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Committee of Experts on International Cooperation in Tax Matters
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Item 3(c) of the provisional agenda
Issues related to the United Nations Model Double Taxation Convention between Developed and Developing Countries

Co-Coordinators' Report: 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*** and ***approval*** at its Twenty-sixth Session.

The Committee had a first discussion of a proposed subject-to-tax rule, set out in E/C.18/2022/CRP.23, at its Twenty-fifth Session. This note sets out the Subcommittee's revised draft of such a provision along with the first draft of the Commentary on the provision.

The Committee is asked to:

(a) ***discuss and approve*** the Subcommittee's draft text in paragraphs 5, 7 and 9 hereof; and

(b) ***approve*** the Subcommittee's proposal to discontinue work on the application of subject-to-tax rules by the residence State, as described in paragraph 10.

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I. Introduction

1. At its Twenty-fifth Session, the Committee of Experts on International Cooperation in Tax Matters considered note E/C.18/2022/CRP.23, on the Subcommittee's proposal for the inclusion of a subject-to-tax rule in the United Nations Model Double Taxation Convention between Developed and Developing Countries (the UN Model). The report of that Committee Session includes the following regarding the discussion in the Committee:

> 19. Mr. Das then presented the note on the proposed subject-to-tax rule, E/C.18/2022/CRP.23. He explained that the Subcommittee proposes a broad rule that is not limited to the BEPS concerns relating to transactions between related parties. In addition, it was important to developing countries that the provision be self-executing, and not limited to regimes that were adopted after a treaty had entered into force. However, the Subcommittee had recognized that there would be situations, in bilateral negotiations, where exceptions would be appropriate, such as for collective investment vehicles or pension funds or in the case of a participation exemption. Accordingly, the proposed provision includes a placeholder for the inclusion of such exceptions. It is anticipated that the Commentary will include proposed drafting for the most common exceptions.
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> 20. In general, Members and Observers supported the drafting approach, while some made drafting suggestions. A Member expressed concerns that the proposed rule was broader than necessary to address the BEPS concerns that had prompted it, and stated that, if the Committee decides to go beyond addressing BEPS concerns and try to achieve a minimum level of taxation, a cap on the level of taxation should be applied by the source state. This position did not receive general support from the Committee. Several Members suggested that the provision should not be applied at the time that a payment is made, but only afterwards, based on the way the payment is taxed over a taxable period. It was recognized that the application of withholding requirements is, of course, not set out in the UN Model or its Commentaries; rather, it is specifically left to domestic law. Ashfaq Ahmed noted that attention would have to be paid to the issue of operationalization of the STTR when incorporated and rolled out. Others also supported the need to encourage speedy implementation of any UN Model STTR.
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> 21. An Observer expressed the view that the Committee should wait for the results of the work of the Inclusive Framework before proceeding with the adoption of a subject-to-tax rule. Mathew Gbonjubola reminded the Committee that it has its own mandate and works independently. Marlene Nembhard-Parker commented that even those countries that adopt the proposals of the Inclusive Framework are free to adopt better solutions.
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> 22. Mr. Das thanked the Members and the Observers for the valuable comments, which will be taken into account in the next draft of the proposed provision. He also noted that the immediate focus is on drafting the provision; a discussion on implementation is best left to the future.

2. The Subcommittee accordingly has produced a revised proposal, set out in Section II. It has also drafted a proposed Commentary, set out in Sections III and IV, to address certain policy and technical points that were made during the Committee Session and its own internal discussions.

II. Revised Proposed Treaty Text

3. Because there was general support for the approach taken in the initial proposal, the paragraph proposed to be included in the UN Model text has not been changed substantially. However, it was noted that subdivision (b)(ii) made the original subdivision (a)(i) redundant. Accordingly, subparagraph (a) has been simplified.

4. The Subcommittee considered a point made by an observer regarding the use of the term "derived by" in subparagraph (a). He noted that there will be circumstances when income may be subject to tax in the residence State not because it is "derived by" that person but because it is attributed to another person under that State's domestic law. He suggested that the words "attributable to" might be used instead of the words "derived by". The phrase "derived by" is used in paragraph 2 of Article 1, a provision that also is intended to address cases of double non-taxation,[1] in cases involving transparent entities. That provision very clearly does not apply to circumstances where the income may be taxable in a State through attribution (such as through the application of controlled foreign company rules). The Subcommittee therefore believes that "derived by" is appropriate in these circumstances.

5. The Subcommittee therefore invites the views of the Committee on the revised provision, proposed to be included in Article 1 of the UN Model:

> 3. (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 is subject to a low level of taxation in that other State within the meaning of subparagraph (b).
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> (b) Income is subject to a low level of taxation in that other State if:
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> > (i) it is subject to a statutory tax rate of ___ per cent [the percentage is to be established through bilateral negotiations] or less; or
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> > (ii) it is subject to a statutory 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.
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> (c) Subparagraph (a) will not apply to income that: [exemptions, if any, appropriate in the context of the bilateral relationship between the Contracting States].

III. Draft Commentary to the Subject-to-Tax Rule

6. The proposed Commentary set out in paragraph 7 addresses the issues that were mentioned in E/C.18/2022/CRP.23 as well as several additional issues that were raised during the Committee Session. The Committee is invited to discuss the proposed Commentary.

7. Proposed Commentary on the subject-to-tax rule, proposed to be added after paragraph 9 of the Commentary on Article 1 of the UN Model:

[1] See paragraph 7 of the Commentary on Article 1 of the UN Model, quoting paragraph 5 of the Commentary on the OECD Model.

[10.] In 202[ ], the Committee introduced paragraph 3, which is intended to deny the benefits of the treaty in respect of items of income which are subject to no or low tax in the residence State. Members of the Committee believed that paragraph 3 is consistent with the basic philosophy of the allocation of taxing rights. Paragraph 20 of the Introduction to the UN Model, quoting paragraph 15.2 of the Introduction to the OECD Model, states that:

> Most of the provisions of tax treaties seek to alleviate double taxation by allocating taxing rights between the two States and it is assumed that where a State accepts treaty provisions that restrict its right to tax elements of income, it generally does so on the understanding that these elements of income are taxable in the other State.

Accordingly, in cases where paragraph 3 applies, the source jurisdiction shall have the right to impose tax in respect of such income under its domestic law. The tax is therefore a secondary taxing right that only is triggered if the jurisdiction that has the primary taxing right does not exercise that right to impose a certain minimum level of tax on the relevant income. Paragraph 3 does not affect entitlement to tax treaty benefits in respect of income that is taxed at or above the minimum rate; it therefore is not a reallocation of taxing rights.

[11.] Consistent with this rationale, the rule could apply to any type of income where taxation by the source State is limited under the distributive rules of the relevant convention. For example, it could apply to payments by a resident of the source State for services rendered by an unrelated party that is a resident of the other Contracting State when the source State is prevented from taxing that payment because the recipient of the income does not have a permanent establishment in the source State. The provision uses the term "income" to be consistent with the use of the term throughout the UN Model. It should be given the wide meaning that it has for the purposes of the Convention and therefore applies to profits and gains as well; those countries that need to do so could add the words "or profits" and/or "or capital gains" throughout the provision in order to clarify the point.

[12.] Similarly, the rule is not limited to income derived in transactions between associated enterprises. A [XX minority] of the Committee believed that paragraph 3 should be limited to addressing the concerns that are the focus of the OECD/G20 Base Erosion and Profit Shifting Project and, in line with that policy objective, that paragraph 3 should apply only to base eroding payments or mobile income between related parties. Those holding that view may want to achieve that goal by modifying the provision to read:

> This Convention shall not affect the taxation by a Contracting State of any interest or royalty arising in that State and derived by a resident of the other Contracting State that is a connected person (within the meaning of paragraph 7(d) of Article 29) with respect to the payer if the interest or royalty is subject to a low level of taxation in that other State within the meaning of subparagraph (b).

[13.] Paragraph 3 applies not only when the income is completely exempt from tax in the residence State, but also when the taxation in the residence State is below an agreed minimum level. The standard will be met when the statutory rate of tax imposed by the residence State on that income is less than the rate agreed in bilateral negotiations. In many cases, a statutory rate will apply to all income derived by a taxpayer, and that statutory rate will exceed the agreed minimum, so the inquiry will end there. However, where the taxation laws of a State provide for a lower statutory rate on certain categories of income,

or for taxpayers with certain characteristics or meeting certain conditions, that special rate will be the rate applicable for purposes of applying subdivision (b)(i) of paragraph 3.

[14.] Subdivision (b)(ii) describes a second situation in which income will be treated as having been taxed below the agreed minimum level. In this situation, the applicable tax rate exceeds the agreed minimum, but the beneficial owner is entitled to a special benefit that results in the amount of tax paid in the residence State being less than the amount that would have been paid if the agreed rate had been applied to the income, without regard to such benefit. This determination is not required if the beneficial owner does not receive such special benefits. (That is, there is no requirement to calculate an "effective tax rate".) For these purposes, the term "beneficial owner" means the person entitled to the benefits of a tax treaty with respect to an item of income under the applicable article.[2]

[15.] Subdivision (b)(ii) is not implicated by deductions for interest, royalties, salaries and other ordinary business expenses even though they reduce the taxpayer's tax base. It therefore would not apply to depreciation deductions or expensing of capital costs (whether accelerated or otherwise) that are limited to a taxpayer's investment in the relevant property. It would apply, however, to extraordinary deductions, such as depreciation deductions that exceed the taxpayer's investment in the relevant property. It would not apply to ordinary, relatively modest exemptions related to personal or family status, but would apply in the case of an individual who benefits from certain regimes that do not fully tax foreign-source income. It would not apply with respect to an exemption for pension distributions in a jurisdiction that does not provide benefits for contributions to private pension plans. However, it would apply to exemptions applicable to ordinary business income. Treaty negotiators are encouraged to consider aspects of their country's domestic tax law that provide preferential treatment to particular income or persons and to discuss their treatment under this provision with potential treaty partners.

[16.] The determination to be made under paragraph 3(b) applies separately with respect to each item of income derived by the taxpayer. For example, assume that paragraph 3(b)(i) of Article 1 of the State R-State S tax treaty provides for an agreed rate of 12 per cent. State R's corporate income tax rate is 20 per cent. However, State R's domestic law includes a headquarters company regime under which any income earned by a State R company from providing a number of "headquarters company services" (including financing and certain managerial services) to associated enterprises is excluded from the State R tax base. A State S company pays interest and management fees to its State R affiliate. The interest income derived by the State R company is subject to tax at the corporate income tax rate of 20%; accordingly, the State R company would benefit from any reduction in State S tax provided by Article 11 of the relevant convention. However, the management fees that qualify for the benefits of the headquarters company regime would be denied benefits under paragraph 3 because those management fees would not be subject to tax in State R, after application of the exclusion in State R's domestic law. Similarly, the receipt by a taxpayer of special benefits with respect to domestic-source income will not affect the taxpayer's entitlement to treaty benefit with respect to foreign-source income that is not eligible for the same benefits.

[17.] A [XX minority] of Members agree that the determination of subdivision (b)(ii) should apply separately with respect to each item of income, but believe that it is difficult

[2] See, for example, paragraph 15 of the Commentary on Article 10 of the UN Model, quoting paragraphs 12 to 12.7 of the Commentary on Article 10 of the OECD Model.

to align the extraordinary deductions or other tax incentives with a specific item of foreign income. They therefore believe that the application of subdivision (b)(ii) will give rise to uncertainty and disputes in practice and suggest that subdivision (b)(ii) should not apply in the case of tax incentives that are implemented through a taxpayer's costs or expenditures.

[18.] The UN Model leaves the determination of the minimum level of taxation to be established through bilateral negotiations. While setting the minimum rate, countries should try to balance, on the one hand, providing for fair taxation by the source State with, on the other hand, the need to avoid excessive taxation, taking into account reasonable profitability margins. They may also want to consider how to take into account graduated rates, if any, provided in their domestic law for individual and corporate taxpayers with relatively low amounts of income.

[19.] Because paragraph 3 authorizes the imposition of tax by the source State in the circumstances described, such taxation is "in accordance with" the treaty, so the residence State would be required to provide relief under the terms of Article 23. In that connection, Subdivision 3(b)(ii) does not apply when the tax paid in a residence State would exceed the threshold rate but is reduced below that rate by a credit that is required by the terms of the treaty with the source State. For example, the tax treaty between State S and State R provides for a maximum source State tax on interest of 8%. State R imposes a final tax of 15% on investment income (less than the corporate rate of 20% but more than the 10% rate provided in paragraph (3)). A State S company pays 100x in interest to a State R resident and collects 8x of withholding tax, which it pays to State S. State R would impose tax of 15x, but under Article 23 of the State S-State R treaty, provides a credit for the 8x State S tax, so that the total tax paid to State R is 7x. This credit does not trigger the application of paragraph (3).

[20.] Countries therefore should consider the combined tax that would be imposed by the source State and the residence State after application of the rule and the relief of double taxation provisions of Article 23. In cases where the residence State exempts the income entirely, the application of Article 23 is straightforward. However, in cases where the relevant income is taxed in the residence State, but at a lower level, imposition of full domestic taxation by the source State may not result in the shared taxing right anticipated in the negotiation of a withholding rate, for example. For this reason, some Members of the Committee believe that there should be a cap on the tax that can be imposed by the source state. The following language could be adopted to implement such a cap:

> 3. (a) If income arising in a Contracting State and derived by a resident of the other Contracting State is subject to a low level of taxation in that other State within the meaning of subparagraph (b), that income may be taxed by the State in which the income arises under its domestic law, except that, if the resident of the other Contracting State is also the beneficial owner of the income, the tax so charged shall not exceed ___ per cent of the gross amount of the income paid to that resident of the other Contracting State.

[21.] Some countries may want to reflect the fact that they have significant subnational income taxes in drafting the provisions. For example, it may be appropriate to agree to a lower minimum rate, if the rate takes into account only taxes imposed at the federal level. Alternatively, subdivision (i) could specifically refer to subnational taxes:

(i) it is subject to a combined statutory tax rate of ___ per cent [the percentage is to be established through bilateral negotiations] or less, taking into account income taxes imposed by their political subdivisions and local authorities; or

[22.] Paragraph 3 applies no matter what circumstances led to its conditions being met (unlike paragraph 4 of Article 23 Alternative A, which addresses double non-taxation from the perspective of the resident State, but only when such double non-taxation results from a conflict of qualification[3]). It also applies to any legislation, regulation or administrative practice (including a ruling practice) that exists before or comes into effect after the treaty is signed. A [XX minority of Members] believe, however, that the provision should provide more certainty to taxpayers and therefore should be limited to situations where the two Contracting States have agreed that the conditions of subparagraph (b) have been met. Countries that share that view may want to include additional language to that effect along the following lines:

(d) This paragraph shall not apply unless the Contracting States have identified, through an exchange of notes, an exemption, exclusion or reduction as falling within subdivision (b)(ii).

[23.] A number of Committee Members 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. All of those exemptions likely would fall within subparagraph (b) by reason of the application of subdivision (b)(ii). Accordingly, subparagraph (c) of paragraph 3 is a placeholder provision intended to remind treaty negotiators to discuss whether there are any exemptions, exclusions or reductions under the tax laws of the two Contracting States that might fall within the literal terms of subdivision (b)(ii) but where the two Contracting States agree that the result is not problematic. Those cases should be excluded from the application of the paragraph. In that regard, the wording of subdivision (iv) of the definition of "special tax regime" found in paragraph 144 of the Commentary on Article 1[4] may aid in the drafting of such exclusions.

[24.] Many countries relieve double taxation of their residents by exempting from taxation the business income earned in their foreign branches or permanent establishments. The possibility that such exemptions for foreign branch profits could produce inappropriate results is already addressed in paragraph 8 of Article 29. Accordingly, if that paragraph is included in the relevant bilateral treaty, it would be appropriate for subparagraph (c) to exclude from the operation of paragraph 3 income earned through exempt foreign branches and permanent establishments.

[25.] The Commentary on Article 18 sets out a number of options that countries should consider when negotiating the pension provisions of bilateral tax treaties. In doing so, they should also consider the application of paragraph 3 and whether any additional exclusion should be added to paragraph (c) in order to achieve an equitable result.

[26.] Consideration should be given to how the rule would be implemented in the context of each country's general approach to providing treaty relief. Paragraph 149 of the

[3] See paragraph 19 of the Commentary on Article 23 Alternative A of the UN Model.
[4] Quoting paragraph 86 of the Commentary on Article 1 of the OECD Model.

> Commentary on Article 1 of the UN Model, quoting paragraph 109 of the Commentary on Article 1 of the OECD Model, expresses a strong preference for providing relief at the time payment is made in order to ensure "expeditious implementation of taxpayers' benefits". It further suggests that a refund method should only be used in the case of "observable difficulties in identifying entitlement to treaty benefits". Some of the information necessary to determine whether subdivision (b)(ii) applies will not be available until after the end of the taxable year in which a payment is made. Countries that provide treaty relief at the time payment is made should consider whether it is possible to maintain normal withholding and relief operations, and to apply paragraph 3 to collect additional tax on an *ex post* basis when the relevant information becomes available. The delay in availability of relevant information may also affect countries that require a withholding tax to be collected at the time a payment is made and then provide treaty relief through a refund mechanism.

8. The inclusion of paragraph 3 may require some consequential changes to portions of the Commentary on Article 1 dealing with various anti-abuse rules. Any such changes will be submitted to the Committee at a future session, after the parameters of the subject-to-tax rule are agreed.

IV. Application of the Subject-to-Tax Rule to Taxation of Capital

9. The Subcommittee also considered whether the rule of paragraph (3) should apply with respect to capital taxes in addition to taxes on income. It concluded that modifying paragraph (3) to apply to both income and capital taxes would be too cumbersome. However, it concluded that it would be useful to refer to the possibility of including such a rule in the Commentary on Article 22. A new paragraph could be added after paragraph 3, which includes a long quotation from the Commentary on the OECD Model, which could read:

> 4. Countries may be concerned about giving up their taxing rights by using the wording of paragraph 4, placed within brackets, in cases where there is no or low taxation of such capital in the other Contracting State. If that other State does not impose capital taxes at all, it may be appropriate not to include Article 22 in the treaty. However, if both Contracting States do impose capital taxes, but provide different exemptions or exclusions, countries may want to consider including in Article 22 a rule similar to that of paragraph (3) of Article 1, which addresses the issue in the case of taxes on income.

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

10. The Subcommittee had requested guidance regarding whether to proceed with the development of a subject-to-tax rule that would apply when the residence State has agreed to exempt income but the source State failed to exercise its right to tax. As described above, the focus of the discussion during the Committee session was on the application of a subject-to-tax rule by the source State. Accordingly, the Subcommittee proposes to discontinue work on this topic, although it may come back to it if it becomes aware of specific problematic cases that are not addressed by paragraph 4 of Article 23 Alternative A.

V. Questions for the Committee

11. The Committee is asked to discuss and approve the Subcommittee's draft text in paragraphs 5, 7 and 9 hereof. It is also asked to confirm the Subcommittee's proposal to discontinue work on the application of subject-to-tax rules by the residence State, as described in paragraph 10.