*** developing countr***y***~~ies~~ should aim to have a reasonably consistent treaty practice with respect to limits ~~of~~ ***on*** source taxation applicable to dividends ***in its treaties***. If, for example, a developing country agrees to a limit in one of its treaties that is significantly lower than the limits found in its other treaties, the negotiators from other countries will typically insist ***on***~~in~~ getting an equivalent lower limit in

[28] Note [19].
[29] Paragraph ~~13~~***16*** of the Commentary on Article 10 of the UN Model, quoting paragraphs 13.1 and 13.2 of the Commentary on Article 10 of the OECD Model. The addition of the definition of "recognized pension fund" in ***paragraph 1(g) of Article 3 of*** the ~~2017 OECD~~ ***2021 UN*** Model would be relevant to the drafting of an exemption for dividends paid to pension funds.
[30] ***See paragraph 31 of the Commentary on Article 1 of the UN Model, quoting*** paragraphs 67.1 – 67.7 ***of the Commentary on Article 10 of the OECD Model and paragraph 32 of the Commentary on Article 1 of the UN Model, quoting paragraphs 28.10 to 28.12 of the Commentary on Article 13 of the OECD Model.***
[31] See section II.B dealing with the development of a country's tax treaty policy framework and model treaty.

order to avoid the competitive disadvantage that the higher source taxation of dividends would create for their resident investors. Negotiators of developed countries that are concerned that a developing country may agree, in future treaties, to a lower limit of source taxation of dividends will often seek the inclusion in the treaty of a most favored nation (MFN) provision that will require the developing country, in the event that it agrees on a lower rate with a third country, to provide similar treatment to its existing treaty partner. The pros and cons of such provisions are discussed in paragraphs [119 to 121] above.

[349.] The limit~~s~~ ***on source taxation of dividends*** provided ~~for~~ in paragraph 2 appl***ies***~~y~~ only where the beneficial owner of the dividends is a resident of the treaty partner ~~country~~. If ***that is not the case***~~the dividends are paid to a resident of the other country who acts as an agent or nominee for a resident of another country who is the beneficial owner of the dividends~~, the source country is not obliged to reduce its tax ~~in accordance with the treaty with the state of residence of the direct recipient of the dividend.~~[32] ***and may apply the tax rates provided under its domestic law. Thus, for example, if dividends arising in state A are paid to a resident of state B who receives them as agent or nominee for a resident of state C, then state A is not obligated, under the treaty between state A and state B, to limit its source taxation.***

[349.A] On the other hand, if the resident of state B receives the dividends as agent for another resident of state B and the latter person is the beneficial owner of such dividends, then the limit provided by paragraph 2 of the treaty between state A and state B applies since the beneficial owner is a resident of state B. Where the immediate recipient of such payments (acting as agent or nominee) is a resident of a third state, the Commentary on the UN Model states that the restriction on source taxation provided in the treaty between the source state and the treaty partner remains applicable if the beneficial owner of the payments is a resident of the treaty partner.[33]

[350.] As explained in the Commentary ~~of~~***on*** the UN Model, the concept of "beneficial owner" was introduced in paragraph 2 to clarify that the words "paid … to a resident" used in paragraph 1 do not require a state to apply the limits of paragraph 2 where the dividends are directly "paid to" a person that merely acts ~~and~~ ***as*** an agent or nominee for another person who is the real beneficiary of the dividends. The Commentary adds that the same logic applies where a company, being the formal owner of dividends, has, as a practical matter, very narrow powers which render it, in relation to these dividends, a mere fiduciary or administrator acting on account of the other parties.

[351.] The Commentary ~~on the OECD model~~ was amended in ~~2014~~ ***2021*** to provide additional explanations ***of***~~n~~ the meaning of "beneficial owner".[34] As noted in that Commentary, the fact that a person may qualify as the beneficial owner of dividends does not mean that it is automatically entitled to the limits provided for in paragraph 2:[35] under the rules of Article 29 (Entitlement to treaty benefits), the source state is not required to limit its source taxation of dividends in abusive cases, including treaty-shopping arrangements.

[32] ~~In that case, however, the source state should apply the limits provided in its treaty with the state of which the beneficial owner is resident; see paragraph 13 of the Commentary on Article 10, quoting paragraph 12.2 of the Commentary on Article 10 of the 2010 OECD Model. The wording of paragraph 2 of Article 10 of the OECD Model was modified in 2014 to provide expressly for that result: that paragraph indicates that the limits apply to any dividend paid by a company resident of one state that is beneficially owned by a resident of the other state.~~

[33] ***Paragraph 15 of the Commentary on Article 10 of the UN Model, quoting paragraph 12.7 of the Commentary on Article 10 of the OECD Model.***

[34] ***See paragraph 15 of the Commentary on Article 10 of the UN Model, quoting*** paragraphs 12 to 12.6 of the Commentary on Article 10 of the OECD Model.

[35] ***See paragraph 15 of the Commentary on Article 10 of the UN Model, quoting paragraph 12.5 of the Commentary on Article 10 of the OECD Model.***

[352.] The treaty does not prescribe how the limit is to be applied. Paragraph 2 authorizes the competent authorities to settle by mutual agreement the mode of application of the limitation. Each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment.[36] Most countries collect tax on dividends paid to non-residents through the imposition of a withholding tax which is deducted by the payer of the dividends and remitted to the tax authority of the source state. The source state may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.[37] Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

[353.] Finally, paragraph 2 clarifies that the limits on source taxation do not affect taxation of the company profits out of which the dividends are paid. The paragraph is concerned only with taxation of the distributions to the shareholder, not with taxation of the underlying company profits.

Paragraph 3

[354.] Paragraph 3 specifies the meaning of the term “dividends” for purposes of the treaty. The definitions in the UN and OECD models are identical and cover income from all kinds of shares or other rights that participate in profits, as well as income from other corporate rights that are taxed in the same way as dividends in the source state.***[38] Negotiators should become familiar with the types of rights and transactions that would be covered by this paragraph under their domestic law and the law of their potential treaty partner.***

[Article 12 – Changes as a result of the addition of a minority view on computer software]

[407.] The Commentary was modified in 2017 to address various interpretation issues related to the phrase “payments for the use, or the right to use, industrial, commercial or scientific equipment.”[39] Other aspects of the definition of “royalties” may also give rise to difficulties, particularly with respect to payments for ~~computer software or for~~ know-how.[40] ~~These issues are discussed in the Commentary.~~ These ***interpretive*** matters should ~~also~~ be discussed during negotiations and, if necessary, clarifications should be included in the treaty or agreed upon through the mutual agreement procedure.

[407.A] The application of Article 12 to common transactions involving computer software has been addressed in the Commentaries several times.[41] ***In 2021, the Commentary on Article 12 was modified to include an alternative provision that would allow for source state taxing rights with respect to payments for computer software in a broader set of circumstances than under the existing definition as***

[36] Paragraph 1~~3~~***6*** of the Commentary on Article 10 of the UN Model, quoting paragraph 18 of the Commentary on Article 10 of the OECD Model.

[37] Paragraph ~~26.2~~ ***109*** of the Commentary on Article 1 of the OECD Model***, quoted in paragraph 149 of the Commentary on Article 1 of the UN Model,*** expresses a strong preference for application of treaty limits at source, rather than subsequent refund.

[38] Paragraph 18 of the Commentary on Article 10 of the UN Model, quoting paragraphs 23 to 30 of the Commentary on Article 10 of the OECD Model, provides detail regarding the instruments and income covered, including distributions upon liquidation of a company, redemption of shares and reduction of capital.

[39] Paragraphs ~~13~~***17*** to ~~13.4~~***21*** of the Commentary on Article 12 of the U~~n~~***N*** Model.

[40] Paragraphs 22 to 24 of the Commentary on Article 12 of the UN Model.

[41] Paragraph ~~12~~***13*** of the Commentary on Article 12 of the UN Model, quoting paragraphs 8 to 19 of the Commentary on Article 12 of the OECD Model, and paragraphs~~ 14–16~~ ***15*** of the Commentary on Article 12 of the UN Model***, setting out a minority opinion disagreeing with certain aspects of the quoted text.***

currently interpreted.[42] Under the alternative provision, the definition in paragraph 3 would encompass any payment for the use of computer software, without regard to the use of copyright. Because computer software is frequently provided as part of "mixed contracts" involving services or physical goods, if negotiators agree to include the alternative provision in a bilateral treaty, they are encouraged to discuss the exact scope of the provision.

9. Article 12B – Income from automated digital services

[448.A] Article 12B was added to the United Nations Model Tax Convention in 2021. Under this new Article, which is based on Articles 12 (Royalties) and 12A (Fees for Technical Services) and has no equivalent in the OECD Model, a state may tax income from certain digital services arising in that state and paid to a resident of the other Contracting State. If the recipient of payments underlying income from automated digital services is the beneficial owner of such payments, the tax is subject to a limit, expressed as a percentage of the gross amount of such payments, to be agreed to through bilateral negotiations. The beneficial owner of the income from automated digital services may, alternatively, opt to pay tax on a net profit basis for the whole year.

[448.B] Throughout the UN Model, the term "payments underlying income from automated digital services" generally is used when referring to actual disbursements while the broader term, "income from automated digital services" can refer to either the cross-border payments or the beneficial owner's profits from the relevant activities. The same approach is used throughout this Manual when referring to Article 12B.

[448.C] The Commentary notes that income from automated digital services was identified as a matter of priority for the Committee. With the advent of modern means of telecommunications and the spread of digitalization, enterprises have the ability to effectively engage in substantial business activities in the market country without a fixed place of business there, or to conclude contracts remotely through technological means with no involvement of individual employees or dependent agents, therefore avoiding the creation of a permanent establishment. Accordingly, under Article 12B, a country will be able to tax income from automated digital services even if the automated digital services are not performed in that country and/or the non-resident service provider does not have a permanent establishment or fixed base in that country. Article 12B therefore represents a departure from the traditional permanent establishment concept for services that can be performed remotely, in a manner similar to that of Article 12A.

[42] Paragraph 16 of the Commentary on Article 12 of the UN Model.

Example

Country R's "R-Dramas" (and other pop culture) have become a worldwide phenomenon. Company R provides a streaming service for R-Dramas that can be accessed by customers directly from all over the world. Customers pay several euros a month for unlimited access to Company R's catalog of R-Dramas.

Individual S is one of hundreds of thousands of residents of state S who have subscribed to Company R's streaming service. Individual S can access her account through any internet-connected device, and usually watches R-Dramas on either her phone or her family's television.

Company R has no physical facilities outside of state R and has no agents in state S; customers find its service through word-of-mouth. It does not license the R-Dramas to any broadcasting or streaming services in state S.

If there is a tax treaty between state S and state R that is based on the UN Model but does not include Article 12B, state S could not tax Company R on the millions of euros in business profits that it receives every year with respect to its customers in state S because Company R does not have a permanent establishment in state S. However, because the subscription payments constitute income from automated digital services, state S could tax those payments at the negotiated rate if the State R-State S treaty includes Article 12B and the domestic law of state S provides for the imposition of such a tax.

[448.D] Article 12B therefore is intended to allow jurisdictions to apply their domestic legislation levying taxes on income derived from digital business models. Such domestic legislation could be targeted specifically to automated digital services but, in most cases, the relevant domestic law is likely to apply more broadly. For example, many countries impose a withholding tax on all payments made by their residents or borne by permanent establishments situated therein; Article 12B would allow that general tax to be applied to automated digital services.

[448.E] Some countries may oppose the inclusion of Article 12B in treaties for various reasons, including their disagreement with the position that the market, on its own, generates profits from automated digital services such that the market jurisdiction should be allocated taxing rights. The Commentary notes that, while the members of the Committee recognized that certain highly digitalized business models have caused tax challenges, a large minority thereof considered the reallocation of profits of a multinational enterprise group to the market jurisdiction to be ill-suited to a bilateral solution. For these and other reasons set out in the Commentary, the inclusion of Article 12B in a treaty between a developing and a developed country may therefore be a very controversial issue during the negotiation of that treaty. The Commentary provides the pros and cons of the inclusion of Article 12B in a treaty and discusses different arguments that may be raised during such negotiations.[43]

[448.F] Negotiators from developing countries considering the inclusion of Article 12B should take the following factors into account:

> ***- For the article to have practical effect, the domestic law of the source state must allow for taxation of income from automated digital services derived by non-resident service providers.***
> ***- An efficient withholding system should be in place or be adopted to ensure that the tax imposed on non-resident service providers can be collected effectively.***
> ***- Some countries may be reluctant to agree to the inclusion of the new article or may request significant concessions on other issues.***
> ***- The applicable rate of tax on the automated digital services should not be so high so as to discourage cross-border provisions of automated digital services or to result in payments for these services being systematically grossed-up to include the amount of the tax.***

Paragraph 1

[448.G] Paragraph 1, similarly to paragraph 1 of Articles 12 and 12A of the UN Model with respect to royalties and fee for technical services, provides that income from automated digital services, underlying payments for which arise in one state and are paid to a resident of the other state, may be taxed in the residence state. There are no limits imposed under the treaty on the taxing rights of the residence state (although the residence state is required to relieve double taxation where the source state is also permitted to tax the income).

Paragraph 2

[448.H] Paragraph 2 provides that the state in which income from automated digital services arises may also tax the income from automated digital services in accordance with the provisions of its domestic law but if the relevant income is beneficially owned by a resident of the other state, the tax is limited to a percentage of the gross amount of the payments underlying such income. If the source state imposes a

[43] Paragraphs 1 to 2 and 5 to 15 of the Commentary on Article 12B of the UN Model.

tax in accordance with paragraph 2, the residence state is required by Article 23 of the UN Model[44] to eliminate any double taxation.[45]

[448.I] The UN Model does not specify the limit on the source tax applicable to payments underlying income from automated digital services, leaving this for negotiation between treaty partners but does suggest that it be a low rate, such as 3 per cent.[46] The negotiators should take account of the factors listed in the Commentary[47] in determining this limit.

[448.J] Paragraph 2 as drafted applies regardless of the amount of income from automated digital services received by the beneficial owner. Some countries, however, consider that the source taxation allowed under Article 12B is not appropriate for smaller-sized taxpayers that are not in a position to absorb the tax or to taxpayers that are just entering a particular market as they may be operating at a loss during a start-up phase. The Commentary thus includes an alternative provision[48] that would allow taxation at source of income from automated digital services only if certain thresholds have been met. If the negotiators plan to agree to include this alternative, they should discuss how the thresholds would be applied in practice.

[448.K] To avoid uncertainty, Paragraphs 2 and 3 apply "notwithstanding Article 14." Thus, although payments underlying income from automated digital services made to a services provider who is a resident of one state are not taxable under Article 14 if the service provider does not have a fixed base in the source country or is not present in the source country for 183 days or more, such payments are subject to tax under Article 12B (although the Commentary notes that, due to the nature of automated digital services, it is unlikely that such income would also be treated as covered by Article 14).[49] A similar result applies with respect to Article 7.[50] Therefore, even if a non-resident service provider does not have a permanent establishment in the source country, any payments underlying income from automated digital services made to a service provider by a resident of the source country or by a non-resident carrying on business through a permanent establishment in the source country are subject to tax by the source country under paragraph 2.[51] However, like paragraph 4 of Articles 12 and 12A, paragraph 8 of Article 12B provides for taxation under Articles 7 and 14 where the income from automated digital services are effectively connected with a permanent establishment or fixed base situated in the country in which such income arises (the source state).[52]

[448.L] Paragraphs 2 and 3 are subject to Article 8. Therefore, if Article 8 applies to income from automated digital services, it would take priority over the provisions of paragraphs 2 and 3. The Commentary makes clear that an airline that sells tickets for its own flights through a digital interface does not derive income from automated digital services.[53] However, if the airline's digital interface also allows for the sale of tickets on other airlines, fees earned as a result could constitute income from

[44] Some countries may be willing to include Article 12B but not to apply the rules of Article 23 to relieve double taxation with respect to taxes that may be imposed thereunder. Negotiators should consider the likely economic effects of the unrelieved double taxation that could result from this approach.
[45] The obligation to eliminate double taxation applies even where the services are performed in the residence state.
[46] Paragraph 28 of the Commentary on Article 12B of the UN Model.
[47] Paragraph 29 of the Commentary on Article 12B of the UN Model.
[48] Paragraph 26 of the Commentary on Article 12B of the UN Model.
[49] Paragraph 38 of the Commentary on Article 12B of the UN Model.
[50] This priority results from the provisions of paragraph 6 of Article 7.
[51] Paragraph 38 of the Commentary on Article 12B of the UN Model.
[52] See paragraph [475] below.
[53] Paragraph 60 (iv) of the Commentary on Article 12B of the UN Model.

automated digital services but could also constitute income from international traffic or income ancillary to its own sales under Article 8,[54] in which case Article 8, and not Article 12B, would apply and the income would not be taxable in the source state.

[448.M] The limit on source taxation of payments underlying income from automated digital services provided in paragraph 2 applies only where the beneficial owner of the income from automated digital services is a resident of the treaty partner. If that is not the case, the source state is not obliged to reduce its tax and may apply the tax rates provided under its domestic law. Thus, for example, if payments underlying income from automated digital services arising in state A are paid to a resident of state B who receives them as agent or nominee for a resident of state C, then state A is not obligated, under the treaty between state A and state B, to limit its source taxation.

[448.N] On the other hand, if the resident of state B receives the payments underlying automated digital services as agent for another resident of state B and the latter person is the beneficial owner of such payments, then the limit provided by paragraph 2 of the treaty between state A and state B applies since the beneficial owner is a resident of state B. Where the immediate recipient of such payments (acting as agent or nominee) is a resident of a third state, the Commentary on the UN Model states that the restriction on source taxation provided in the treaty between the source state and the treaty partner remains applicable if the beneficial owner of the payments is a resident of the treaty partner.[55]

[448.O] The explanations of the concept of "beneficial owner" provided above[56] with respect to the use of those words in the context of Article 10 are equally applicable in the context of Article 12B.

[448.P] Paragraph 2 does not prescribe how the limit is to be applied. As with source tax limits imposed under Articles 10, 11, 12 and 12A, each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment. The source state may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.[57] Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

Paragraphs 3 and 4

[448.Q] Paragraph 3 allows the beneficial owner of income from automated digital services to elect to be taxed on its "qualified profits" on a net basis and provides detailed rules for determining such qualified profits of a beneficial owner.

[448.R] Under paragraph 3, where segmental accounts are maintained, the profits of the beneficial owner attributable to a Contracting State are determined by applying the profitability ratio of the taxpayer's automated digital services business segment (or the ratio of the automated digital services business segment of the multinational enterprise group to which it belongs, if that ratio is higher) to the gross annual revenue derived from such services in the source State. Negotiators should be aware that determinations under paragraphs 3 and 4 will be made on the basis of the financial accounts of the

[54] See paragraph 13 of the Commentary on Article 8 of the UN Model, quoting paragraph 8 of the Commentary on Article 8 of the OECD Model.
[55] Paragraph 37 of the Commentary on Article 12B of the UN Model.
[56] Paragraphs [349 to 351].
[57] Paragraph 149 of the Commentary on Article 1 of the UN Model, quoting paragraph109 of the Commentary on Article 1 of the OECD Model, expresses a strong preference for application of treaty limits at source, rather than subsequent refund.

beneficial owner (or multinational enterprise group),[58] which might produce a different result than would be the case under paragraph 8 if the beneficial owner had a permanent establishment in the host state.

[448.S] The "qualified profits" subject to net taxation under paragraph 3 constitute 30% of the amount determined under that first calculation. Paragraph 4 and the Commentary[59] on Article 12B provide additional guidance regarding various aspects of these determinations, including the definition of a multinational enterprise group, the use of segmented accounts and the determination of the profitability ratio.

Example

Company R, a resident of state R, earns 10,000 in gross revenue from streaming R-Dramas to users in state S. The State R-State S income tax treaty includes a provision identical to Article 12B of the UN Model, with a maximum withholding rate under paragraph 2 of 3%. State S imposes corporate tax at a fixed rate of 25% of net profits.

All of Company R's business consists of the provision of automated digital services. The profitability ratio for Company R is 9% while the profitability ratio for the multinational enterprise group of which it is a part (and whose entire business also only consists of the provision of automated digital services) is 12%. Therefore, according to paragraph 3, if Company R elected to be taxed under paragraph 3 of Article 12B, the qualified profits of Company R would be 360 (30% x 12% x 10,000). Company R would pay 90 (360 x 25%) in corporate tax to state R, which would be significantly less than the 300 (3% x 10,000) that would be due under paragraph 2. Company R therefore makes the election.

[448.T] The Commentary notes that a large minority of the members of the Committee objected to various aspects of the rules for calculating the "qualified profits" (for example, the allocation of a fixed ratio of 30% to the host state, the application of the profitability ratio of the multinational enterprise group rather than that of the beneficial owner alone or the application of the rule to the "routine profits" of an enterprise); the Commentary[60] includes an alternative provision for use in bilateral treaties by countries that share those concerns.

Paragraph 5

[448.U] Paragraph 5 provides a basic definition of automated digital services. Under that definition, "automated digital services" means "any service provided on the Internet or another electronic network, in either case requiring minimal human involvement from the service provider." The term "automated" is defined in the Commentary[61] to refer to situations in which the user can obtain the service automatically through equipment and services in place. Consistent with this, the Commentary makes clear[62] that the reference to "minimal human involvement" refers to the time at which the services are provided; therefore, a service may constitute "automated digital services" even though there is

[58] Paragraph 47 of the Commentary on Article 12B of the UN Model.
[59] Paragraphs 40, 42, 44 and 47 of the Commentary on Article 12B of the UN Model.
[60] Paragraph 48 of the Commentary on Article 12B of the UN Model.
[61] Paragraph 53 of the Commentary on Article 12B of the UN Model.
[62] Paragraph 53 of the Commentary on Article 12B of the UN Model.

significant human involvement in "creating or supporting or maintaining the system needed for the provision of services, maintaining and updating the system environment, dealing with system errors, or making other generic, non-specific adjustments unrelated to individual user requests." An "important indicator" of automated digital services is the ability to provide the same services to new users with minimal human involvement.[63] The Commentary further expands upon these concepts.

[448.V] Unlike the definition of "fees for technical services" in Paragraph 3 of Article 12A, Paragraph 5 does not include specific exclusions. In this context, the most consequential difference between the two definitions is that Article 12B does not exclude from its coverage payments for services for the personal use of an individual. The Commentary notes[64] that many multinational enterprise groups that depend on digital business models derive a very significant portion of their income from the provision of automated digital services to individual customers. Accordingly, an exception for payments by individuals for personal use was not included in Article 12B. However, because some countries believe that imposing withholding obligations on such payments by individuals would be difficult to enforce and might cause serious compliance problems for such individuals, the Commentary also includes an alternative provision[65] that could be used in bilateral negotiations by those countries that would be willing to include Article 12B in their treaties but wish to exclude payments made by individuals for personal use of automated digital services.

Paragraph 6

[448.W] Paragraph 6 lists a number of examples of what typically constitutes "automated digital services." These will constitute automated digital services, however, only if they fall within the definition of paragraph 5, that is to say, where the service is provided through an electronic network with minimal human involvement when the services are provided to the user. The relationship between paragraph 6 and paragraph 5 of Article 12B is analogous to the relationship between paragraph 2 and paragraph 1 of Article 5.

[448.X] The specific examples mentioned in paragraph 6 are:

(a) online advertising services;
(b) supply of user data;
(c) online search engines;
(d) online intermediation platform services;
(e) social media platforms;
(f) digital content services;
(g) online gaming;
(h) cloud computing services; and
(i) standardized online teaching services.

The scope of each of these categories is described in the Commentary.[66]

[448.Y] The Commentary also gives examples of services that do not constitute automated digital services under the general principles.[67] These are:

[63] Paragraph 54 of the Commentary on Article 12B of the UN Model.
[64] Paragraph 63 of the Commentary on Article 12B of the UN Model.
[65] See paragraph 65 of the Commentary on Article 12B of the UN Model.
[66] See paragraph 58 of the Commentary on Article 12B of the UN Model.
[67] See paragraph 59 of the Commentary on Article 12B of the UN Model.

(i) customized professional services;
(ii) customized online teaching services;
(iii) services providing access to the Internet or to another electronic network;
(iv) online sale of goods and services other than automated digital services; and
(v) revenue from the sale of a physical good, irrespective of network connectivity ("internet of things").

The Commentary's explanations of why these services are not covered[68] illustrate the general principles reflected in paragraphs 5 and 6.

Paragraph 7

[448.Z] Paragraph 7 is a coordination rule with Articles 12 and 12A that provides that Article 12B will not apply when the payments underlying the income from automated digital services also qualify as either royalties or fees for technical services. The first step therefore is to determine the character of the payment by applying the definitions in the different articles (and their relevant Commentaries); once the character is determined, the appropriate article is applied.[69] The Commentary[70] includes the standard statement[71] that a "mixed contract" must in principle be broken down into its various parts and then the aforementioned determination made with respect to each part.

Paragraph 8

[448.AA] Under paragraph 8, which is similar to paragraph 4 of Articles 12 and 12A, the rules of paragraphs 1, 2 and 3 for the allocation of taxing rights over income from automated digital services do not apply where the income from automated digital services is effectively connected with a permanent establishment or fixed base situated in the country in which such income arises (the source state) or is effectively connected with other business activities carried on in the source state that are of the same or similar kind as the activities of the permanent establishment and which are covered by paragraph 1(c) of Article 7. In these cases, the source or host state may tax the income from automated digital services as business profits falling under Article 7 (Business profits) or as income covered by Article 14 (Independent personal services), as the case may be. That is, the source state's taxing rights are limited as to the base of the tax but not as to the rate of the tax (subject to the non-discrimination rule of paragraph 3 of Article 24). The references to a fixed base and to Article 14 should be deleted from treaties that do not include Article 14; similarly, if the treaty does not include paragraph 1 (c) in Article 7, negotiators should delete this reference in paragraph 8 of Article 12B.

[448.BB] Thus, for tax treaties containing Article 12B, the existence of a permanent establishment or fixed base in a country determines the mode of taxation of income from automated digital services, rather than whether the source country is entitled to impose tax on such income at all. If a non-resident service provider receives income from automated digital services from the source state, that income is taxable by the source country on a net basis if it is earned through a permanent establishment or fixed base in the source country (or is effectively connected with activities referred to in paragraph 1 (c) of Article 7), but is otherwise taxable under paragraphs 1 and 2 of Article 12B on a gross basis or under the rules of paragraph 3 if an election to that effect has been made.

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[68] Paragraph 60 of the Commentary on Article 12B of the UN Model.
[69] Paragraph 66 of the Commentary on Article 12B of the UN Model.
[70] Paragraph 66 of the Commentary on Article 12B of the UN Model.
[71] See paragraph 13 of the Commentary on Article 12 of the UN Model, quoting paragraph 11.6 of the Commentary on Article 12 of the OECD Model.

[448.CC] Paragraph 8 requires that the income from automated digital services be "effectively connected" with, as the case may be, the permanent establishment, the fixed base or the business activities referred to in paragraph 1 (c) of Article 7. The Commentary explains[72] that this requires a determination on the basis of all the relevant facts and circumstances and adds that, as a general rule, such a connection would exist if the automated digital services are closely related to or connected with the permanent establishment or fixed base or if the business activities are similar to those carried out through the permanent establishment.

Paragraph 9

[448.DD] Paragraph 9 provides the source rule for determining, for treaty purposes, whether income from automated digital services arises in a state and may therefore be taxed by that state under Article 12B. The paragraph, which applies regardless of the domestic source rules of each state and regardless of where the services are performed, provides that income from automated digital services is deemed to arise in the state in which the payer is a resident. In addition, where the payments underlying income from automated digital services are, in effect, an expense of a permanent establishment or fixed base situated in a contracting state, the related income is deemed to arise in the state where the permanent establishment or fixed base[73] is located. This approach will generally ensure that, if a payment underlying income from automated digital services derived by a resident of one state is a deductible expense of the payer in the other state, the income is sourced in that other state and that state is allowed to tax them under Article 12B.

[448.EE] The source rule of paragraph 9, like most source rules in the UN Model, operates on the basis of "payment." Therefore, the fact that users are located in a country does not necessarily result in that country having a right to tax income from automated digital services arising from that use. The Commentary provides an example[74] related to online advertising services illustrating this rule.

[448.FF] The source rule of paragraph 9 is, however, subject to the exception of paragraph 10.

Paragraph 10

[448.GG] Under paragraph 10, income from automated digital services is deemed not to arise in a state if the payer has a permanent establishment or fixed base in the other state and the payments underlying that income are borne by that permanent establishment or fixed base. The effect of this negative source rule is that a state cannot impose tax on income from automated digital services relating to payments made by residents of that state where such payments are deductible in computing the profits of a permanent establishment or fixed base in the other state. In this situation, the payments relate to a business or activities carried on in that other state, as demonstrated by the fact that they are deductible in that state, and, as a result, the link between the income and that other state is stronger than the link with the state in which the payer is a resident. This justifies not allowing the latter state to tax the income.

Paragraph 11

[448.HH] Paragraph 11, which is similar to paragraph 6 of Article 12 and paragraph 7 of Article 12A, deals with a particular form of tax avoidance where a taxpayer seeks to reduce its overall taxation by inflating deductible payments made to non-resident related parties for automated digital services. Where

[72] Paragraph 69 of the Commentary on Article 12B of the UN Model.
[73] If Article 14 (Independent personal services) is not included in the treaty, the references to "fixed base" should be deleted from paragraph 9.
[74] Paragraph 74 of the Commentary on Article 12B of the UN Model.

payments underlying income from automated digital services exceeding an arm's length amount are made as a result of a special relationship between the payer and the recipient (or between both of them and a related party), paragraph 11 provides that the treaty limits on source taxation apply only to the arm's length amount, that is, the amounts that would have been payable if an arm's length payment had been agreed to. The excess amount remains subject to tax under the domestic law of the source State, "due regard" being had to the other provisions of the treaty. Negotiators may want to discuss how each country would tax amounts that are found to be in excess of the arm's length amount and, if necessary, clarify such treatment in the treaty or a memorandum of understanding.[75]

[448.II] "Special relationship" commonly refers to the relationship between associated enterprises such as that described in Article 9 (Associated enterprises). It may, however, also refer to a relationship between individuals, such as individuals related by marriage or family ties, or between individuals and companies, such as the relationship between a company and its majority shareholder.

[448.JJ] Depending on the circumstances, tax avoidance arrangements involving the making of excessive payments underlying income from automated digital services might also be dealt with through the general anti-abuse rule of paragraph 9 of Article 29 (Entitlement to benefits). Issues relating to excessive payments for services would, however, more typically be addressed through domestic transfer pricing rules.

[Article 13 – Changes as a result of changes to text and Commentary on Article 13]

[450.] Not all countries tax capital gains, and countries vary in how they apply tax to capital gains under their domestic law: they may, for example, be added to other income or they may be subject to a special tax. Tax treaties do not dictate how a capital gain should be calculated, whether and when it should be taxed or what kind of tax should apply. They only allocate taxing rights between the two treaty partners and, within the limits set by the treaty, each country may apply its domestic law when taxing a capital gain.[76] If a treaty allows taxation of a capital gain by a state, that right extends to the entire gain, not only the portion of the gain that accrues after the treaty enters into force.[77]

Paragraph 5

[465.] Paragraph 5 of the UN Model, which has no equivalent in the OECD Model, allows a state to tax gains on the alienation of shares in a company, or comparable interests such as interests in a partnership or trust, where the company or relevant entity is a resident of that state in which the alienator holds directly or indirectly (or has held at any time during the preceding 365 days) a substantial participation. The minimum participation is not specified in paragraph 5, but it is often 25 per cent. The 365-day rule is an anti-avoidance provision designed to ensure that a taxpayer cannot escape source taxation by selling off multiple small parcels of shares that together form a substantial holding. ***The Commentary provides guidance for applying the minimum participation rule when the shares are held through a transparent entity.[78]***

[466.] Treaty practice varies with respect to this provision. Some treaties do not include a minimum participation, although it should be recognized that there are significant administrative and compliance

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[75] ***See paragraphs 83 and 84 of the Commentary on Article 12B of the UN Model.***
[76] Paragraphs ~~s~~ 3 of the Commentary on Article 13 of the UN Model, quoting paragraph 3 of the Commentary on Article 13 of the 2010 OECD Model.
[77] ***Paragraph 3 of the Commentary on Article 13 of the UN Model, quoting 3.1 of the Commentary on Article 13 of the OECD Model.***
[78] ***See paragraphs 21 to 26 of the Commentary on Article 13 of the UN Model.***

difficulties in enforcing taxation in respect of gains from small shareholdings. Some countries specifically exclude gains from the alienation of quoted shares.[79] Others provide for a concessional rate of tax on gains from the alienation of shares. Still others limit taxing rights over gains from disposal of shares to gains by individuals who are former residents of that state. Many countries do not include paragraph 5 at all in their treaties. ~~There is no equivalent to paragraph 5 in the OECD Model.~~

[467.] In deciding their position on this paragraph, countries should take into account their ability to identify, and collect tax on, sales of shares by non-residents. They should also take into account the fact that ~~since~~ the paragraph***, unlike paragraph 4***, applies only to the alienation of shares or comparable interests of resident companies and entities**. I**~~i~~t does not apply, for example, where the shares of a company that is resident of a state in which it has significant business operations are held through a non-resident holding company and it is the shares of that holding company that are alienated. ~~That situation, which is covered under paragraph 4 (if the resident company derives its value primarily from immovable property in that state) but not under paragraph 5,~~ ***If a country wants to cover this situation***, sometimes referred to as an "offshore indirect transfer",[80] ***it will want to consider the inclusion of paragraph 7.***

Paragraph 6

[467.A] Paragraph 6 of the UN Model, which has no equivalent in the OECD Model, allows a State to tax gains from the alienation of rights granted under the law of that State as long as these rights allow the use of resources that are naturally present in that State and that are under the jurisdiction of that State. Although the rights to which the provision applies often will also constitute immovable property, the provision also applies to other rights that may not constitute immovable property under the domestic laws of the Contracting State granting such rights, such as fishing quotas. The provision does not cover rights granted contractually between private parties even if these rights are protected under the law of a State. The Commentary provides examples both of the types of rights that are included within the provision and those that are not.

[467.B] The Commentary notes that the provision only applies where the right referred to therein is itself alienated. It therefore would not apply in the case of an "indirect transfer" of such a right, e.g. where the right is held by a company and the shares of that company are alienated (subject to the possible application of anti-abuse rules such as those of paragraph 9 of Article 29). Depending on the circumstances, however, such indirect transfers could fall within the scope of paragraph 4, 5 or 7.

Paragraph 7

[467.C] Paragraph 7 of the UN Model, which has no equivalent in the OECD Model, addresses the situation where, instead of directly disposing of property over which a state has taxing rights under another provision of Article 13, an interest in an interposed entity is alienated. The paragraph ensures that the capital gain, where that gain primarily represents an increase in the value of such property held directly or indirectly through one or more companies, partnerships or trusts, may be taxed in the country where such property is located. This paragraph therefore allows the taxation of what sometimes are referred to as "offshore indirect transfers" (OITs), if a state's domestic law provides for the taxation of

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[79] See the alternative provision included in paragraph ~~13~~***27*** of the Commentary on Article 13 of the UN Model.
[80] For a discussion of offshore indirect transfers, see Platform for Collaboration on Tax, The Taxation of Offshore Indirect Transfers— A Toolkit, available at https://www.tax-platform.org/sites/pct/files/publications/PCT_Toolkit_The_Taxation_of_Offshore_Indirect_Transfers.pdf. ~~https://www.un.org/esa/ffd/wp-content/uploads/2017/08/Taxation-of-Offshore-Indirect-Transfers-A-Toolkit.pdf.~~

such gains.[81] In deciding their position on this paragraph, countries should take into account their ability to identify, and collect tax on, sales of shares of companies by non-residents, particularly in the case of sales of shares of non-resident companies.

[467.D] Paragraph 7 applies to gains from the alienation of shares or comparable interests (such as interests in a partnership or trust) in a local or offshore company or entity where, at any time during the 365 days preceding the alienation, more than 50 per cent of the value of these shares or comparable interests derived directly or indirectly from property with respect to which that state would, under the other provisions of Article 13, have had the right to tax the gain from a direct alienation. It allows the state in which the underlying assets are situated to tax that gain if the alienator holds directly or indirectly (or has held at any time during the preceding 365 days) a substantial percentage. The minimum percentage necessary for paragraph 7 to apply is not specified but is left to bilateral negotiations. The 365-day rule is an anti-avoidance provision designed to ensure that a taxpayer cannot avoid source taxation by selling off multiple small parcels of shares that together form a substantial holding.

[467.E] The Commentary provides an example of the application of the rule.[82] That example makes clear that, where it applies, paragraph 7 allows a state to tax the full capital gain derived from the alienation of the relevant shares or interests even though part of that gain may be attributable to property with respect to which that state would not, under the other provisions of Article 13, have had the right to tax the gain from a direct alienation. The Commentary also addresses the risk of unrelieved double taxation that may arise under this rule[83] and includes suggestions of ways that states may want to modify the provision.[84]

*Paragraph **8***

[468.] Paragraph ~~6~~***8*** (paragraph 5 in the OECD Model) is a "sweep-up" provision allocating taxing rights over all capital gains that are not dealt with in the previous paragraphs of the Article. In both the UN and OECD models, these gains may be taxed only in the country of residence of the alienator.[85]

[469.] Some countries, however, including many developing countries, prefer to retain taxing rights over capital gains arising in their state.[86] This approach will allow both countries to tax such gains in accordance with their domestic law, with the country of residence of the alienator providing double tax relief where necessary. Since the place where capital gains may be said to "arise" can give rise to difficulties, negotiators adopting this approach should clarify during negotiations how the source of capital gains is to be determined.

[470.] Some countries also seek to confirm in a treaty their right to subject capital gains accrued before a change of residence to an "exit" or "departure" tax provided under their domestic law. As indicated in the Commentary[87] and confirmed by paragraph 3 of Article 1, nothing in Article 13 or in the rest of the treaty would prevent the application of such a tax to the extent that the liability to that tax arises when a person is still a resident of the state that applies the tax and does not extend to ***the part of the gain***~~income~~ accruing

[81] For a discussion of offshore indirect transfers, see Platform for Collaboration on Tax, The Taxation of Offshore Indirect Transfers— A Toolkit, ~~discussion draft~~ available at https://www.tax-platform.org/sites/pct/files/publications/PCT_Toolkit_The_Taxation_of_Offshore_Indirect_Transfers.pdf. ~~https://www.un.org/esa/ffd/wp-content/uploads/2017/08/Taxation-of-Offshore-Indirect-Transfers-A-Toolkit.pdf.~~

[82] See paragraph 37 of the Commentary on Article 13 of the UN Model.

[83] See paragraph 39 of the Commentary on Article 13 of the UN Model.

[84] See paragraph 43 of the Commentary on Article 13 of the UN Model.

[85] Paragraph 5 of Article 13 of the OECD Model.

[86] Paragraph ~~18~~***45*** of the Commentary on Article 13 of the UN Model, which includes a suggested alternative version of paragraph ~~6~~***8*** that would achieve that result.

[87] Paragraph ***86***~~61~~ of the Commentary on Article 1 of the UN Model.

after the cessation of residence. Where, however, the liability to such a tax arises after the cessation of residence or the tax applies to the part of a gain that arose after the cessation of residence, a specific exception to the general rule of paragraph ~~6~~***8*** would be required in order to allow taxation of that part of the gain where such ***taxation***~~assets which may not~~ otherwise ***would not be allowed***~~be taxed~~ under paragraphs 1 to ~~5~~***7.***

[471.] In negotiating provisions on capital gains, countries should consider, in particular, which gains are taxable under their domestic law, and the extent to which their tax administration is able to enforce tax liabilities of non-residents on such gains.

[Article 14 – Coordination with Article 12B]

[475.] Income from personal services may be covered by the provisions of both Articles 12A (Fees for technical services) and 14. Since paragraph 2 of Article 12A indicates that the article applies "notwithstanding the provisions of Article 14", source taxation is allowed by Article 12A even if paragraph 1 of Article 14 would otherwise prevent taxation by a country because the income is not attributable to a fixed base situated in that country and is not derived from activities performed in that country by a person whose stay in that country has exceeded the period of 183 days referred to in paragraph 1 (b) of Article 14 (see below). Where, however, income from personal services to which article 12A would otherwise apply is attributable to a fixed base situated in the state in which the payment arises, paragraph 4 of Article 12A expressly provides that such income will be covered by Article 14 rather than Article 12A. Thus, for example, if a resident of state S pays a fee for independent personal services to an individual resident of state R and the payment falls within the definition of "fee for technical service" in paragraph 3 of Article 12A, Article 12A shall govern the taxation of the fee unless the fee is attributable to a fixed base in state S that is regularly available to the individual. ***Although the same analysis would apply with respect to income from independent personal services that also constituted income from automated digital services that is subject to Article 12B, the coordination rule in the case of Article 12B is included primarily for the sake of completeness, as the likelihood of overlap between Article 12B and Article 14 would appear to be substantially lower than that of overlap between Article 12A and Article 14.***

[Article 18 – Change to text of Alternative B]

[516.] Article 18 allocates taxing rights over pensions paid in respect of past employment and social security payments. There are two versions of this Article in the UN Model. Article 18 (alternative A) gives to the recipient's country of residence the exclusive right to tax pensions, while Article 18 (alternative B) allows source taxation if the pension is paid by a resident of the source country or ***borne by*** a permanent establishment situated there. In both versions, social security payments are taxable only in the paying country.

…

[521.] A significant number of countries, however, consider that the source country should also have a right to tax pensions arising in their jurisdiction, particularly those countries where pensions are regarded as deferred compensation for income from employment exercised in that country, or where tax incentives have previously been provided in that country in respect of retirement savings.[88] The UN Model therefore offers Article 18 (alternative B), pursuant to which pensions paid in respect of past employment may be taxed in both the residence state of the recipient (paragraph 1) and the treaty partner country if paid by a resident of, or ***borne by a*** permanent establishment ***or fixed base*** in, that country (paragraph 2) ***and the***

[88] Paragraph 4 of the Commentary on Article 18 of the UN Model, quoting paragraph 9 of the Commentary on Article 18 of the OECD Model, and paragraph 11 of the Commentary on Article 18 of the UN Model.

obligation to pay the pensions or similar remuneration was incurred with respect to such permanent establishment or fixed base.

[Article 20 – Change to Commentary and proposed drafting change to alternative provision]

[547.] The Article applies only to students, business trainees and apprentices who are visiting the country solely for the purpose of their education or training and covers payments for maintenance, education or training only when the source of these payments is outside the country being visited.[89] The Article does not cover payments for services (which are covered by Article 15 or 19 in the case of employment services and by Article 7, 12A or 14 in the case of independent services). A number of countries, however, prefer to extend the exemption to remuneration for services rendered by the student or trainee, particularly where the services that are provided are connected with the student's studies or training.[90] This approach can lead to difficulties in the country being visited as it provides for a better treatment of foreign students compared to domestic students.

…

Article for teachers

…

[551.] Typically, such a provision would exempt from tax in the host country the remuneration of visiting teachers, professors and, sometimes, researchers derived from their teaching or research activities in that country.[91] These provisions are, however, often difficult to apply and administer, so negotiators should be careful in drafting the article to ensure that the scope and application of the exemption is clear. ***Small changes in drafting can result in significant differences in result. For example, the following provision includes a "cliff" under which the teacher, professor or researcher would lose the exemption entirely if that person stays for a day more than two years:***

> ***Notwithstanding the provisions of Article 15, a professor or teacher who makes a temporary visit to one of the Contracting States for a period not exceeding two years from the date of first arrival in that state, solely for the purpose of teaching or carrying out research at a university, college, school or other educational institution in that state and who is, or immediately before such visit was, a resident of the other Contracting State shall, in respect of remuneration for such teaching or research, be exempt from tax in the first-mentioned state.***

By moving the phrase "for a period not exceeding two years from the date of first arrival in that state" to the end of the provision, the cliff would be eliminated and the teacher, professor or researcher would

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[89] ***Paragraph 2 of the Commentary on Article 20 of the UN Model, quoting paragraphs 3 and 4 of the Commentary on Article 20 of the OECD Model.***

[90] Draft wording could be along the following lines: "2. Notwithstanding the provisions of Articles 14 and 15, remuneration for services rendered by a student or a business apprentice in a Contracting State shall not be taxed in that state, provided that such services are in connection with his studies or training."

[91] ~~The following is an example of such a provision: "Notwithstanding the provisions of Article 15, a professor or teacher who makes a temporary visit to one of the Contracting States for a period not exceeding two years from the date of first arrival in that state, solely for the purpose of teaching or carrying out research at a university, college, school or other educational institution in that state and who is, or immediately before such visit was, a resident of the other Contracting State shall, in respect of remuneration for such teaching or research, be exempt from tax in the first-mentioned state."~~ The scope of application of some of these provisions is restricted to remuneration derived by the professor or teacher from outside the host state.

qualify for the exemption for two years even if that person stayed for a longer (but still "temporary") period.[92] The Commentary identifies the choice between these two results as something the Contracting States should determine.[93]

[Article 21 – Changes to Commentary]

[558.] The paragraph addresses the case of income that does not constitute business profits but is paid with respect to assets effectively connected with a permanent establishment or fixed base. It covers such income even where the payer and the person deriving the income are residents of the same state but the income is paid in respect of ***a*** right or property that is effectively connected with a permanent establishment or fixed base of the recipient in the treaty partner country. For example, interest paid by a resident of state A may be beneficially owned by another resident of state A but paid in respect of right or property that is effectively connected with a permanent establishment of that person situated in state B. In this case, paragraph 2, in combination with Article 7, will allow state B to tax the income, and Article 23 will require state A to relieve double taxation.[94]

[559.] If state A relieves ***double taxation*** by the exemption method, however, this will result in that state not being able to tax the income at all, notwithstanding that the interest arises in state A. Some countries do not agree with this outcome and seek to include a provision that ensures that state A may impose tax as the source country (limited, where appropriate, in accordance with treaty provisions such as Articles 10, 11, 12***,*** ~~or~~ 12A ***or 12B***).[95] Under paragraph 3 of Article 24, state B, in which the permanent establishment is situated, should give relief to the permanent establishment for any double taxation to the same extent as it would give relief to a local enterprise deriving similar income from state A.[96]

[Article 23 – Changes to Commentary on Article 21 and relating to 12B]

[589.] Paragraph 2 provides for the credit method to apply in respect of dividends, interest, royalties***,*** ~~and~~ fees for technical services ***and income from automated digital services*** which may be subjected to limited taxation in the source state in accordance with the treaty. ***In the case of income from automated digital services, the credit method will apply with respect to amounts covered by both paragraphs 2 and 3 of Article 12B.***

[Article 25 – Finalization of DAR handbook]

[648.] In addition to the guidance found in the Commentary, detailed explanations on the practical application of the mutual agreement procedure may be found in ~~the~~ Chapter ***4 - The*** Mutual Agreement

[92] This version of the provision would read: "Notwithstanding the provisions of Article 15, a professor or teacher who makes a temporary visit to one of the Contracting States, solely for the purpose of teaching or carrying out research at a university, college, school or other educational institution in that state and who is, or immediately before such visit was, a resident of the other Contracting State shall, in respect of remuneration for such teaching or research, be exempt from tax in the first-mentioned state for a period not exceeding two years from the date of first arrival in that state."

[93] See paragraph 13 of the Commentary on Article 20 of the UN Model.

[94] See paragraph 4 of the Commentary on Article 21 of the UN Model, quoting paragraph 5 of the Commentary on Article 21 of the OECD Model.

[95] See paragraph 15 of the Commentary on Article 23 of the UN Model, quoting paragraph 9.1 of the Commentary on Article 23 of the OECD Model.

[96] ~~Paragraph 4 of the Commentary on Article 21 of the UN Model, quoting paragraph 5 of the Commentary on Article 21 of the 2014 OECD Model.~~

Procedure of the ~~proposed~~ United Nations *Handbook on ~~Dispute~~ Avoidance and Resolution* ***of Tax Disputes***.[97]

…

[652.] The Commentary does not stipulate any special procedure as to how requests for mutual agreement are to be presented.[98] Appropriate procedures, conditions, methods and techniques may be agreed to by the competent authorities under paragraph 4 of Article 25 of the UN Model. The Commentary[99] highlights some of the information that a state would typically require in order to consider that a MAP request has been correctly presented. Given that, under paragraph 5 of alternative B, the presentation of a MAP request that includes all the necessary information is the starting point of the period of time after which arbitration may be requested, more details on the information required for that purpose would typically be provided in the mutual agreement that provide the details of the arbitration process.[100]

[97] ~~The latest version of that Chapter is available at https://www.un.org/esa/ffd/events/event/tax-eighteenth-session.html.~~ ***Available at: https://www.un.org/development/desa/financing/document/un-handbook-avoidance-and-resolution-tax-disputes.***

[98] Paragraph ~~9~~ ***12*** of the Commentary on Article 25 of the UN Model, quoting paragraph 16 of the Commentary on Article 25 of the OECD Model.

[99] Paragraphs 22–24 of the Commentary on Article 25 UN Model. ***See also Section 4.4.2.4 of the United Nations Handbook on the Avoidance and Resolution of Tax Disputes***, ***available at: https://www.un.org/development/desa/financing/document/un-handbook-avoidance-and-resolution-tax-disputes.***

[100] Paragraph ~~18~~ ***22*** of the Commentary on Article 25 ***of the*** UN Model, quoting paragraph 75 of the Commentary on Article 25 of the OECD Model.