

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



United Nations

Department of Economic and Social Affairs
Division for Public Administration and Development Management

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Notes

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The designations “developed” and “developing” economies are intended for statistical convenience and do not necessarily imply a judgment about the stage reached by a particular country or area in the development process.

The term “country” as used in the text of this publication also refers, as appropriate, to territories or areas.

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FOREWORD

The United Nations, since its inception in 1945, and its forerunner, the League of Nations since the 1920s, have endeavoured to tackle the question of avoidance of double taxation through the preparation of model conventions, which have been found very useful by both developed and developing countries. Initially, the United Nations had published the *United Nations Model Double Taxation Convention between Developed and Developing Countries* in 1980 and its companion publication the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* in 1979. In view of the structural changes which have taken place in the international economic, financial and fiscal environment in the last two decades, it was considered necessary to revise both the United Nations Model Convention and the Manual.

The revised edition of the United Nations Model Convention was recently published in June 2001 and I am pleased to present the revised version of the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*. While the United Nations Model Convention is the basic document containing the model articles and the authentic commentary thereon, the Manual is primarily meant as a training material explaining the process and purpose of negotiation of bilateral tax treaties, as well as the fundamentals of international taxation and international tax evasion and avoidance. We hope that this publication will be found to be of particular interest to tax administrators and bilateral tax treaty negotiators from developing countries and countries with economies in transition.

I wish to express my deep appreciation and gratitude to the participants of the Tenth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters who made many useful comments and suggestions to enhance the practical and functional utility of the revised version of the Manual. I must specifically recognize the contributions of Ms. Iraci Kahan (Brazil), and Messrs. Antonio Hugo Figueroa (Argentina), Zhang Zhiyong (China), Abdoulaye Camara (Cote d'Ivoire), Talat Hommam Mohamed Badr (Egypt), Paul Perpere (France), Mercellin-Edgard Mebalet (Gabon), Wolfgang K.A. Lasars (Germany), O.P. Srivastava (India), Mayun Winangun (Indonesia), Mayer Gabay (Israel), Errol Hudson (Jamaica), Armando Lara Yaffar (Mexico), Nouredine Bensouda (Morocco), Pieter J. Vogelaar (The Netherlands), J.A. Arogundade (Nigeria), Riaz Ahmad Malik (Pakistan), Babou Ngom (Senegal), Jose Antonio Bustos (Spain), Daniel Luthi (Switzerland) and Michael Waters (UK). I would be remiss if I did not mention here the important contribution of DESA's staff and consultants, namely, Messrs. Abdel Hamid Bouab, Suresh Shende, Masakatsu Ohyama, Walter Hellerstein and Michael McIntyre.

The Monterrey Consensus has highlighted the importance of international tax cooperation and of dialogue among national tax authorities. It is hoped that the Manual will become an important tool to achieve those objectives.

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INTRODUCTION

1. This Manual provides a detailed introduction to the issues addressed in the United Nations Model Double Taxation Convention between Developed and Developing Countries as revised in 2001. The goal of the Manual is to assist developing countries and economies in transition to negotiate tax treaties among themselves and with developed countries. The first edition of this Manual was published in 1979, which will be of interest to those wishing to study more deeply the history of double taxation avoidance agreements.

2. The Manual as revised consists of three parts. Part One contains an analytical and historical overview of international double taxation and tax avoidance and evasion. Part Two contains in consolidated form the guidelines formulated by the Group of Experts. Part Three contains suggestions relating to procedural aspects of tax treaty negotiations and to the application of the guidelines. The Annex to the Manual reproduces the texts of the following model treaties: (1) the Model Bilateral Convention for the Prevention of the Double Taxation of Income (Mexico Draft, 1943); (2) the Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property (London Draft, 1946); (3) the Model Convention for the Avoidance of Double Taxation Between Member Countries and Other Countries Outside the Andean Sub-region (Andean Model); (4) the OECD Model Convention on Income and on Capital (OECD Model, 2000); (5) the Convention on Mutual Administrative Assistance in Tax Matters (OECD and Council of Europe, 1988); and (6) the United Nations Model in Practice.

3. The twin goals of a tax treaty¹ are firstly, to encourage economic growth by mitigating international double taxation and other barriers to cross-border trade and investment, and secondly, to improve tax administration in the two Contracting States by reducing opportunities for international tax evasion.

4. Economic development is a high priority in most developing countries. Many developing countries seek to achieve greater levels of development by participating fully in the global economy. That is, they have opened their borders to a free flow of trade and investment capital. For that strategy to succeed, developing countries must be able to attract foreign capital. A bilateral tax treaty can make a developing country a more attractive investment location by removing tax barriers to investment, including international double taxation. In addition, a bilateral tax treaty can provide an avenue for resolving tax disputes, and can reduce uncertainties about the tax regime the investor will confront. A tax treaty can provide a positive tax incentive for investment in a developing country by residents of a developed country.

5. International tax evasion undermines a country's tax policy by preventing that policy from being implemented. If taxpayers learn that they can successfully evade taxes with impunity, they are far less likely to conform their conduct to the requirements of the tax laws. All countries taxing worldwide income encounter serious problems in collecting the proper income tax on profits derived

¹ The terms "treaty" or "convention" are used in this Manual interchangeably. See Vienna Convention on the Law of Treaties of 23 May 1969, art. 2(1)(a): "treaty" means an international agreement concluded between States in written form and governed by international law... whatever its particular designation. The formal name of a tax treaty typically is "Convention" or "Agreement".

outside their borders. Those problems tend to be particularly acute in developing countries, however, because their tax administrations frequently are ill equipped to monitor foreign transactions. In addition, the consequences of international tax evasion can be acute in a developing country because that evasion is often accompanied by a loss of badly needed investment capital and foreign exchange reserves. Bilateral tax treaties help reduce the risk of international tax evasion by providing a framework for cooperation between the tax authorities of the Contracting States.

6. In recent years the rapid increase in electronic commerce further illustrates the need for cooperation among governments on tax matters. E-commerce takes place across national borders without the usual border checks that accompany traditional commerce. A residence country, acting alone, may not be able to effectively tax income derived from e-commerce, partly due to lack of information on what has occurred at the source country and partly from the ease with which profits from many forms of e-commerce can be shifted to a tax haven. The source country also may have difficulty in taxing e-commerce income, partly from administrative difficulties and partly from the tendency of income taxes imposed at source to operate as excise taxes on the purchaser. Acting in concert, however, residence countries and source countries should be able to develop viable approaches to the taxation of e-commerce.

7. Many multinational enterprises (MNEs) undertake integrated production activities in several countries. Where they place a particular operation is quite often based on business considerations unrelated to taxation. Various studies have highlighted the significance of non-tax factors in the selection of an appropriate location, such as, the availability of natural resources or of a workforce in the required numbers and with the requisite skills, access to markets, economic and political stability, the legal and regulatory framework, the necessary infrastructure, etc. In some cases, however, the MNE may determine that it can satisfy its business requirements in more than one country. In such cases, it is likely to attempt to reduce the aggregate tax liability of its corporate group by locating operations in a country where the statutory tax rates are low or where generous tax concessions or incentives are offered. The competitive advantage that a country gets from offering tax concession may be short lived. Other countries seeking to compete for foreign investment may feel compelled to offer a comparable package of tax concessions. The result may ultimately work to their collective disadvantage. The countries with the greatest need of investment capital are likely to suffer, for they will experience the detriments of granting tax incentives without attracting significant new foreign investment.

8. For many centuries, individuals have derived substantial incomes from investments or from business or professional activities carried out in foreign countries. The number of people engaging in these activities has increased exponentially in recent years, due to reduced costs of travel, technological advances in communications and in the transfer of funds, and more convenient and less expensive institutional arrangements for holding assets abroad. Many individuals holding foreign investment assets are tempted to under-report their income from those assets, in the firm conviction that their national tax administration does not have the ability to find them out. In many cases, the assets are held in a tax haven — a country or territory that has little or no taxes. Many tax havens cater to tax evaders by providing them, *inter alia*, with effective immunity from discovery of their banking transactions. Many hedge funds, investment funds, and mutual funds have established their residence in a tax haven country that offers such immunity from discovery. The total deposits

reported by some of the tax haven countries far exceed their GDP and are disproportionately large compared to their economies and the number of their inhabitants.

9. The advent of new and innovative financial instruments, such as derivatives and similar financial products, has created complex problems for tax administrations and increased the possibility of harmful tax competition. It is becoming increasingly difficult for governments to trace the income generated by these financial instruments, to determine the location or the source thereof, and to identify the taxpayer who has earned the income. Very few attempts have been made to crystallize the legal position concerning the taxation of income attributable to new financial instruments. In the taxation of income derived from these financial products, tax policies are lagging behind technical developments. As financial markets become increasingly integrated and complex, and as capital movements intensify, national tax administrations cannot keep pace with these issues in a comprehensive manner. The daily transfers of these derivative financial products are measured in the trillions of United States dollars, and their total value exceeds the total gross domestic product of the entire world. In most cases, these capital movements do not leave a trace in terms of an actual movement of money. As a result, a tax department would have extreme difficulty in determining the taxable income associated with these capital movements and in allocating that income to specific countries.

Avoidance of double taxation

10. The conclusion of bilateral tax treaties for the prevention or elimination of double taxation has emerged since the 1960s as a salient feature of inter-State economic relations. In fact, double tax conventions are now the established way for States to agree at the international level on the resolution of double taxation problems that arise in levying personal and corporate income taxes on cross-border activities of their residents and nationals. There have been some attempts to move away from a regime of bilateral tax conventions to one of multilateral conventions. They have had only partial success, the most successful being the Nordic agreements involving Denmark, Finland, Iceland, Norway, Sweden and the Faeroe Islands. The multinational agreements have normally followed the patterns of bilateral double tax conventions and are, to some extent, a technique for achieving uniform bilateral agreements between members of the participating group.

11. Each convention is a compromise between the internal laws of the two Contracting States that are parties to the convention. These individual compromises have come to take standard forms. The OECD model treaty has been the basis for virtually all tax treaties between developed countries since it was first published in draft form in 1963 and finally published as the OECD Model Double Taxation Convention on Income and on Capital in 1977. The OECD model tax convention is not concerned, however, with the way in which each of the Contracting States puts the obligations of a convention into effect.² Similarly, most double tax conventions are silent about how the Contracting States will give effect to them. This is an issue for the internal (constitutional) law of each State. Under the constitutions of some States, treaties come into force directly, whereas in other States additional legislation is needed. That legislation is required so that individual taxpayers may benefit from, or be directly subject to, the provisions of the conventions of which their State is a party.

² International Fiscal Association (1998): "Practical Issues in the Application of Double Tax Conventions" 1998 London Congress; Vol. LXXXIII b, page 23.

12. The domestic legislation of many developed countries provides unilateral relief from double taxation. However, unilateral double tax relief by the investor's country sometimes frustrates developing countries' aim of providing the foreign investor with tax benefits. When the double tax relief provided by a developed country entails only a reduction in that country's tax equal to the foreign tax actually paid, any relief given by a developing country with regard to profits currently taxed in a developed country may result (depending on the taxpayer's circumstances) in an increase in the developed country's tax. In the end, it is as though the treasury of the developing country transferred the amount of the tax it has forgone to the treasury of the developed country. The foreign investor pays the same amount of tax but pays more to the developed country and less to the developing country. Many tax treaties between developed and developing countries address this issue through the practice known as "tax-sparing credits". Under a tax-sparing provision, the developed country typically agrees to allow its foreign investors in the developing country to claim a tax credit for the amount of taxes that they would have paid but for the tax concession granted by the developing country. The United States is the only developed country that does not provide tax sparing in any of its tax treaties. Despite its popularity in some quarters, the practice of granting tax-sparing credits is controversial, due to disagreements over its effectiveness, its benefits relative to costs, its impact on tax competition, its effect on tax equity and the potential for encouraging tax avoidance.

13. Experience has shown that unilateral measures may not be fully adequate to eliminate or alleviate the effects of double taxation. This inadequacy stems from the diversity of tax systems, which, in turn, originates from differences among countries in legal and tax history, fiscal policy, revenue needs, and the level of compliance and enforcement. These differences are reflected in the approach that a country takes to the promotion of foreign investment, the characterization and computation of taxable income, and the various methods used for allocating income to domestic and foreign sources. As a result of the growing complexity of tax systems and the multiplicity of taxes levied, it has become increasingly difficult to provide fully effective relief from international double taxation through the unilateral approach.

14. Bilateral tax treaties can solve many double taxation problems by reconciling differences in the concepts of various types of income and their geographical source, establishing a common method of determining how certain items of income shall be classified and taxed, and either assigning exclusive tax jurisdiction over certain items of income to one of the treaty countries or dividing the tax revenue between the two countries when neither is willing to relinquish its claim entirely. Furthermore, in many cases, capital-exporting countries have granted relief under bilateral treaties in forms that they are not prepared to extend indiscriminately by statute. For example, some capital-exporting countries, whose internal legislation provides no significant relief from double taxation or provides relief essentially through the credit method, have agreed under bilateral treaties to exempt from taxation income generated in the other treaty countries or to tax such income at a reduced rate. Conversely, capital-importing countries may grant considerably more far-reaching tax relief under a treaty than that available to investors residing in non-treaty countries. Tax treaties thus permit a degree of mutual accommodation that is not possible under the much less flexible statutory schemes applying to transactions with all countries in general. Additional benefits of such treaties, and of the orderly international tax relationships created by them, are the exchange of fiscal information and procedures for mutual assistance among the Contracting States and the customary

non-discriminatory clause of the treaties, which puts local businesses owned by foreign investors on an equal footing with local businesses owned by local investors.

15. Bilateral tax treaties have been negotiated in the light of various monetary, fiscal, social and other policies important to the negotiating parties. Conclusion of a treaty between two developed countries is facilitated by their approximately similar levels of development, so that the reciprocal flows of trade and investment — and hence the respective gain or loss of revenue to the parties from reducing taxes on those flows — have been relatively equal in magnitude. The presumption of equal reciprocal advantages and sacrifices underlying treaties between developed countries is not valid when the negotiating parties are at vastly different stages of economic development. In addition, a loss of revenue that may be of relatively minor importance to a developed country can constitute a heavy sacrifice for a developing country. For many developing countries, the scarcity of foreign exchange resulting from outflows of tax-exempt locally produced income may be of even greater importance than the loss of revenue. Consequently, developing countries have, generally speaking, been reluctant to enter into tax treaties under which their tax revenue from locally produced income and their foreign exchange reserves might be reduced, unless they can reasonably assume that the treaties will ensure that those detriments are likely to be offset by benefits flowing from the treaty.

PART ONE

**ANALYTICAL AND HISTORICAL REVIEW OF
INTERNATIONAL DOUBLE TAXATION AND
TAX EVASION AND AVOIDANCE**

I. INTERNATIONAL DOUBLE TAXATION

A. Concepts and issues

1. The jurisdiction to impose income tax is based either on the relationship of the income (tax object) to the taxing state (commonly known as the source or *situs* principle) or the relationship of the taxpayer (tax subject) to the taxing state based on residence or nationality. Under the source principle, a State's claim to tax income is based on the State's relationship to that income. For example, a State would invoke the source principle to tax income derived from the extraction of mineral deposits located within its territorial boundaries. Source taxation is generally justified on the ground that the State has contributed to the creation of the economic opportunities that allow the taxpayer to derive income generated within the territorial borders of the State. Of course, jurisdiction to tax is also about power, and a State generally has the power to tax income if the assets and activities that generated it are located within its borders.

2. Income itself does not have a geographical location. It is a quantity, calculated by adding and subtracting various other quantities in accordance with certain accounting rules. By long standing convention, however, income is assigned a geographical location by reference to the location of the assets and activities that are used to generate the income. When all of those assets and activities are located in one State, that State may be considered to be the unambiguous source of the income. For example, wages paid to an employee stationed in a State that represent compensation exclusively for work performed in that State would have a source exclusively in that State. When some of the assets or activities generating income are located in more than one State, the source of the income is less clear. For example, business profits derived from the manufacture of goods in State A and their sale in State B have a significant relationship to State A and to State B. In these circumstances, some rules for determining source are needed. Those source rules might apportion the income between the two claimant States, or they may assign it to one State exclusively. In some cases, States may adopt inconsistent source rules that result in both States exercising source jurisdiction over the same item of income.

3. Under the residence principle, a State's claim to tax income is based on its relationship to the person deriving that income. For example, a State would invoke the residence principle to tax wages earned by a resident of that State without reference to the place where the wages were earned. In general, a State invokes the residence principle to impose tax on the worldwide income of its residents. Basing the tax on the taxpayer's overall capacity to pay, without reference to the source of income, is consistent with most theories of distributive justice. Whatever the theory, a State cannot tax the worldwide income of its residents unless in practice it has the power to do so. A State typically has some degree of power to compel tax payments from its residents, but only if it has reliable information about the amount of income they have earned. Bilateral tax treaties containing appropriate exchange of information provisions or a multilateral agreement on exchange of information for tax purposes may assist a State in determining the foreign source income of its residents. A bilateral or multilateral treaty with an assistance-in-collection provision may also be helpful to a State in collecting taxes due with respect to foreign-source income.

4. The reach of a State's residence jurisdiction depends on how a taxpayer's residency is determined. Physical presence in a State for an extended period is an important indicator of

residence. Some States also determine residency of an individual by reference to a variety of other indicators of allegiance to the State, such as the location of the individual's abode, his family, and his fiscal interests. In other States, physical presence in the State 183 days of the year is enough to establish residence for that year. Conflicts in residency rules can result in an individual being a dual resident — that is, a resident of two different States. Tax treaties generally do an excellent job at resolving problems of double taxation resulting from conflicting residence rules.

5. When income is derived within a State by a resident of that State, both the source principle and the residence principle can be invoked to support a tax on that income. A State can invoke only the source principle to tax income derived within its territorial boundaries by a non-resident. It can invoke only the residence principle to tax income derived by a resident from activities conducted outside the State's territorial boundaries. Most States utilize both the residence principle and the source principle. All States utilize the source principle.

6. A few States tax on the basis of the source principle alone (so-called territorial system).³ The number of States using a territorial system has diminished, because countries have recognized that the failure to tax residents on income derived from foreign activities undermines the fairness of the tax system and provides residents with a tax incentive to invest abroad. Such an incentive is almost certainly contrary to the national interests of a State in need of capital for domestic investment. Nevertheless, if only a tiny percentage of the population of a State derives any foreign source income, the residence principle may have little practical importance to that State.

7. States that invoke only the source principle are typically concerned about the ability of their tax department to determine the amount of foreign source income derived by their residents. In some cases, an exemption for foreign source income can complicate tax administration, due, for example, to legal disputes that may arise over the source of particular items of income or to the difficulties the tax administration may encounter in determining whether a deduction claimed by a taxpayer properly relates to domestic or foreign income. In some cases, a State exercising only source jurisdiction may be tempted to adopt source rules that may conflict with the source rules of other countries in order to tax income that does not present them with significant enforcement problems. They may be inclined, for example, to treat the income of government employees earned abroad as domestic source income.

8. A few States consider nationality as establishing a sufficient relationship between the taxpayer and the taxing State to justify taxation on worldwide income. Because it is based on the connection of the tax subject to the taxing State, this principle is best understood as a variation on the residence principle. The overwhelming majority of citizens of a State are also residents of that State. As a result, residence jurisdiction and nationality jurisdiction overlap considerably. The United States of America is the only State where tax jurisdiction based on nationality is important, although a few other States, including Bulgaria, Mexico and the Philippines, have used citizenship as a basis for taxation in the past. The United States of America generally does not tax its citizens

³ Taxing jurisdictions continuing to use the territorial system include: Bolivia, Costa Rica, El Salvador, Guatemala, Hong Kong SAR, Kenya, Malaysia, Nicaragua, Panama, Paraguay, Singapore and Uruguay.

on foreign earnings below a high threshold amount if they have established a foreign residence. Many countries take an individual's citizenship into account in determining whether that person is a resident. Tax treaties, including Article 4.2.c of the United Nations Model Double Taxation Convention between Developed and Developing Countries, use citizenship as a tie-breaker in resolving problems of dual residency.

9. The jurisdictional principle based on the tax object (source, *situs*) and tax subject (residence, nationality) were developed initially for individuals in the context of the personal income tax. States also invoke those principles, at least by analogy, in asserting the right to tax juridical persons or other entities, such as corporations and trusts. All States invoke the source principle in taxing corporations and other taxable legal entities. Many States also invoke an adapted version of the residence or nationality principle to tax certain corporations and other legal entities on their worldwide income. A corporation taxable by a State on its worldwide income is sometimes referred to as a domestic corporation.

10. Some States determine the residence or nationality of a corporation based on its place of incorporation.⁴ Other States determine the residence of a corporation by reference to its place of management.⁵ As a practical matter, most States using a place of management test employ some objective standard, such as the place where the board of directors meet, to determine place of management. Otherwise, the place of management would be indeterminate in many important situations. Some States use both a place-of-incorporation test and a place-of-management test.⁶ A corporation that is subject to tax on its worldwide income may be able to avoid taxation on foreign-source income by creating an affiliated foreign corporation and arranging for that affiliated corporation to earn the foreign-source income it otherwise would have earned. Most developed countries and some developing countries have adopted rules to tax their domestic companies on certain categories of income deflected to a foreign affiliated corporation for tax avoidance purposes.

1. The concept of international double taxation

11. International double taxation, narrowly defined, occurs when two States impose a comparable income tax with respect to the same item of income on the same taxable person. The concept has been defined more broadly, but with less precision, as the result of overlapping tax claims of two or more States.⁷ The concept of international double taxation that bilateral tax treaties seek to remove is broader than the narrow definition. It includes some types of economic double taxation — that is, taxation that has the effect of imposing multiple burdens with respect to the same item of income whether or not the income item is formally subject to multiple levels of taxation. For example, many tax treaties operate to provide tax relief to a corporate group when a State has imposed an income tax on profits earned by a subsidiary corporation and another State otherwise

⁴ e.g., United States of America, Sweden, France.

⁵ e.g., United Kingdom (before 1988).

⁶ e.g., United Kingdom (since 1988), Canada, Australia, Germany, The Netherlands.

⁷ International Fiscal Association: The Revised OECD Model Double Taxation Convention on Income and Capital: Proceedings of a Seminar held in Vienna in 1977 during the Thirty-first Congress of the International Fiscal Association, Introduction by Dr. M. Widmer, page 9.

would impose an income tax on its parent corporation when those profits are distributed as a dividend. In general, tax treaties attempt to eliminate most forms of international double taxation, narrowly defined, and various other forms of international double taxation when a failure to do so would have a demonstrably harmful impact on international trade and investment.

12. A major goal of bilateral tax treaties is to remove impediments to international trade and investment by reducing the threat of double taxation that can occur when both Contracting States impose tax on the same income. This goal is advanced in four distinct ways. First, a bilateral tax treaty generally increases the extent to which exporters residing in one Contracting State can engage in trading activity in the other Contracting State without attracting tax liability in that latter State. Second, when a resident of a Contracting State does engage in a sufficient activity in the other Contracting State for that State to have the right to tax, the treaty establishes certain guidelines on how that income is to be taxed. For example, those guidelines may assign to one Contracting State or the other the primary right of taxation with respect to particular categories of income. They may, in certain cases, provide for the allowance of deductions in measuring the amount of income subject to tax. They may require a reduction in the withholding taxes otherwise imposed by a Contracting State on payments made to a resident of the other Contracting State. Third, a bilateral tax treaty provides a dispute resolution mechanism that the Contracting States may invoke to relieve double taxation in particular circumstances not dealt with explicitly under the treaty. Fourth, where income or gains remain in principle taxable in both Contracting States, the State of residence of the taxpayer will relieve the double taxation that results either by allowing a credit for the tax paid in the other State or by exempting the income or gain from its own tax in practice.

13. Although a State may address the issue of double taxation unilaterally through domestic tax laws, it typically cannot achieve unilaterally many of the goals of a bilateral tax treaty. Domestic legislation is a unilateral act by a State. Such a unilateral act can reduce or eliminate double taxation only if the State is prepared to bear all of the financial cost of granting that relief. A bilateral tax treaty, by definition, is a joint act of two Contracting States, typically resulting from some negotiations. In that context, the financial costs of relieving double taxation can be shared in a manner acceptable to the parties. In particular, the domestic legislation of a State typically addresses tax issues without reference to the particular relationship that the State may have with another State. In a bilateral tax treaty, that relationship can be taken into account explicitly and appropriately. For example, a State may use a bilateral tax treaty to fashion a particular remedy for double taxation when the flows of trade and investment with the other Contracting State are in balance. It may adopt a different remedy, however, when the trade and investment flows favour one State or the other.

14. Bilateral tax treaties help to reduce the risk of double taxation by establishing the minimum level of economic activity that a resident of one Contracting State must engage in within the other State before the latter State may tax the resulting business profits. The bilateral tax treaty lays out ground rules providing that one State or the other, but not both, will have primary taxing jurisdiction over income derived from the branch operations in one Contracting State by a corporation that is resident in the other Contracting State. Similarly, the treaty may specify which Contracting State may tax income derived from the performance of services in one Contracting State by an individual who is a resident in the other Contracting State. In general terms, the tax treaty may assign primary (but not exclusive) jurisdiction to tax to the Contracting State in which the economic activities occur

if those activities have substance and continuity that exceed some threshold level. When the economic penetration is relatively minor, however, exclusive jurisdiction to tax may be assigned to the Contracting State where the corporation or individual is a resident.

15. The scope of a bilateral tax treaty typically is not limited to commercial and business activities. Treaties may remove tax impediments to desirable scientific, educational, cultural, artistic and athletic interchanges. In addition, a treaty may address issues arising in the tax treatment of pension plans and Social Security benefits, of contributions to charitable organizations, of scholarships and stipends paid to visiting scholars, researchers, and students, and even of alimony and child support payments.

16. A bilateral tax treaty cannot anticipate every income tax issue that is likely to arise between Contracting States. Some issues, such as issues relating to the growth of electronic commerce, are difficult to address currently by tax treaty because the international community has not yet reached a consensus on the appropriate standard for taxation. The international community generally recognizes that the current treaty rules relating to the definition of a permanent establishment were based on premises about how commerce is conducted that may not hold for electronic commerce. What is not yet well understood is the changes, if any, that the development of electronic commerce will require in the treaty definition of a permanent establishment. To deal with such emerging issues, the parties to a bilateral tax treaty may wish to agree to consult on those issues within a stipulated period after the treaty enters into force. The length of the period with respect to a particular issue might be chosen so as to allow time for an international standard on that issue to emerge, for example, from the Organization for Economic Cooperation and Development (OECD).

17. The typical tax treaty provides a mechanism enabling the tax authorities of the two States to adopt ad hoc rules to eliminate double taxation when it occurs. In tax treaty parlance, the tax authorities responsible for negotiating a solution to particular cases of double taxation are the Competent Authorities. Each Contracting State appoints one or more Competent Authority in accordance with its domestic laws. The Competent Authorities are particularly useful in relieving double taxation that occurs because the States do not agree on the facts underlying the imposition of their taxes. States may disagree, for example, on whether a particular deduction claimed by a taxpayer relates to income earned in one or the other Contracting State. In some cases, the factual dispute might arise because the taxpayer himself took inconsistent positions on the tax returns filed in the two countries as part of a plan to minimize its taxes. In many cases, the potential for double taxation arises because States do not agree on how prices should be established on transfers or other transactions between related persons.

18. A multinational enterprise, more than any other taxpayer, may be able to minimize its taxes in a State by manipulating the prices charged in transactions between its affiliates in different countries. Consider, for example, two related companies: Company A, resident in State A, and Company B, resident in State B. Company A manufactures goods in State A at a unit cost of 40, sells the goods to Company B, and Company B sells the goods to unrelated customers in State B at a unit price of 90. Under these conditions, the multinational enterprise has total unit profits of 50. The location of those profits depends on the price charged on the sale by Company A to Company B. If the sale is made at a price of 40, then all of the profits end up in Company B presumably taxable

in State B. If the price is set at 90, the profits end up exclusively in Company A presumably taxable in State A. At any sales price between 40 and 90, a portion of the profits will be taxable in both countries. Under these conditions, the multinational enterprise controls where the profits will be taxable, assuming that State A and State B do not have in place a set of rules to prevent transfer-pricing abuses. All other things being equal, the multinational enterprise would plan its transactions in such a way to ensure that its income is reported in the jurisdiction with the lowest effective tax rate. The prices set on transfers between related persons are referred to as transfer prices. The possibility that multinational corporations will systematically use transfer prices to avoid taxes has made transfer pricing one of the most important international tax issues.

19. To limit the potential for transfer-pricing abuses by multinational corporations, a State must include in its domestic tax legislation detailed rules on how prices are to be established on sales and other transactions with related persons. To develop such rules, it is necessary to establish a benchmark by which to evaluate the prices charged. The benchmark adopted by most developed and developing countries is the arm's length standard. Under the arm's length standard, the price charged to a related person should be similar to the price as it would have been had the parties to the transaction been unrelated to one another — in other words, similar as if they had bargained at arm's length.

20. In some cases, it is relatively easy to find benchmark prices to be used in estimating an arm's length price. For example, if the multinational corporation is selling a commodity that regularly trades on a commodity exchange, the prices on that exchange provide good evidence of the appropriate price. In other cases, an extensive analysis may be required to determine an appropriate arm's length price. This analysis requires an examination of the functions performed by the related persons, the resources employed, and the risks assumed by each party. For each task performed, the related person should be adequately compensated or remunerated in accordance with prevailing market prices for comparable tasks. This analysis may be performed in a variety of ways. If a State conducting such an analysis comes to a different set of conclusions than the multinational enterprise, it may determine that additional taxes are due. If that analysis is also conducted by another State where the multinational enterprise is conducting business, that State may also reach a set of conclusions that differ from those reached by the other State and by the multinational enterprise. In such circumstances, the risk of double taxation is quite real. One of the important functions of income tax treaties is to minimize that risk.

21. In many cases, multinational corporations engage in transactions with related parties that are not closely comparable to transactions conducted at arm's length by unrelated persons. In some cases, the transactions between related parties are highly specialized or involve unique intangibles. For example, assume that a pharmaceutical enterprise has developed a medical process that it is able to use in manufacturing a product it can sell for a high profit. A parent corporation may be prepared to license that process to a related subsidiary corporation, with the understanding that the subsidiary would not reduce the overall profits of the multinational enterprise by competing with its parent corporation in the same market. It is quite unlikely, however, that the parent corporation would give up its monopoly position by licensing the product to an unrelated corporation that would constitute a potential competitor. In such circumstances, a State probably would not be able to locate a comparable sale of comparable technology to an unrelated person. To prevent transfer-pricing

abuses, therefore, it must employ some pricing method that is not dependent on finding comparable sales of comparable products by unrelated persons. During the late 1980s and early 1990s, the tax authorities in the United States of America developed various pricing methods that were not dependent on finding such comparables. These methods included the use of multi-factor formulas and profit splits in appropriate cases. Most of these methods make reference to the overall profitability of unrelated persons performing comparable functions. They do not, however, depend on finding comparable transactions. The United States' methods, promulgated by regulation in 1994, were developed in consultation with the OECD. The profit split methods, however, were found to be acceptable only as a method of last resort.

22. Traditional arm's length pricing methods are quite often ineffective in determining arm's length prices in highly integrated industries that do not exist in unintegrated form. Global securities trading is an example of such an industry. Many local firms do engage in securities trading. So-called 24-hour trading of securities, including innovative financial instruments such as derivatives, is conducted, however, only through integrated multinational financial firms. These firms have branch operations and affiliated companies all over the world. The profits earned by separate branches or affiliates depend heavily on the combined operations of the multinational firm and only partially on activities having a significant relationship to a particular geographical location. Traditional transactional methods work quite well for global trading in those instruments. The most global of all securities markets is the market for U.S. Treasury Bonds. Trading in physical securities is not at all integrated and results in commissions being paid. Those commissions are usually calculated on the basis of a comparable uncontrolled price (CUP) or a resale price or cost plus method. In this context, it may be nearly impossible to apply traditional pricing methods and traditional methods for determining the source of income.⁸ In 1998, the OECD published a paper on global trading that explored various ways of allocating and taxing the profits in each country where global trading is conducted. This publication describes the factual background to global trading and discusses a range of policy options to tackle the problems it presents to tax administrators.⁹ The OECD report suggests that those problems are becoming more common in other industries with the spread of globalization and the communications revolution.

23. Most multinational businesses having substantial operations in a State typically incorporate a separate affiliated corporation in that State. That separate entity is taxable by the State on its income. Tax treaties provide that the remaining part of the multinational enterprise is not taxable in that State because of its ownership of the domestic affiliate. If the domestic affiliate engages in transactions with the remaining part of the enterprise, its income is determined by application of the arm's length standard. In some cases, however, a multinational enterprise will operate in a country through a branch. This form of organization is commonly used by international banks and global trading corporations, due in part to the capital requirements that many States require such firms to meet. If the activities of a branch are substantial, as they typically would be for a bank or other financial services provider, the branch will constitute a permanent establishment of the multinational corporation of which it is a part. Under tax treaties, a taxpayer having a permanent establishment in

⁸ The United States does not, and never did, use formulary apportionment for global trading. The formulas used are intended to provide an arm's length allocation of income. Those who adopt and rely on formulary apportionment methods generally accept that they do not provide an arm's length allocation of income.

⁹ OECD: *The Taxation of Global Trading of Financial Instruments* (1998).

a State is taxable in that State on the income properly apportioned to the permanent establishment. The rules for determining the income of a permanent establishment, however, are far less developed than the rules applicable to affiliated corporations. Various governments and international organizations are now actively engaged in the development and refinement of the rules for taxing branches that constitute a permanent establishment.¹⁰ No consensus has yet emerged, however, on how profits should be attributed to a permanent establishment.

24. Tax treaties have traditionally provided only a general framework for determining the income of taxpayers. Each State provides its own rules for computing income in domestic legislation, and those rules prevail unless they are inconsistent with the framework provided in the applicable tax treaty. Treaties generally do contain some language dealing with the computation of branch profits of a permanent establishment. In general, a State agrees by treaty to allow a branch to take appropriate deductions, with some limitations, if that branch constitutes the permanent establishment of an enterprise of the other Contracting State. A State also agrees to determine the profits of a branch by reference to “the profits which it might be expected to make” if it were a separate entity dealing at arm’s length with unrelated persons.¹¹ In many cases, it is fairly easy to extrapolate from agreed rules for taxing affiliated companies to rules for taxing branches. In other cases, special problems arise. For example, assume that Company P manufactures goods in State A through a manufacturing branch and sells them in State B through a sales branch. Under these facts, should the sales branch be entitled to the profits that would have been earned by a commission agent or by a distributor? If Company P had organized the manufacturing branch and the sale branch as separate entities, those entities would have been required to specify the nature of their relationship. In operating through branches, however, Company P has no business need to specifying one form or the other. In addition, the form chosen typically would have no legal effect because Company P would bear any risk of loss no matter how the transactions were specified. For another example, assume that Company P owns a valuable trademark that it affixes to goods that it manufactures through its manufacturing branch in State A. If Company P sells those goods in State B through a sales branch, should the sales branch be required to pay an arm’s length price for the use of that trademark? The problem in assigning a charge for the trademark is that the trademark is owned as much by the sales branch as by any other part of Company P. If the sales branch is treated as the owner of the trademark, then a charge is inappropriate under an arm’s length standard. The UN Model treaty suggests that an imputed charge for the trademark would be inappropriate in these circumstances.¹²

25. Special problems arise in determining the appropriate interest expense attributable to a branch of a multinational bank or other financial intermediary. Banks generally earn their profits by borrowing money under a variety of circumstances and lending out that money to customers. The interest rates that multinational banks pay on their various loans may vary considerably. Some loans may be denominated in a depreciating currency and have a high nominal interest rate associated with them. The reverse situation may prevail with respect to loans denominated in an appreciating currency. Some loan funds are obtained at very low interest rates from customers making deposits

¹⁰ See, e.g., OECD, Discussion Draft on Attributing Profits to a Permanent Establishment.

¹¹ United Nations Model Double Taxation Convention between Developed and Developing Countries (2001), Art. 7(2).

¹² *op. cit.* Art. 7(3).

in a demand savings account or checking account. These customers may be compensated for the low rate, however, by the provision of financial services of substantial value. Loans may also be made at long-term, medium-term, and short-term rates. Some may have a high interest rate due to high risk, whereas other loans may have no risk premium. Some loans may have a low or nonexistent nominal interest rate but may have been made by issuing debt instruments at a deep discount. Due to the fungibility of capital, a linkage of a particular loan at a particular interest rate with lending activities in a particular geographical region may be difficult or even pointless.

26. There are two basic methods that might be employed to determine the appropriate interest expense of a branch of a multinational bank. One method would be to determine the actual interest expense incurred by the bank and then to allocate that expense among its many branches in accordance with their actual or deemed use of the bank's borrowed capital. The allocation might be done through some formula or through some mechanism that included tracing of borrowed funds to their particular use. For example, a formula might allocate all of the bank's debt and equity capital to the branches in proportion to their use of that capital in making loans to customers. The appropriate interest deduction would be determined by calculating the bank's average interest expense for all its loans, and treating that interest rate as the rate attributable to each loan.

27. A second method for calculating the branch profits of a bank would be to treat each branch as if it were a separate legal entity and then calculate its interest expense by reference to the interest expense that a separate entity would have incurred in engaging in comparable business activities. Numerous assumptions must be made in order to apply this second method. For example, assumptions must be made about the percentage of equity capital and loan capital that would be attributed to a branch, the currencies in which its loans would be denominated, the period over which its deemed loans had been made, the risks associated with those loans, the deemed entities from which the loans were made and so forth. Comparisons with comparable entities probably would not be possible because multinational banks normally operate through branches, not affiliated companies. A State's tax administration might develop guidelines for making all of the necessary assumptions, or it might accept the various assumptions made by the banks on their books of account. If the latter approach is taken, the expectation should be that the banks would be tempted to make assumptions that would minimize their tax liability. It may be relevant to mention that the OECD has done a great deal of work on this issue and has recently released a discussion draft regarding the proper attribution of profits to permanent establishments.

28. Not all the tax treaties that States have entered into provide explicitly that banks should be allowed to compute the profits of a branch by treating the branch as if it were a separate entity and taking an interest expense deduction for hypothetical interest payments to some assumed parent company with respect to a hypothetical loan for which it is not legally liable. (Special attention is

invited to the new U.S –U.K. tax treaty and specifically to the notes regarding the provisions of Article 7 thereof). Some commentators have asserted, however, that the right of banks to use a separate entity approach can be read into the language of Article 7(2) of the OECD and UN Model Conventions, which provide that “there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise.” This language does not necessarily support the position for which it is asserted. The simple fact is that “separate and distinct enterprises” do not make payments on hypothetical loans for which they have no legal liability. Another plausible reading of the above language is that the profits of a branch from transactions that actually occurred should be measured by reference to market prices.¹³

29. Double tax conventions are an established way for States to agree at the international level on a method for reducing or eliminating the risk of double taxation. Double taxation may occur for any of the following reasons:

- (a) Two States may tax a person (individual or company) on his world-wide income or capital because they have inconsistent definitions for determining residence. For example, a corporation may be treated by State A as its resident because it is incorporated therein, whereas State B may treat that corporation as its resident because it is managed therein. As another example, State A may treat an individual as its resident for a taxable year under its domestic tax rules because that individual was present in the State for 183 days during that year. That same individual may be treated as a resident of State B under its domestic laws because the individual has lived in that State for many years and maintains close financial and social ties to that State. Residence-residence conflicts can occur rather frequently with respect to corporations, unless a corporation has intentionally made itself a dual resident to obtain the benefit of a loss in more than one State.
- (b) One State may tax income derived by a person by application of the residence or nationality principle, whereas another State may tax that same income by application of the source principle. For example, Company A, a resident of State A, may earn income in State B from extensive activities therein. State A would tax Company A on its worldwide income, which would include the income earned in State B. State B would tax the income arising from the activities conducted within its territorial boundaries. A major objective of bilateral tax treaties is to provide for relief from such source- residence double taxation, typically by requiring the residence State either to give up its claim to tax or to make its claim subordinate to the claim of the source State.
- (c) Two States may invoke the source principle to tax the same item of income, due to conflicts in the way the source of income is determined under their domestic

¹³ In 1999, a United States court held that the tax treaty between the United States of America and the United Kingdom should be interpreted to provide for separate entity treatment of branches. See *National Westminster Bank v. United States*, 44 Fed. Cl. 120 (1999). For analysis of that case and related issues, see Michael J. McIntyre, *The International Income Tax Rules of the United States*, Lexis Publishing (2nd edition 2000) at § 4/B.1.2.

legislation. For example, the domestic tax laws of State A may provide that sales income of a non-resident corporation is taxable in that State if the sale was made through an office located in that State. In contrast, the tax laws of State B may tax income derived from sales by a non-resident corporation if the transfer of possession of the goods sold takes place within that State. Given this conflict in the tax rules of State A and State B, income derived from a sale made through an office located in State A for delivery in State B would be taxed in both States. Tax treaties may address cases of such source-source conflicts.

- (d) In some cases, a State may have a source-residence conflict with one State and a source-source conflict with another State. For example, assume that Company A is a corporation resident in State A. It has an office in State B and makes sales from that office into State C. Under their domestic laws, State A taxes income from those sales under the residence principle and State B and State C both tax that income under the source principle. A bilateral tax treaty between State A and State B is likely to solve the residence-source conflict but probably would not solve the source-source conflict. If State B and State C also have a bilateral tax treaty, however, the source-source conflict may also be solved.

2. Methods of relief from international double taxation

30. Two main methods, the exemption method and the credit method, have commonly been used to mitigate international double taxation. These methods may be applied on a unilateral basis, or within the framework of bilateral tax treaties.

(a) The exemption method

31. Under the exemption method, a State exempts from taxation certain items of income derived by its residents in another State. It may do so in accordance with its domestic legislation or by treaty. Domestic legislation typically would grant the exemption without reference to the State where the income is generated, whereas an exemption granted by treaty would be limited to treaty States. The typical effect of the exemption method is that the State where an item of income is generated, that is, the source State, has the exclusive right to tax that item of income. As a rule, exemptions granted to residents for foreign-source income are confined by statute or treaty to profits derived through foreign permanent establishments and income from real property situated abroad or wages earned abroad. The policy goal of this limitation is to confine the exemption to income that the source State would have jurisdiction to tax, although the source State may choose to exempt the income as an investment incentive.

32. Under a variation of the exemption method, called exemption with progression, a State exempts its residents on certain income arising in another State but requires the residents to take that income into account in applying the progressive rate schedule. Assume, for example, that R is a resident of State A. R earns wages of 800 in State A and 200 in State B. Under the rate schedule applicable in State A, income below 100 is taxed at 20 per cent and income above that amount is taxable at 30 per cent. State A is required, by treaty or domestic legislation, to exempt 100 of income. In determining the tax on the remaining 900 of income, however, it is permitted to tax 900 of income at 30 per cent, just as it would have done if all of R's income had been taxable. The effect

of exemption with progression is to take the exempt income into account in determining a resident's ability to pay but applying a zero tax rate to that income. The exemption with progression method has been used in many treaties, including treaties concluded by Austria, Belgium, Germany, Finland, France, Iceland, Luxembourg, The Netherlands, Spain and Switzerland.

33. States using the exemption method ordinarily do not extend the exemption to foreign dividends, interest and royalties. Many countries, however, grant special relief for domestic intercorporate dividends in order to eliminate or mitigate recurrent corporation taxation, first at the level of a subsidiary and then again at the level of the parent company. Some of these States, either by domestic law or by treaty, extend this special relief to dividends paid by a foreign subsidiary to a domestic parent. Other States do not provide this special relief. These States may be reluctant to give relief to avoid recurrent taxation when the foreign profits may not have been previously taxed anywhere. States normally do not give relief for interest and royalties because those items typically would be deductible expenses in the source State.

34. By granting a full exemption to its residents with respect to their foreign-source income, a residence State may put its foreign investors in a position of tax equality with residents of the source State. Whether this equality of position actually occurs depends on the actions of the source State. If the source State provides tax incentives targeted at foreign investors, as frequently occurs, then the foreign investors may be treated more favourably than residents of the source State. In any event, a source State that is granting tax concessions to foreign investors favours a full exemption system on the part of the residence State because its concessions are not reduced or cancelled by the tax of the investor's country of residence. As a result, the full benefits of the concession go to the intended beneficiary, the foreign investor.

(b) The credit method

35. The essential feature of the credit method, whether granted unilaterally or by bilateral tax treaty, is that the residence State treats a foreign income tax paid to the source State by its residents, within certain statutory limitations, as if it were an income tax paid to itself. When the foreign tax rate is lower than the domestic rate, only the excess of the domestic tax over the foreign tax is payable to the residence State. When the foreign tax is the higher one, the residence State does not collect any tax. The effective overall tax burden is the higher of the domestic tax or the foreign tax.

36. States using the credit method reduce their normal tax claims on their resident taxpayers by the amount of the tax that those residents have already paid to the source State on profits derived from that State. The source State could thus raise its tax rate on the foreign resident to the level of the tax of the residence State without imposing an additional tax burden on the foreign resident. It must be stressed, however, that a source State may not be free to manipulate its tax rules to take advantage of this feature of the credit. For example, if the source State applied a higher tax rate on corporations residing in a State granting a credit, it might be held to have violated a non-discrimination provision in a tax treaty. In addition, a rate that discriminates against credit States

might endanger the allowance of a credit if the residence State has adopted domestic legislation that disallows the credit for foreign taxes imposed in a discriminatory manner.¹⁴

37. In general, when a source State grants special tax concessions to a foreign investor resident in a State using the credit mechanism, the foreign investor has a corresponding increase in the amount of tax due to its State of residence. With some exceptions, the benefit of the concession accrues to the treasury of the resident State, not to the foreign resident. One exception applies if the source State otherwise imposes taxes at an effective rate higher than the effective rate in the residence State and the concessions merely reduce the level of taxation in the source State to the level charged by the residence State. In addition, a corporation resident in a State employing the credit mechanism may use a number of tax planning techniques to benefit from a tax concession granted in a source State. Most capital exporting States do not tax the normal business profits of a foreign affiliate of a resident corporation until the profits have been repatriated in the form of a dividend. By operating in the source State through a foreign affiliate, therefore, a resident corporation may be able to utilize a tax concession granted by the source State to indefinitely postpone any residence tax on the profits derived from the source State. In addition, the resident company may be able to utilize various tax-planning strategies for reducing its taxes that would not be available without the tax concession. A company may also benefit from tax concessions due to operation of the foreign tax credit limitation in its State of residence.

38. Every State that grants a foreign tax credit imposes some limitations on that credit. There are many different types of limitations, some applicable to all of the income derived in a particular country (per country limitation) and some applicable to specific types of income (separate basket limitations). A common feature of those limitations is that the credit allowable with respect to the relevant category of income cannot exceed the tax that the residence State would have imposed on that income if it had been earned domestically. In computing the limitation, the residence State typically computes income according to its own concepts, not according to the tax rules applicable in the source State. As a result, limitation problems may arise from differences in the definitions of taxable income used by the residence State and by the source State. For example, assume that Company P, a resident of State A, earns 100 in State B, computed under the tax rules of State B. State B imposes a tax of 30 on that income. Under the tax laws of State A, however, Company P has taxable income of only 60, due to differences in the way depreciation deductions are calculated in the two States. If the tax rate in State A is 40 per cent, the limitation on the credit will be 24 (40% of 60). Thus, only 24 of the tax paid of 30 will be allowed as a credit, notwithstanding the fact that State B's nominal tax rate of 30 per cent is lower than the nominal tax rate of 40 per cent imposed by State A.

39. Countries applying the credit method normally deduct from their own tax only the foreign tax levied directly on the income of their residents. Assume, for example, that R, an individual resident of State A, receives a dividend of 100 from Company S, a resident of State B. State B imposes a withholding tax on the dividend of 10. State B also imposed a tax of 30 on the business

¹⁴ e.g., sec. 6 AB(6), Income Tax Assessment Act 1936 (Australia) (credit absorption tax); United States Treasury Regulation sec. 1.901-2(c) (soak-up tax); Income Tax Act sec. 126(4) (Canada).

profits of Company S, out of which the dividend was paid. If State A allows a credit for foreign taxes paid by its residents, it would allow Company P to claim a credit of 10 for the withholding tax imposed by State B. It would not allow a credit, however, for the 30 of taxes paid by Company S. Some States, nevertheless, do allow their resident corporations to claim a credit for taxes paid by a foreign affiliate when the profits with respect to which the tax was paid are distributed to the resident corporation as a dividend. A credit for the taxes paid by a foreign affiliate is referred to as indirect credit.

40. States may grant the credit by domestic legislation and also by treaty. The credit granted by treaty may be somewhat broader than the unilateral credit and may be fine tuned to accommodate the particular circumstances of the Contracting States. For example, a Contracting State may by treaty specify that certain taxes levied by the other Contracting State qualify for the credit, although the credit might not be allowable, or its status might be uncertain, under domestic rules. A treaty may provide that one Contracting State will grant a foreign tax credit and the other Contracting State will use the exemption method to relieve double taxation. This mix of methods typically occurs when one Contracting State grants the credit unilaterally and the other Contracting State provides exemption relief unilaterally.

41. Proponents of the credit method generally consider it to be superior to the exemption method in two respects. First, they claim that it is more effective in promoting fairness because it generally causes residents of a State to pay the same amount of income tax without reference to the source of their income. Second, they claim that the credit method promotes an efficient allocation of investment capital by treating income from foreign and domestic investment equally. The credit method cannot overcome the unequal treatment of comparably situated taxpayers that results from the imposition of taxes in the source country at effective rates above the rate in the residence country. The exemption method, however, also is ineffective in this regard. Some commentators contend that the credit method may be more complicated to administer than the exemption method. That may be true in some respects, but it is not true in all respects. For example, use of the credit method tends to reduce the tax benefits obtained in the source country from transfer pricing abuses and from the improper allocation of deductions, thereby reducing practical complexity.

42. States that wish to use tax incentives to attract foreign investment would prefer that capital exporting States use the exemption method. Although the credit method does not eliminate the benefits of tax concessions in the source State, it may weaken the incentive effects in many cases. Because the credit method tends to reduce the impact of tax incentives on investment decisions, it also tends to reduce harmful tax competition among developing countries. States that doubt the wisdom of using tax concessions to attract foreign investment, therefore, might prefer that capital-exporting States adopt the credit method.

(c) Tax-sparing methods

43. Tax-sparing credits is the practice of a residence State using the credit method of adjusting the taxation of its residents to permit those residents to receive the full benefits of tax concessions provided to them by a source State. It often takes the form of a credit for taxes that would have been paid but for a tax incentive. For example, assume that Company A, a corporation resident in State A, is investing and earning income in State B. State A and State B have entered into a tax-sparing agreement. Company A earns 100 in State B. Under their normal rules, State A and State B impose taxes at a rate of 35 per cent. Thus, Company A normally would owe taxes of 35 to State B. State B, however, has provided Company A with a tax holiday that reduces its taxes to zero. In the absence of the tax-sparing agreement, State A would impose a tax of 35 on Company A, thereby wiping out the benefit to Company A of the tax holiday. Under the tax-sparing agreement, State A may grant Company A a credit for the taxes that would have been paid (that have been spared) but for the tax holiday. In that way, Company A receives the intended benefits of the tax holiday.

44. Most developed countries have provided tax-sparing credits in their tax treaties with developing countries. The list of countries providing tax-sparing credits by treaty includes Canada, France, Germany, Japan and the United Kingdom. In its initial report on harmful tax competition, however, the OECD has expressed some concerns about tax-sparing agreements, due to the possibility that they foster harmful tax competition.¹⁵ The United States of America has opposed tax-sparing for nearly half a century and has never ratified a tax treaty that included a tax-sparing provision.¹⁶ The United States' position is based, in part, on its strong commitment to the principle of capital export neutrality and to the principle that residents with equal taxable incomes should pay equal amounts of tax.

45. Tax-sparing credits is a practice designed to promote the effectiveness of local tax incentives for foreign investment. Developing countries are often willing to provide foreign investors significant fiscal incentives in order to encourage foreign direct investment. It is generally accepted, by developed and developing countries, that investment in productive activities is generally highly beneficial to economic growth and national wealth. As a result, States often find themselves in competition for foreign investment. Tax incentives are one way for a State to conduct that competition. Popular incentives offered by some developing countries include lengthy tax holidays, the allowance of rapid cost-recovery, including expensing of capital investments, and special tax credits for investment. States offering tax concessions to prospective investors want to maximize the potential benefits of those concessions to those investors. Tax-sparing credits is a technique for achieving that goal.

46. An evaluation of the merits of tax-sparing credits cannot be divorced from an evaluation of the tax incentives that they encourage. Proponents of tax incentives for investment in developing

¹⁵ OECD, *Harmful Tax Competition: An Emerging Global Issue* (1998). OECD, *Tax Sparing: A Reconsideration* (1998).

¹⁶ The United States of America and Brazil negotiated a tax treaty in the late 1960s in which the United States agreed to give a special tax credit for certain investment in Brazil. The United States Senate refused to ratify that aspect of the treaty, and it never went into force. Similarly, the United States' tax treaty with Pakistan, which included a tax-sparing credit, was rejected by the Senate.

countries contend that the incentives are a cost-effective way of directed investment to countries badly in need of such investment. They also contend that many developing countries have few alternative methods available to them to encourage needed foreign investment. Critics of tax incentives contend that the costs of tax incentives are routinely understated and the benefits overstated. In assessing costs, they note that many countries that have employed incentives to attract foreign investment have been forced by economic and political considerations to extend the incentives to local investment as well, thereby magnifying the costs substantially. They also contend that well-managed businesses — the type that make attractive investment partners for developing countries — base their investment decisions primarily on factors unrelated to tax concessions. Finally, they contend that the overall impact of tax incentives in directing investment to developing countries is probably smaller than generally recognized, due to the widespread availability of self-help tax avoidance through the use of tax havens. For a detailed discussion of the “tax-sparing credits” mechanism, please see pages 265-268 of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (June 2001).

(d) Implications for developing countries of the various methods for the provision of relief from international double taxation

47. Whatever the merits of tax incentives generally, developing countries that offer tax incentives to attract foreign investment obviously want the benefits of those incentives to go to the prospective foreign investor and not to the State where that investor is a resident. In treaty negotiations, therefore, a developing country is likely to press its prospective treaty partner to provide relief for double taxation in a way that supports rather than undermines the developing country’s tax incentive programme. In theory, an exemption system or a credit system with tax sparing could be designed to support a developing country’s tax incentive programme. In practice, a developing country is unlikely to have sufficient bargaining power in treaty negotiations to influence the way its prospective treaty partner provides double tax relief. If the developed country generally provides double taxation relief by using the credit method, it almost certainly will insist upon using that method in its treaty with a developing country. Similarly, a developed country that uses the exemption method is highly unlikely to switch to the credit method as a result of its treaty negotiations with a developing country. The only practical issue for negotiation is whether the developed country is willing to tailor its relief mechanism to accommodate the developing country’s tax incentive programme.

48. Policy makers in developing countries have somewhat greater freedom to design tax incentives according to their own preferences if the foreign investors that they are hoping to attract are residing in a State employing a full exemption method. For those investors, the only tax that matters is the tax in the source State. Thus, the source State can design its local tax rules to have an extraterritorial impact on investment decisions made in the residence State without fear that its actions will provoke the residence State to take countervailing measures. In contrast, when the residence State is using the credit method with tax sparing, it typically grants the tax sparing credit only if it has specifically agreed to do so after negotiations with the source State. If the resident State concludes that a particular type of tax concession is unwise or contrary to its national interests, it may decline to give the tax-sparing credit with respect to that concession. Even if it ultimately

agrees to give the credit, the process of negotiations may have delayed implementation of a particular tax concession for an extended period of time.

49. The flexibility that an exemption system affords to developing countries comes with significant costs. First, tax incentives may not be effective in attracting foreign investment if they are available everywhere. To attract foreign investment through tax concessions, a developing country must be able to offer the prospective foreign investor a benefit not available in other countries competing for that investment. The freedom that the exemption system gives to a particular developing country, however, is also given to all of the countries with which that country is competing. The likely result is a tax competition that benefits the foreign investor without affecting the location of its investment. Second, many developing countries have so little leverage over prospective foreign investors that they feel compelled to grant whatever tax concessions an investor demands. As a result, the control ceded by the resident State is exercised not by the source State but by the foreign investor. In general, a tax concession designed to satisfy terms set by a residence State will be more cost effective than a concession designed by the foreign investor.

50. One of the objectives of tax treaties is to strengthen the ability of States to impose taxes fairly and effectively on taxpayers engaged in cross-border activities. That purpose is defeated if a method intended to relieve double taxation promotes the elimination of all taxation. The persistent trend towards a global economy is putting pressure on all tax systems, but especially on the tax systems of developing countries. To flourish in the global economy, developing countries need to develop both their private and public sectors. They have a common interest with developed countries, therefore, in promoting measures that prevent multinational corporations from exploiting their market power and their ability to shift investments around the world to avoid a reasonable level of taxation on their profits. It is only through the cooperation of sovereign States that the sovereign power to tax can be protected from the corrosive powers of the marketplace.

B. Historical overview

51. The international efforts to deal with the problems of international double taxation, which were begun by the League of Nations and have been pursued in the Organisation for Economic Cooperation and Development and regional forums, as well as in the United Nations, have in general found concrete expression in a series of model bilateral tax conventions. The Fiscal Committee of the League of Nations gave the following rationale for the elaboration of these conventions:

“The existence of model draft treaties has proved of real use ... in helping to solve many of the technical difficulties which arise in [the negotiation of] tax treaties. This procedure has the dual merit that, on the one hand, in so far as the model constitutes the basis of bilateral agreements, it creates automatically a uniformity of practice and legislation, while, on the other hand, inasmuch as it may be modified in any bilateral agreement reached, it is sufficiently elastic to be adapted to the different conditions obtaining in different countries or pairs of countries.”¹⁷

¹⁷ League of Nations, Report of the Fiscal Committee to the Council on the work of the fifth session of the Committee [C.252.M.124.1935.II.A), p. 4, paragraph II.B.4.

1. The 1928 Model Bilateral Tax Conventions

52. In October 1928, the General Meeting of Government Experts on Double Taxation and Tax Evasion convened by the Council of the League of Nations adopted a Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Direct Taxes, together with three other model bilateral conventions dealing respectively with the succession duties, administrative assistance in matters of taxation and judicial assistance in the collection of taxes. The work of the General Meeting was based on draft model conventions prepared by a group of high-level tax officials. Composed of officials from seven European countries when originally established in 1922, the group was enlarged in 1925 to include officials from two more European countries and Japan and from Argentina and Venezuela. The United States of America joined the Group in 1927. The group had prepared only one text, relating to direct taxes, but the General Meeting found it advisable to prepare two new additional draft model conventions on the same matter, because the first draft, intended primarily for Contracting States whose tax systems consisted of impersonal taxes on income from domestic sources and a general income tax on income from all sources, foreign as well as domestic, was felt to be not easily adaptable to the many tax systems based on a single graduated income tax which applied both to income derived by non-residents from domestic sources and to income derived by residents from all sources. The two new texts drew no distinction between impersonal and personal taxes; the first of these texts was to be applied particularly to relations between countries in which taxation by reference to domicile predominated, and the second to relations between countries possessing different fiscal systems.

53. Although the 1928 model bilateral tax conventions in theory granted considerable taxing power to the source countries, that power was limited in practice by the pattern of international flows of private capital in the era preceding the Great Depression. Most foreign investment in capital-receiving countries at that time took the form of portfolio investment, and under the conventions the income from these investments was taxable in the country of the investors' fiscal domicile, which the conventions defined as the normal residence of the taxpayer. There was relatively little direct investment, which, under the newly formulated concept of permanent establishment, would have been liable, to a large degree, to taxation in the source country.

2. The 1935 Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation

54. During sessions held at the end of the 1920s and the beginning of the 1930s, the Fiscal Committee of the League of Nations¹⁸ devoted considerable attention to formulating, for tax purposes, rules for the allocation of business income of undertakings operating in several countries (the term 'undertakings' being understood as making no distinction between natural and legal persons). A Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation was formulated, first at meetings of a Subcommittee held in New York and Washington D.C. under the auspices of the American Section of the International Chamber of Commerce, and then at the full meeting of the Fiscal Committee in June 1933. The Draft

¹⁸ The Fiscal Committee had been set up in 1929 pursuant to a recommendation of the General Meeting of Government Experts on Double Taxation and Tax Evasion.

Convention, which was revised by the Fiscal Committee at a session held in June 1935, was never formally adopted, but was of great significance because of the importance of the issues with which it dealt.

55. The Draft Convention contained a definition of business income which excluded from such income all items of income allocable to specific sources such as dividends and interests; the remaining items of income were grouped together as business income, which was taxable on the basis of the accounts of each permanent establishment from which the income had originated. The underlying purpose of the definition was to assimilate the permanent establishment that an enterprise had in other Contracting States to independent legal entities doing business with each other on the same or similar conditions as with independent enterprises and to permit the determination of the net income of each establishment on the basis of the separate accounts pertaining to such establishment.

The Draft Convention authorized the tax authorities of the Contracting States to rectify the accounts produced, notably to correct errors or omissions, or to restate the prices or remunerations entered in the books at the value that would prevail between independent persons dealing at arm's length. If the envisaged rectification could not be effected in that way or if an establishment could not produce an accounting showing its operations, or if the accounting produced did not correspond to the normal usages of the trade in the country where the establishment was situated, the tax authorities might determine business income by applying a percentage to the turnover of that establishment and by comparing the results with those of similar enterprises operating in the country. If the foregoing methods of determination were found to be inapplicable, the net business income of the permanent establishment might be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment might be determined by a computation based on the total income derived by the enterprise from the activities in which such establishment had participated. The determination was made by applying to the total income coefficients based on a comparison of gross receipts, assets, number of hours worked or other appropriate factors, provided such factors were so selected as to ensure results approaching as closely as possible to those that would be reflected by a separate accounting.

3. The 1943 Mexico Model Bilateral Tax Conventions

56. At the June 1939 session of the Fiscal Committee of the League of Nations, it was suggested that the three 1928 Model Conventions dealing with direct taxes should be revised in the light of the technical improvements embodied in the various bilateral tax treaties concluded during the 1930s, taking into account the new trends and problems which had arisen in the fields of international trade and investment and the views and recommendations expressed by the Fiscal Committee itself at its various sessions.

57. The work of revision was begun by a Subcommittee that met at The Hague in April 1940 and continued by two Regional Tax Conferences held under the auspices of the League of Nations at Mexico City in June 1940 and July 1943. The Regional Conferences were attended by representatives of Argentina, Bolivia, Canada, Chile, Colombia, Ecuador, Mexico, Peru, the United States of America, Uruguay and Venezuela. The Second Regional Conference had before it the Draft Model Convention for the Prevention of Double Taxation of Income, which had been prepared by the First Regional Conference, as well as documents submitted by the Secretariat of the League

of Nations and various experts on the prevention of double taxation of successions, the establishment of reciprocal cooperation between national tax administrations for the assessment and collection of direct taxes and on post-war fiscal problems. At the conclusion of its deliberations, the Second Regional Conference adopted a Model Bilateral Convention for the Prevention of the Double Taxation of Income and a Protocol thereto, a Model Bilateral Convention for the Prevention of the Double Taxation of Successions and a Protocol thereto, and a Model Bilateral Convention for the Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Direct Taxes and a Protocol thereto.

58. The Model Bilateral Convention for the Prevention of the Double Taxation of Income, which was to replace the three 1928 Model Conventions dealing with direct taxes and also incorporate the provisions of the 1935 Draft Convention for the Allocation of Business Income, advocated the taxation of income derived by non-residents almost exclusively at source. Although at the Mexico Conferences Canada aligned its position with those of the Latin American countries, the Mexico Model Bilateral Convention for the Prevention of the Double Taxation of Income has nevertheless been viewed as representing “the first attempt by the developing countries to write a model treaty reflecting their particular problems.”¹⁹ However, the positions embodied in the Mexico Model were similar to those taken earlier by the representatives of capital-importing countries at the 1928 General Meeting of Government Experts on Double Taxation and Tax Evasion. At that Meeting, widely divergent views were expressed by the representatives of capital-exporting and capital-importing countries as to whether the source country or the country of residence should be empowered to tax dividends and interest.

4. The 1946 London Model Bilateral Tax Conventions

59. In March 1946, the Fiscal Committee of the League of Nations convened in London for its tenth session, at which it reviewed the Mexico Model Bilateral Tax Conventions. The Fiscal Committee was of the opinion that the models represented “a definite improvement on the 1928 Model Conventions”, but that “nevertheless, since the membership of the Mexico City and London meetings differed considerably, it was natural that the participants in the London meeting held different views on various points from those which inspired the model conventions prepared in Mexico”. The general structure of the model conventions drafted at the tenth session was similar to that of the Mexico models, although a certain number of changes were made in the wording and some articles were suppressed because they contained provisions already contained in other clauses. The Committee observed that virtually the only clauses where there was an effective divergence between the views of the 1943 Mexico meeting and those of the London meeting were those “relating to the taxation of interest, dividends, royalties, annuities and pensions.” The Committee added that it was aware that the provisions of the 1943 model conventions might appear more attractive to some States, in Latin America for instance, than those which it had agreed to during its current sessions, and that it thought “that the work done both in Mexico and in London could be usefully reviewed and developed by a balanced group of tax administrators and experts from both capital-importing and capital-exporting countries and from economically-advanced and less-

¹⁹ Manila Conference on the Law of the World, *The Emerging International Tax Code: Report of the Committee on Taxation of the World Association of Lawyers* (August 1977), p. 4.

advanced countries, when the League work on international tax problems was to be taken over by the United Nations.”²⁰

60. With regard to the Fiscal Committee’s remarks concerning the taxation of interest, dividends and royalties by the country of source, it is the taxation of such items of income which has always been in dispute. In the case of taxes on business profits and income from immovable property, the primary right of the source country to tax has never been questioned, has been recognized in all model conventions, and has been a constant feature of treaty practice. According to the Committee on Taxation of the World Association of Lawyers at the Manila Conference on the Law of the World, on the occasion of the London meeting, “the capital-exporting countries reasserted themselves, and the London model [Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property] sought to encourage the outflow of capital from industrialized countries into developing countries by limiting taxation to the country where income was ultimately received.”²¹

61. The Fiscal Committee of the League of Nations, which held its tenth session in London from 20 to 26 March 1946, was gratified to note the recommendation of the Preparatory Commission of the United Nations set forth in paragraph 34 of the Report of that Commission in regard to the desirability of establishing a Fiscal Commission of the Social and Economic Council. The recommendation read as follows:

“Fiscal Commission.

34. This Commission would make studies and advise the Council on matters related to:
- (a) International taxation problems;
 - (b) Exchange of information among States on the techniques of Government finance and on their social and economic effects;
 - (c) Fiscal techniques to assist the prevention of depressions or inflation; and
 - (d) Such functions of the Fiscal Committee of the League of Nations as the United Nations may decide to assume.

(a) International tax problems:

These tax problems may be mainly considered under the following headings:

1. Double taxation of income, estates and successions, property and capital, etc.;
2. Extraterritorial taxes;
3. Discriminatory and special taxes on foreigners and on capital invested abroad;
4. Special taxes on international transactions, such as taxes on the purchase of foreign exchange and remittances abroad;
5. Taxes on international communications and transport; and

²⁰ League of Nations, *Fiscal Committee: Report on the Work of the Tenth Session of the Committee* (C.37.M.37.1946.II.A), p. 8.

²¹ Manila Conference on the Law of the World, *op. cit.*, p. 12.

6. Mutual assistance between national tax administrations in connection with the assessment and collection of taxes, including the prevention of fiscal evasion.”²²

62. The tax experts who have met under the auspices of the League of Nations since 1923 have considered most of these problems in their major aspects and the Model Conventions which they drafted have exercised an influence as previously indicated, especially in the field of the prevention of international double taxation and fiscal evasion, by facilitating the conclusion of numerous bilateral tax treaties. Much remains to be done, however, especially on account of the constant increase of tax burdens and also with a view to assisting the desired revival of international trade and investment. Indeed, efforts to remove these obstacles on international economic intercourse which result from tariffs, preferences and other restrictive trade practices can be largely frustrated through the operation of tax laws.

63. The Fiscal Committee therefore desires to emphasize its belief that further studies should be made with a view to solving these tax problems in the interest of world rehabilitation. The importance of international tax problems is illustrated by the fact that, since the beginning of the 1920s, well over sixty general treaties have been concluded for the prevention of double taxation and that nearly 250 special agreements on various international tax matters were signed, not counting the treaties of friendship and establishment, the commercial treaties and other international instruments that contain incidental clauses on tax matters.

64. The Committee wishes to draw attention to the fact that, among the topics relating more especially to the prevention of international double taxation, there are two which seem to require prompt consideration. First, it is desirable to arrive at a comprehensive set of rules regarding the determination and allocation of taxable income in the case of business enterprises carrying on their activities in more than one country. The provisions suggested by the Fiscal Committee for that sound purpose embody principles that are generally recognized as sound. These principles may, however, require some elaboration as regards the manner in which they should be applied to the various types of enterprises. Second, there persists a difference of opinion between capital-importing and capital-exporting countries as regards the taxation of interest and dividends. Such divergences might be more easily reconciled in the negotiation of tax treaties if studies were undertaken of the various legal, administrative and economic aspects of this problem.

65. The structure and incidence of a country's tax system have a direct influence on the capacity and willingness of domestic concerns to do business abroad as well as on the ability of the country to attract foreign capital and enterprises. It would be difficult to remove the obstacles which taxation may oppose to international trade and investment without determining the manner in which the different types of taxes, considered separately and together, can be adapted to the social and economic conditions of the various countries.”

5. OECD Model Bilateral Tax Conventions

²² League of Nations: *Fiscal Committee: Report on the Work of the Tenth Session of the Committee held in London from March 20 to 26, 1946.* (Geneva, April 25, 1946) Official No. C.37.M.37.1946.II.A.

66. Like the 1928 model bilateral conventions, which never won wide acceptance, the model conventions of Mexico and London were never fully accepted. However, the principles contained therein were followed with certain variants in numerous bilateral tax treaties between developed countries until the Organisation for European Economic Cooperation (OEEC, which subsequently became the OECD) created its Fiscal Committee in 1956 and entrusted it with the task of working out a draft model bilateral tax convention “which would effectively resolve the double taxation problems existing between OECD member countries and which would be acceptable to all member countries.”²³ The need for a new draft bilateral tax convention on income and capital which would facilitate the extension of the network of bilateral tax treaties to all member countries of OEEC arose from the fact that the Mexico Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property presented in respect of several essential questions “considerable dissimilarities and certain gaps.” It arose more particularly from “the increasing economic interdependence of the member countries of OEEC in the post-war period, and the economic cooperation established among them showed increasingly clearly the importance of measures for preventing international double taxation.”²⁴

67. The Fiscal Committee used as its main reference text the London Model Bilateral Convention for the Prevention of the Double Taxation of Income and Property and revised it extensively taking into account practices embodied in bilateral tax treaties which had been negotiated on the basis of that model convention. Originally published in 1963, the OECD Model Double Taxation Convention on Income and Capital was revised from 1967 onwards and was published in its revised form in 1977. Revisions continued thereafter, and a new model was published in 1992, again to be revised in 1994, 1995, 1997 and 2000.²⁵

68. The OECD Model Double Taxation Convention on Income and on Capital rests essentially on two premises: (a) the country of residence would eliminate double taxation through the credit method or the exemption method; and (b) the country of source, in response, would considerably restrict the scope of its jurisdiction to tax at source and reduce the rates of tax where jurisdiction was retained.

69. Recognizing that the effort to eliminate double taxation between Member countries’ needs to go beyond the field of periodic taxes on income and capital, OECD in July 1963 instructed its Fiscal Committee to work out a draft convention which would provide a means of settling on a uniform basis the most common problems of double taxation of estates and inheritances. The Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Estates and Inheritances was published in 1966.

6. United Nations Model Double Taxation Convention between Developed and Developing Countries

²³ Organisation for Economic Cooperation and Development, *Model Double Taxation Convention on Income and on Capital, Report of the Committee on Fiscal Affairs* (Paris, 1977), p. 8.

²⁴ *Ibid.*, p. 7.

²⁵ OECD Committee on Fiscal Affairs, *Model Tax Convention on Income and on Capital* (Paris, 1992 and periodic supplements).

70. The United Nations in 1980 published the *United Nations Model Double Taxation Convention between Developed and Developing Countries*²⁶ (UN Model Convention). During its Eighth Meeting, the Ad Hoc Group of Experts on International Cooperation in Tax Matters (Group of Experts) established a Focus Group to revise and update the UN Model Convention in view of the significant changes which had taken place in the international economic, financial and fiscal environment since 1980. The Focus Group in its meetings in New York in December 1998 and Amsterdam in March 1999 discussed the comments and suggestions of the members of the Group of Experts on the articles and commentaries of the UN Model Convention, and presented a draft revised UN Model Convention before the Ninth Meeting of the Group of Experts held in New York in May 1999. The Group of Experts adopted the revised version of the UN Model Convention, subject to editorial changes of a non-substantive nature. The comments and suggestions of members of the Group of Experts on these editorial changes were examined by the Steering Committee in its meeting held in New York in April 2000, and the final text of the UN Model Convention was adopted on a consensual basis by the Steering Committee. After being approved by the members of the Group of Experts, the final version of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* was published by the United Nations in 2001.

²⁶ United Nations publication: ST/ESA/102: Sales No. E.80.XVI.3.

II. INTERNATIONAL TAX EVASION AND AVOIDANCE

A. Concepts and issues

71. Various features of the globalized economy have enabled an increasing number of individuals and companies to resort to tax evasion or tax avoidance. These features include the ease and rapidity of communications, the progressive elimination of obstacles to the movement of persons and property, the expansion of international economic relations, the differences in national tax systems and hence in the tax burden from country to country, and the growing sophistication and aggressiveness of taxpayers and their advisers in developing legal and illegal techniques for taking advantage of weaknesses in national tax systems.

1. The concepts of tax evasion and tax avoidance

72. The terms “tax evasion” and “tax avoidance” have not always been used precisely or with a uniform meaning.²⁷ Strictly speaking, tax evasion is considered to consist of wilful and conscious non-compliance with the laws of a taxing jurisdiction. Tax evasion is an action by which a taxpayer tries to escape legal obligations by fraudulent or other illegal means. The illegal conduct might involve simply failing to report income or fabricating deductions, or it may involve highly sophisticated tax planning that is premised on false or intentionally deceptive representations to the tax authorities. Tax evasion may arise as a result of a failure to properly report income that is legally earned. It may also result from the evasion of tax on income that arises from illegal activities, such as smuggling, drug trafficking, and money-laundering. In a broader sense, tax evasion may encompass a reckless or negligent failure to pay taxes legally due, even if there is no deliberate concealment of income or relevant information.

73. Tax avoidance, in contrast, involves the attempt to reduce the amount of taxes otherwise owed by employing legal means.²⁸ However, the borderline between evasion and avoidance in specific cases may be difficult to define. For one thing, the criminal laws of countries differ, so that behaviour that is criminal under the laws of one country may not be criminal under the laws of another.²⁹ In addition, the definitions of civil and criminal tax fraud may overlap, so that it is within administrative discretion whether or not to pursue a criminal fraud case in a specific instance. In reality, there is a continuum of behaviour, ranging from criminal fraud on one extreme, to civil fraud, to tax avoidance that is not fraudulent but which runs afoul of judicial or statutory anti-avoidance rules and therefore does not succeed in minimizing tax according to law, and finally to

²⁷ Part of the problem is a linguistic one. In English, “tax evasion” is synonymous with tax fraud, and means criminal activity. In French, “evasion” means avoidance. Tax evasion should therefore be translated into French as “fraude fiscale”. Even within the same language, the term “tax evasion” has sometimes been used with a different meaning. For example, section 482 of the United States Internal Revenue Service Code refers to allocation of income that “is necessary to prevent evasion of taxes,” but the intended concept is one of avoidance.

²⁸ Black’s Law Dictionary (Fifth Edition) has defined ‘tax avoidance’ as: “The minimization of one’s tax liability by taking advantage of legally available tax planning opportunities. Tax avoidance may be contrasted with tax evasion, which entails the reduction of tax liability by using illegal means”.

²⁹ While most countries define criminal tax fraud fairly broadly, there are some exceptions. For example, Switzerland has a narrow concept of “tax fraud”, which is an offence subject to imprisonment, defining it as the use of “forged, falsified or substantially incorrect documents”. See Direct Federal Tax Law, art. 186.

tax-planning behaviour which is successful in legal tax reduction. The compound expression “tax avoidance and evasion” is therefore often used to encompass a whole range of activity along this spectrum.

74. Courts in most countries have consistently recognized the right of taxpayers to avoid taxes by means that are within the law.³⁰ However, courts in many countries have also found that the tax laws should be interpreted so as to prevent their avoidance by the use of transactions that have no business purpose, although there is considerable variety in the approaches of courts in different countries.³¹ Tax laws also typically include a variety of specific or general anti-avoidance rules. Tax avoidance is a less precise concept than tax evasion, as the discussion above suggests. Put very broadly, tax avoidance may be considered to occur when persons arrange their affairs in such a way as to take advantage of weaknesses or ambiguities in the law to reduce taxes, without actually breaking the law. Although tax avoidance may be regarded as immoral in some circumstances, the means employed are legal and not fraudulent.

75. Depending on the existence of judicial or statutory anti-avoidance rules, tax avoidance may or may not be successful if a case is audited and litigated. However, to apply anti-avoidance rules, the tax authorities typically must (1) discover the relevant transaction in a tax audit, and (2) obtain and analyse the information necessary to apply the anti-avoidance rules. This may be difficult in a cross-border situation where information is located abroad.

76. Globalization and the removal of impediments to the free movement of capital and exchange controls have promoted sustainable economic development. However, they have also increased the scope for tax avoidance and evasion with consequential substantial loss of revenue. International tax avoidance and tax evasion cause many problems. Governments lose significant amounts of revenue and hence the honest taxpayers who do not escape their liability to pay tax must bear an additional

³⁰ In the United Kingdom the classic statement of this principle was made by Lord Tomlin in *IRC vs. Duke of Westminster* [1936] AC: “Every man is entitled, if he can, to order his affairs so that tax attaching under the appropriate Acts is less than it would otherwise be. If he succeeds in ordering them so as to secure this result, then, however unappreciative the Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.”

For the United States of America, see *Helvering vs. Gregory*, 69 F 2d 809, 810 (2nd Cir. 1934): “Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one’s taxes” (per Learned Hand, J.).

For Belgium, see Judgment of February 27, 1987, Cour de Cassation, 1987 Pas. Be. 1, No. 387, at 777 (taxpayer allowed to choose “the lesser taxed way”).

³¹ For example, in the United Kingdom, the leading case of the modern era is *WT Ramsay Ltd. vs. CIR* [1981] 1 All ER 449, where the House of Lords held that, where there is a composite transaction, the court is entitled to determine the tax liability by looking at the end result rather than the individual steps in the transaction. The effect of *Ramsay* has been clarified in subsequent cases, most recently in *McNiven vs. Westmoreland Investments Limited* [2001] STC 237, in the House of Lords in February 200. Lord Nicholls’ opinion in *McNiven* stated that *Ramsay* made three points: “First, when it is sought to attach a tax consequence to a transaction, the task of the courts is to ascertain the legal nature of the transaction. If that emerges from a series or combination of transactions, intended to operate as such, it is that series or combination which may be regarded.... Second, this is not to treat a transaction, or any step in a transaction, as though it were a ‘sham’.... Nor is this to go behind a transaction for some supposed underlying substance. What this does is to enable the court to look at a document or transaction in the context to which it properly belongs.... Third, having identified the legal nature of the transaction, the courts must then relate this to the language of the statute.”

burden to plug the gap. Countries where the tax compliance is the highest lose out, since the trade flows are diverted elsewhere.

(a) International cooperation

77. Tax authorities in the Member States of the OECD have responded to concerns about avoidance and evasion by taking on new powers to collect information from taxpayers. Delegates to the Working Party on Tax Avoidance and Evasion systematically inform other countries about the means at their disposal for countering avoidance. These reports cover legislation, court decisions and audit techniques. It is through this exchange of experiences that the Committee is able to develop and promote the adoption of practices that should enable tax authorities to administer their tax laws in an effective and equitable manner. An example of the results of such discussions is the OECD recommendation on the use and disclosure of Tax Identification Numbers (TINs) to increase compliance on cross-border income flows.

78. Ways of increasing compliance in cross-border financial transactions and on access to bank information for tax purposes are the focus of current work. Additional work will also be carried out to identify and address other barriers to the identification of beneficial ownership and exchange of such information.

79. The Committee has promoted exchange of information between tax authorities as the best way of fighting non-compliance in transactions across borders. For this reason, the OECD Model Convention contains an article on exchange of information. Current work to improve exchange of information includes looking not only at barriers to effective exchange of information but also at how better use of the latest information technology can help. OECD countries have adopted a standard magnetic format for exchange of information. The Working Party is also considering how technology can be used to improve and expedite procedures for the certification of residence for purposes of granting treaty benefits. A pilot study on the exchange of TINs is being conducted. The Committee is also exploring the relationship between money-laundering and tax-related crimes. In particular, it is examining how tax authorities can obtain access to information gathered by anti-money laundering authorities both to pursue tax offences as well as to exchange that information with foreign tax authorities.

80. A major objective of bilateral tax treaties, apart from avoidance of double taxation, is to prevent tax avoidance and evasion and to ensure that treaty benefits flow only to the intended recipients. Bilateral tax treaties achieve this objective in several ways. Firstly, they provide for exchange of information between the tax authorities of the Contracting States. Secondly, they contain provisions designed to ensure that treaty benefits are limited to *bona fide* residents of the other treaty country and not to treaty shoppers. Under the tax treaties, the competent authorities are authorized to exchange information, as may be necessary for the proper administration of the countries' tax laws. The information that is exchanged may be used for a variety of purposes. For example, the information may be used to identify unreported income or to investigate a transfer pricing case. If a country has bank secrecy rules that prevent or seriously inhibit the exchange of information under the tax treaty, it may not be desirable to conclude a bilateral tax treaty with it. In fact, it is necessary to first discuss the issue of information exchange with the other Contracting

State before beginning formal negotiations, because it is one of the very few issues that should be considered as non-negotiable. This may even prevent a country from entering into treaties with some countries with which it may have significant economic ties, but this may be treated as the right policy.

81. Recent technological developments which facilitate international, thus anonymous, communications, and commercial and financial activities can also encourage illegal activities.³² Over the past several years there has been a marked change, as many of the industrialized nations have recognized the importance of exchange of tax information; the absence thereof serves to encourage not only tax avoidance and evasion but also criminal tax fraud, money-laundering, illegal drug trafficking, and other criminal activity.

(b) Tax planning and treaty shopping

82. Another aspect of the bilateral tax treaty policy to deal with tax avoidance and evasion is to include in all treaties comprehensive provisions designed to prevent “treaty shopping”. This abuse of the treaty can take a number of forms, but it generally involves a resident of a third state C that has either no treaty with the country A or a relatively unfavourable one, establishing an entity in a treaty partner B that has a relatively favourable treaty with the country A. This entity is used to hold title to the person’s investments in country A, which could range from portfolio stock investments to major direct investments or other treaty-favoured assets in country A. By placing the investment in the treaty partner, the resident of country C is able to withdraw returns from the country A investments subject to the favourable rates provided in the tax treaty with country B, rather than the higher rate that would be imposed if the person had invested directly into the country A. Of course, the tax imposed by the treaty partner on the intermediate entity must be relatively low, or the structure will not produce tax savings that justify the added transaction costs.

83. Bilateral tax treaties should endeavour to give benefits to the residents of the Contracting States alone. Treaty shopping represents an abusive attempt to siphon off benefits to others. Moreover, if treaty shopping is allowed to occur, then there is less incentive for the third country, with which the country has no treaty, to negotiate a treaty with it. The third country can maintain inappropriate barriers to the first country investment and trade, and yet its companies can obtain the benefits of lower first country tax by organizing its first country transactions so that they flow through a country with a favourable first country treaty. Every country should develop anti-treaty-shopping provisions and encourage other countries to adopt similar provisions that limit the benefits of the treaty to *bona fide* residents of the treaty partner. These provisions cannot be uniform, as each country has its own characteristics that make it more or less inviting to treaty shopping in particular ways. Consequently, each provision must to some extent be tailored to fit the facts and circumstances of the treaty partners’ internal laws and practices. Moreover, the provisions need to strike a balance that avoids interfering with legitimate and desirable economic activity.

³² United States Treasury International Tax Counsel Mr. Philip R. West’s testimony before the Senate Committee on Foreign Relations (October 27, 1999).

84. In addition to the treaty-shopping abuses, there are an increasing number of other types of transactions that seek to use treaties to achieve inappropriate results. Anti-abuse rules are generally complementary to the anti-treaty-shopping rules. Anti-treaty-shopping rules take the broad approach of denying all treaty benefits to persons who are not *bona fide* residents of the treaty country. Anti-abuse rules are more targeted in the sense that they are not blanket exclusions from all treaty benefits; they deny specific treaty benefits in abuse cases. It is relevant to mention that the last paragraphs of the commentaries on articles 10, 11, 12 and 21 in the United Nations Model Double Taxation Convention between Developed and Developing Countries refer to the artificial devices entered into by persons to take advantage of the provisions of those articles through creation or assignment of rights in respect of the income specified in those articles. Contracting States which may wish to specifically address the issue are advised to include the specified clause in their bilateral tax treaties.

85. It is necessary to include anti-abuse rules in bilateral tax treaties in view of several concurrent developments in international tax law. Firstly, although an overwhelming majority of taxpayers who avail themselves of treaty benefits are entitled to those benefits and are not engaged in abusive transactions, aggressive abuse of treaties has increased. It is relevant to point out that both the commentary to Article 1 of the OECD Model Tax Treaty and the OECD Report on Harmful Tax Competition make clear that countries can impose their domestic anti-abuse rules to claims for treaty benefits. In fact, concerns about the adequacy of current treaty rules to prevent abuses have stimulated work in the OECD on this subject.

86. The increase in treaty abuses has unfortunate results for both the treasury of the country and the taxpayers; it requires the treasury to divert resources to fighting abuse that it might otherwise devote to improving the treaty network. The emergence internationally of anti-abuse rules addresses the abuse problem, while at the same time frees up the treasury resources to provide greater benefits to the taxpayers. Most bilateral tax treaties contain only benefits for taxpayers and no provisions that increase tax burdens. As such, it is appropriate to impose reasonable limits on those benefits to curb abusive transactions that may be developed in the future.

(c) Tax avoidance through low-tax jurisdictions

87. In the most general terms, a low-tax jurisdiction can be defined as a jurisdiction which imposes little or no tax on companies, trusts or other entities organized there. By forming a company in such a jurisdiction and arranging for that company to derive income from third countries, a multinational enterprise may be able to shelter income from taxation both at the source and in its residence country. By forming a holding company or a trust in a tax haven, an individual or institution may similarly be able to shelter investment income from taxation. The OECD has distinguished between two types of low-tax jurisdictions – those that simply offer a low-tax environment and those it has identified as “non-cooperative jurisdictions”. The OECD has sought to combat the threat of non-cooperative jurisdictions to the legitimate tax-policy objectives of its Member States by putting economic pressure on those jurisdictions to cooperate in the prevention of tax fraud and evasion.

88. Non-cooperative jurisdictions may also be defined as jurisdictions which do not participate in effective exchange of tax information between tax authorities. A lack of effective exchange of tax information may occur where bank secrecy or other laws prohibit the disclosure of information concerning financial transactions carried out in the country, or where there is inadequate information available regarding the beneficial ownership of accounts, financial instruments and other assets held in the country. The likelihood of international tax avoidance utilizing non-cooperative jurisdictions is increased in situations where non-cooperative jurisdictions have lower or no tax on one or more types of income earned by non-resident individuals and corporate entities. By way of example, a multinational enterprise may be able to shelter income from taxation both at source and in its residence country by forming a company in a non-cooperative jurisdiction which has lower or no tax on relevant income. Similarly, an individual may be able to shelter income by forming a holding company or trust in a non-cooperative jurisdiction which has lower or no tax on relevant income. Examples of both tax avoidance and evasion follow.

(i) Practices resorted to in order to reduce taxes imposed on international income

89. These practices, generally speaking, fall into four categories: a) practices resorted to in order to reduce income taxes imposed by the country of residence or citizenship; b) practices resorted to in order to evade or avoid taxes imposed by the country of source; c) institutional devices and arrangements that facilitate the evasion or avoidance of taxes imposed on international income; and d) the use of related tax-haven entities to reduce such taxes.

- a. Practices resorted to in order to reduce taxes imposed by the country of residence or citizenship

90. Many countries impose taxes on income received from abroad by residents or non-resident citizens. The practices resorted to in order to reduce payment of these taxes include the following:

- i. Failure to file a return

91. One of the most common practices resorted to in order to reduce payment of taxes on international income consists in the deliberate failure of resident aliens to file tax returns in the country in which they are residing. Persons who spend a portion of each year in each of two or more jurisdictions often make inconsistent claims of residence. When a country taxes the worldwide income of its citizens, a citizen who is residing abroad may fail to file a return in the country of his citizenship.

- ii. Failure to report all income subject to tax

92. Another important practice in this category is the wilful or negligent failure to report all items of international income that are subject to tax. The items most often omitted are salaries, wages and non-commercial income, interest and dividends, business income, income from real estate, gains on the disposition of property and royalties.

Salaries, wages and non-commercial income

93. Persons receiving remuneration from abroad in payment for services or in the form of pensions and annuities frequently fail to report this income in tax returns to their country of residence. Consequently, such income, if not taxed at the source, is apt to escape taxation both in the country where it is acquired and in the country in which the recipient is resident.

Interest and dividends

94. In the view of many tax administrators, tax evasion or avoidance is probably most prevalent in connection with this type of income, since interest and dividends can easily be collected anonymously at a financial institution in a third country where the securities are held in custody. This type of income also lends itself to many fraudulent practices through the skilful use of certain special provisions of domestic laws. Thus, certain institutions whose prime purpose is economic or financial are frequently used to facilitate tax evasion or avoidance.

95. Investment trusts and holding companies are of particular concern in this connection. The anonymity of the owners of the securities held by an investment trust is normally assured by the form of their holdings in the trust and also by the fact that often the trust has no tax liability or obligation to report information to the tax administration of the country where it is established. Where the trust is not itself a taxable entity, it pays no tax on profits from its dealings or on income. The owners of the securities who are the true recipients of the profits and income may not be subjected to personal taxation, if the tax administration is not aware of their identity. That identity may be concealed, for example, by holding the securities in bearer form or, if registered, in the name of nominees. As for holding companies, the preferential tax regime applied to them in some countries likewise encourages the creation of legal structures, which may facilitate tax evasion or avoidance with respect to the income from holdings in companies anywhere in the world. As in the case of investment trusts, this situation results first from the fact that no tax, or very little, may be payable by the holding company in respect of the income which it receives and redistributes, and second from the lack of information as to the identity of the individuals or companies receiving distributions of profits from the holding companies.

Business income

96. Taxes on business income are reduced at times by means of deliberate failure to keep accurate books and records within the taxing jurisdiction. A second set of books, which is accurate, may be maintained outside the taxing jurisdiction, and beyond the reach of the authorities of that country. In some instances, the maintenance of false books within the taxing jurisdiction is facilitated by limitations in domestic law on the extent to which the taxpayer's books and records may be examined by the tax authorities. With the advent of electronic bookkeeping, it may be easier to keep two sets of paper records or to falsify paper records, since a computer keeps a record of all changes made to a file. Those changes can in many cases provide an audit trail that is much harder to destroy than physical documents.

97. Business profits properly allocable to the source country may be shifted to other countries by such devices as the establishment of artificial transfer prices for imports and exports, the improper allocation of costs, and licensing agreements under which the user of technology is obliged to purchase imported inputs, equipment and spare parts at inflated prices. Such devices, which transnational corporations are particularly well situated to use, are of great concern to developing countries, whose tax officials often lack the time and expertise to challenge effectively the prices set between affiliated companies.

Thin capitalization

98. Many countries allow corporations to take a deduction for interest expenses but do not allow a deduction for the payment of dividends. This differential treatment of interest and dividends creates a bias in favour of debt finance over equity finance. The bias is particularly strong when the dividends or interest would be paid to an affiliated company. For example, if Company P owns all the stock of Company S, it is generally indifferent, aside from tax considerations, as to whether it receives dividends or interest payments from Company S. To prevent corporate taxpayers from distributing their profits to their parent corporation mostly in the form of deductible interest, many countries have adopted so-called “thin capitalization” rules. Under these rules, a corporation that has what is deemed to be an excessive amount of debt capital will be prevented from taking a deduction for payments made with respect to that excessive debt capital. The amount of debt capital of a corporation typically would be characterized as excessive if the ratio of debt to equity exceeded some number. For example, if the debt:equity ratio for a corporation exceeded 2:1, the interest payments on the excess debt might be classified for tax purposes as a non-deductible dividend. Many countries would use a high debt:equity ratio as an indicator of thin capitalization, but would look at all the facts and circumstances of the particular case before characterizing an interest payment as a dividend for tax purposes.

Income from real estate

99. If a resident of one country owns real property in another country, this person may fail to report rents (and amounts that may be assimilated to rent) as income in the country of his fiscal domicile or residence. Such income may also escape taxation in the country in which the property is situated if the tax authorities are not aware of the identity and domicile of the recipient.

Royalties

100. Royalties paid abroad for the use of or the right to use patents, trademarks, know-how or other intangible property may be used to shift profits out of high-tax countries into low-tax or into no-tax countries by fixing the royalties at artificially high rates. Such devices are facilitated by difficulties in estimating the arm’s length value of monopoly rights. In addition, multinational firms may transfer intangible property to an affiliated corporation under conditions that would not occur between unrelated persons. For example, a multinational corporation might transfer highly profitable know-how that it would never share with an unrelated person to a corporation organized in a tax haven simply for the purpose of generating a deduction in the country where the intangible property is located.

Technical assistance

101. Affiliated corporations may charge improper technical fees as a way of minimizing taxes for the corporate group. In some cases, they may set the fees too high. For example, a corporation engaged in business in a country may pay an excessive technical assistance fee to a related corporation located in a low-tax jurisdiction in order to take an excessive deduction. The source country may have difficulty determining a proper price for technical assistance because those services tend to be unique and difficult to value. In other cases, a corporate group may set the technical assistance fees too low. For example, a foreign corporation making sales of goods into a country may provide technical assistance in conjunction with those sales. Under its tax treaty, the sales income would be exempt if the foreign corporation has no permanent establishment in the country, whereas the fees for technical assistance may be the subject to a withholding tax. To minimize the withholding tax, the foreign corporation may claim that the technical assistance has little value.

iii. Fictitious deductions

102. In a variety of circumstances, a taxpayer may claim fictitious or inflated business expenses as deductions. In employing this tactic, the taxpayer may claim that the purported payment was made to a person located outside the taxing jurisdiction, thereby making an audit of the expenses difficult for the tax authorities. For example, if the taxpayer purchases goods outside the taxing jurisdiction, false invoices may be prepared to show a purchase price greater than the actual amount paid by the taxpayer.

103. Payments characterized as commissions, royalties, technical service fees and similar expenses are sometimes paid by a resident of the taxing jurisdiction to a related non-resident and claimed as a deduction, even though the related non-resident has done nothing to earn these payments.

iv. Credit for fictitious tax

104. A taxpayer who resides in a country that allows a foreign tax credit as a method of relieving double taxation and receives income from another country may seek to reduce tax in the residence country by claiming fictitious or excessive credits for taxes allegedly paid to the other country.

v. Improper characterization of income or expense items

105. Tax may be reduced by improperly characterizing an income or expense item in order to make use of an exemption or reduced rate.

vi. Inconsistent characterizations

106. A taxpayer may characterize a particular transaction in one way in country A, and in a contrary way in country B, in order to obtain tax benefits in both countries. For example, advances

by a parent in country A to a subsidiary in country B may be treated as equity in country A (in order to avoid the necessity for reporting interest income to country A), but as debt in country B (in order to avoid capital stock taxes in country B). Payments made by a subsidiary in country A to its parent in country B may be treated as the purchase price of goods in country A but as royalties or dividends in country B. In some cases, however, inconsistencies of this type may be justified by differences in the internal laws of the two jurisdictions.

vii. Utilizing temporary taxpayer status

107. Where taxation is based on a temporary status, tax evasion or avoidance may occur through transactions that take advantage of that temporary status. For example, because a borrower is not liable to tax on the proceeds of a loan, a foreign national may arrange an ostensible loan while he is a resident of the taxing jurisdiction, and then sell the collateral for the alleged loan to the lender following his departure from the taxing jurisdiction (when he is no longer taxable on sales profit within that jurisdiction), with the “loan” being credited against the sale price.

viii. Flight to evade payment of tax

108. When a taxing jurisdiction determines that a resident alien has taxable income or assesses a tax against him, the individual may flee the jurisdiction to escape tax. Even though the authorities of the taxing jurisdiction have properly assessed the tax, it is collectible only to the extent of the taxpayer’s property within the reach of the administrative and judicial collection power. Generally, that power is limited to the taxing country and its possessions. Thus, when property is removed from the taxing jurisdiction, a tax department may be unable to levy against it because the courts of one country generally will not enforce a judgement for taxes rendered by the courts of another country in the absence of a treaty that provides for mutual assistance in collection.

ix. Improper allocation of expenses

109. When a foreign corporation operates both within and without a country, it often must allocate certain expenses between its branch operations within the country. In some cases, the allocation rule to apply is quite obvious. For example, if Company P has a branch in country B and makes sales in that country through its branch, the expenses associated with the sale should be allocated to the branch. In many other cases, however, the proper allocation rule is less obvious. For example, it is not obvious how the interest expenses of a corporation should be allocated between a domestic and foreign branch. Other expenses creating problems of allocation include head office expenses, certain legal fees, deductible charitable contributions and certain taxes.

b. Practices resorted to in order to evade or avoid taxes imposed by the country of source

110. Tax on non-business income derived from sources within the taxing country by non-residents is generally collected by requiring the payer of the income to withhold the tax before remitting the balance of the payment to the non-resident. There are a number of common techniques for evading the payment of these withholding taxes.

i. False withholding certificates

111. Tax may be evaded by providing false information to withholding agents. For example, a payer of dividends having no definite knowledge of the status of a shareholder may not be required to withhold tax if, under the laws of the taxing country, dividend payments to resident shareholders are not subject to withholding. Accordingly, a non-resident alien recipient may establish a false address within the country, in order to escape withholding. This method of evasion depends on the willingness of the nominee to violate the law by failing to withhold tax when he makes remittances to the true owner outside the country.

ii. Use of bearer securities

112. In many instances, withholding taxes can be avoided by holding securities in bearer form, particularly if they are in the custody of a broker, nominee or agent within the country of the issuing corporation. Again, this method of avoidance assumes that the person holding the bearer securities is prepared to violate the law by failing to withhold when remittances are made to the true owner.

iii. Erroneous characterization of income items

113. Where the withholding rates on certain types of income are lower than the rates on other types of income, related entities may disguise the true character of a payment in order to take advantage of the lower rate. For example, dividends may be paid in the guise of fees or commissions.

iv. Unreported income and fictitious expenses

114. An individual who is temporarily present in the taxing jurisdiction, but is neither a resident nor a citizen, may evade tax on income earned while he was in the jurisdiction by either understating income or overstating expenses.

c. Institutional devices and arrangements that facilitate evasion

115. A variety of institutional devices are used to conceal the existence of international income or to generate fictitious deductions thereby facilitating international income tax evasion.

i. Dummies, nominees and numbered bank accounts

116. Salaries, investment income, business profits and other items of international income are frequently concealed by having these items paid to dummies, nominees or numbered bank accounts inside or outside the taxing jurisdiction. For example, an official of country A may state that he will permit a subsidiary in country A to make certain remittances to its parent in country B only if the parent makes an unreported payment in funds of country B to a nominee of the official (or a numbered bank account maintained by him) in country B or C. Similarly, a resident of country D who sells property at a gain to a resident of country E may stipulate that the sales proceeds are to be deposited in a numbered bank account inside or outside country D.

117. Once an item of international income has been concealed in a numbered bank account or in the name of a nominee, the concealed amount can be used to generate investment income, which may likewise be concealed from the taxing authorities of the country in which the true owner of the account is residing.

ii. Bearer securities

118. In order to conceal the receipt of dividend or interest income, international investors frequently place investments in bearer form. The use of bearer securities also facilitates the transfer of investments from one owner to another without reporting the transaction and paying the tax due by reason of the transfer. It is difficult to police such transactions from a tax standpoint because the use of bearer securities is widespread and entirely legal in many countries.

iii. Foreign holding companies and trusts

119. Under the laws of some countries, a resident may legally avoid tax by placing income producing property in a foreign corporation or trust which he controls. However, under the laws of other countries, the investment income is taxable by the country of residence whether or not it is actually distributed by the foreign corporation or trust to the resident owner. In cases of the latter type, tax is frequently evaded by illegally concealing the existence of the foreign holding company or trust from the tax authorities of the country or residence.

iv. Artificial bank loans

120. A major technique for international tax evasion consists of purportedly borrowing funds that are actually owned by the borrower. This practice not only enables the “borrower” to make open use of funds previously concealed in the name of a nominee or in a numbered bank account, but it also gives the borrower a pretext for claiming fictitious interest deductions. For example, a resident of country A who has deposited unreported international income in a numbered bank account in country B arranges to “borrow” an equivalent amount from that bank at 82 per cent interest. If the bank is paying 8 per cent interest to him on his numbered account, he is actually out of pocket only 2 per cent, but on the return which he files in country A he will treat the receipt of the unreported income as a “loan” and will claim a deduction for the entire 82 per cent interest charge that he pays to the bank.

121. To further disguise the true facts, a resident of country A with a numbered bank account in country B may arrange to have the bank in country B forward funds to an unrelated bank in country C from which he will then “borrow” an equivalent amount.

v. Investment trusts

122. An international investment trust, by concentrating funds from many different sources in a single investment pool, may be utilized by numerous investors as a tool for tax evasion. In many cases, an international investment trust will be used to obtain tax treaty benefits for its investors without the tax authorities in their country of residence learning about the income.

d. Use of related tax-haven entities to reduce taxes

123. Taxpayers sometimes utilize entities organized in tax-haven countries to reduce taxes legally, the legality of the transactions depending on the laws of the country where taxpayers are located. The presence of tax-haven countries, however, invites tax evasion activities that initiate essentially false or illegal relationships with the tax-haven country. Some of the latter situations are described below.

i. Transfer of income-producing assets to a tax-haven entity

124. Tax is sometimes avoided or evaded by transferring income-producing assets at an artificially low cost from the taxing jurisdiction to a controlled entity in a foreign tax-haven country where income from the assets will be taxed at a lower rate or escape tax entirely. The assets transferred to the foreign tax-haven company may consist of:

- Stocks, securities, rental properties, and intangibles such as licensed patents, trademarks and copyrights that will generate passive income; or
- Property of any kind which will be resold by the tax-haven entity to unrelated third parties at a gain.

In many cases, there is no limitation on the amount of income which may be accumulated tax free in the foreign tax-haven entity.

ii. Nominal transfer of income-producing functions to a tax-haven entity

125. An entity in a high-tax country may avoid or evade tax in that country by rendering, or appearing to render services to unrelated persons through a controlled entity in a tax-haven jurisdiction. In the typical case, the controlled entity is a shell corporation that is incapable of performing the services unless it uses personnel or property of the controlling entity.

iii. Payment of deductible expenses to a tax-haven entity

126. An entity in a high-tax jurisdiction may pay management fees, technical service fees, or other deductible fees to a related entity in a tax-haven jurisdiction, although the related entity has not actually earned those fees and will not pay significant taxes on them.

iv. Payment of deductible expenses which benefit a tax-haven entity

127. An entity in a high-tax country may incur deductible expenses in acquiring or developing property which is then made available without adequate reimbursement to a related entity in a tax-haven country. For example, the entity in the high-tax country may take interest deductions with respect to borrowed funds which are re-lent to the related entity interest free. Similarly, the entity in the high-tax country may take depreciation deductions for tangible property that is leased or licensed to the related entity for an artificially low consideration.

128. As previously stated, some of the techniques described above may be legal methods of reducing tax, rather than illegal methods of evading tax, depending on the law of the particular countries involved.

B. Historical overview of international tax avoidance and evasion

129. The question of international tax evasion has been a matter of international concern for well over a century and a half. The first tax treaty was an agreement on reciprocal administrative assistance between Belgium and France signed on 12 August 1843. Shortly thereafter, in 1845, Belgium signed similar agreements with two other States, the Netherlands and Luxembourg.

130. Both the 1920 International Financial Conference at Brussels and the 1922 International Economic Conference at Genoa emphasized the desirability of international action for the prevention of tax evasion. The Brussels Conference stated that it would be desirable to draw attention to the advantages of making progress in this area. “An international understanding which, while ensuring the due payment by everyone of his full share of taxation, would avoid the imposition of double taxation which is at present an obstacle to the placing of investments abroad.”³³ The Genoa Conference expressed itself in the following way:

“We have considered what action, if any, could be taken to prevent the flight of capital in order to avoid taxation, and we are of the opinion that any proposals to interfere with the freedom of the market for exchange, or to violate the secrecy of bankers’ relations with their customers are to be condemned. Subject to this proviso, cooperation to prevent tax evasion might be usefully studied in connexion with the problem of double taxation.”³⁴

131. The 1928 General Meeting of Government Experts on Double Taxation and Tax Evasion adopted a separate bilateral model convention on administrative assistance in matters of taxation. That assistance was to consist of the exchange of fiscal information available in either of the Contracting States and in cooperation between their administrative authorities in carrying out certain procedural measures. The exchange of information was to take place following requests concerning specific cases or on a routine basis (i.e., without any special request) in the case of particulars (name, surname, domicile or residence, family responsibility) with reference to immovable property, mortgages or other similar claims, industrial, commercial or agricultural undertakings, earned income and directors’ fees, transferable securities, claims, deposits and current accounts and successions. The 1928 General Meeting also approved a separate bilateral convention on judicial assistance in the collection of taxes, the word ‘collection’ covering not only measures of execution but also preliminary measures such as the serving of the documents of execution. These two conventions, together with the two double taxation conventions, adopted at the same time (dealing respectively with income and property taxes and succession duties), did not win significant acceptance.

³³ *Recommendations of the Brussels Conference*, resolution proposed by the Commission on International Credits, No. 12.

³⁴ *Recommendations of the Genoa Conference*, resolution proposed by the Financial Commission, No. 13.

132. Pursuant to a request by the Assembly of the League of Nations, the Fiscal Committee of the League studied the question of tax evasion at its sixth session, held in 1936. In its report on that session, the Committee dealt with existing tax evasion practices with particular reference to income from securities. It proposed a new solution based on a system for the exchange of information and asked the Governments of Members of the League, and also non-members, whether they would approve a general convention establishing such a system.³⁵ The response was not encouraging and the Assembly asked the Committee to resume its discussion of the question. The Committee proceeded to draft a questionnaire with a view to determining what could be done to combat tax evasion on the basis of existing tax laws. In the light of the replies to the questionnaire, the Committee expressed the view that

“the administrations have shown great ingenuity in combating evasion in every form. But the efforts of the various administrations were of so special a character that it appeared to be difficult to employ the methods used by one country in other countries, and it was clear that any proposal for a general scheme would have been received with serious hesitation.”³⁶

The Committee was therefore of the opinion that “for the problem of fiscal evasion as for the problem of double taxation, bilateral conventions are the only possibility, as they can be adapted to circumstances and the nature of the results aimed at.”³⁷

133. Consequently, at the two Regional Tax Conferences held under the auspices of the Fiscal Committee at Mexico City in June 1940 and July 1943, and at the tenth session of the Fiscal Committee itself held in London in March 1946, emphasis was placed on the need for bilateral conventions for the prevention of tax evasion. Two special model bilateral conventions were prepared, one in Mexico and the other in London, dealing with the establishment of reciprocal administrative assistance for the assessment and collection of taxes on income, property, estates and successions. Both conventions contain an identical clause under which if the competent authority of a Contracting State considered information concerning particular cases to be necessary for the assessment of taxes covered by the convention, it could obtain that information through direct correspondence with the competent authority of the other Contracting State without having to use diplomatic channels. The conventions also indicated in identical language the kind of information which should be supplied and specified in the cases in which special requests for information or assistance in enforcing tax laws might be refused. Those cases related to requests for information not procurable under domestic laws, to requests implying administrative or judicial action incompatible with domestic laws and practices, to requests compliance with which would involve violation of a professional, industrial or trade secret, and to requests compliance with which might compromise the security or sovereign rights of the other State.

134. The Nordic countries have taken a leadership role in promoting mutual assistance among governments for the prevention of international tax evasion and for mutual assistance in assessment

³⁵ League of Nations, Report of the Fiscal Committee to the Council on the work of the sixth session of the Committee (C.450.M.266.1936.II.A).

³⁶ League of Nations, Report of the Fiscal Committee to the Council on the work of the eighth session of the Committee (C.384.M.II.A), p. 2, paragraph I.3.

³⁷ *Ibid.*, paragraph I.4.

and collection of taxes. The efforts in the field of administrative assistance in tax matters has been pursued by the Nordic countries since the early 1940s. A bilateral agreement on such assistance was signed by Finland and Sweden in 1943; its main purpose was to facilitate the enforcement of taxes in cases in which taxpayers had left one of the Contracting States for the other. It was recognized that the agreement would help prevent tax avoidance. The agreement covered both reciprocal assistance for the enforcement of tax claims and the exchange of information (service of documents and procurement of information on tax matters). The agreement was followed by other agreements in the same field between Norway and Sweden (1949), Denmark and Sweden (1953), Finland and Norway (1954), Denmark and Finland (1955) and Denmark and Norway (1956).

135. The question of the revision of those agreements was taken up by the representatives of the Nordic tax administrations at a meeting held in Helsinki in 1967, at which it was found that the provisions of those agreements and of the relevant legislation of those countries were similar. For that reason, the representatives of the Nordic tax administrations decided at a meeting held in Copenhagen in 1970 that a multilateral convention on administrative assistance in tax matters between Denmark, Finland, Iceland, Norway and Sweden should be prepared. The convention was signed on 9 November 1972, supplemented by a special agreement in 1973 and amended by an additional agreement in 1976. The Nordic Convention on Income and Capital entered into by Denmark, Finland, Iceland, Norway and Sweden, which was concluded in 1983, was replaced in 1987, 1989 and 1996. The Convention on Mutual Administrative Assistance in Tax Matters was drawn up within the Council of Europe on the basis of a first draft prepared by the Committee on Fiscal Affairs. This Convention entered into force on 1 April 1995.

136. International organizations have also been taking increasing interest in the question of international tax evasion. The European Economic Community adopted on 10 February 1975 a resolution³⁸ on the measures to be taken by the Community with a view to combating international tax evasion and avoidance, which is reproduced below.

THE COUNCIL OF THE EUROPEAN COMMUNITIES

Having regard to the communication of 22 November 1974 from the Commission on the problem of international tax evasion and avoidance;

Whereas practices of tax evasion and tax avoidance reaching beyond national borders of Member States lead to budget losses, violations of the principle of fiscal justice and distortions of capital movements and of conditions of competition;

Whereas the international nature of the problem means that national measures, whose effect does not extend beyond State boundaries, are insufficient;

³⁸ European Union: Community Legislation in Force; Document 375 Y0214 (01) Official Journal C035, 14 February 1975, pp. 0001-0002.

Whereas several national tax administrations are already collaborating to this end on the basis of bilateral agreements, and whereas such collaboration both within the Community and third countries should be strengthened and adapted to new forms of tax evasion and avoidance;

Whereas care must be taken to ensure that information exchanged in such collaboration is not disclosed to unauthorized persons, to safeguard within Member States the basic rights and procedural guarantees of citizens and undertakings and to take account of the requirements of those States to preserve secrecy in certain matters. The Member States receiving such information must undertake to use it only for the purpose of making correct assessment for taxes on income or profits or to support a prosecution for failure, by the person concerned, to observe the fiscal law of the receiving State. It must also afford to the information the degree of confidentiality which it had in the State from which it arose;

Considers that it is desirable for action to be taken initially on the points set out below:

- (a) the mutual exchange between Member States, whether on request or not, of all information that appears to be of use for making correct assessments for taxes on income or profits, and in particular of information in every case where there appears to be artificial transfer of profits between undertakings in different countries, or where transactions are carried out between undertakings in two Member States through a third country in order to obtain tax advantages, or where the tax has been or may be evaded for any reason whatever;
- (b) the need, in order to make this exchange of information more effective, to study possibilities of harmonizing the legal and administrative means available to tax administrations for collecting information and exercising their rights of investigation;
- (c) the carrying out of investigations, for making correct assessments for taxes on income or profits, by one State, in compliance with national laws, on behalf of another when the latter State requests it to do so;
- (d) the study of the possible provision of facilities for officials of one State to assist within another State in the work of establishing and exploiting facts that will be of use for making correct assessments for taxes on income or profits owed in the first State;
- (e) the collaboration with the Commission necessary for the permanent study of cooperation procedures and the exchange of experience in the fields considered, and in particular in the field of artificial transfer of profits within groups of undertakings, with the aim of improving them and of preparing regulations suitable for the Community.

Take note that the Commission will, within the scope of its powers, take appropriate steps in this sector.

Furthermore, the Council of the European Economic Community adopted on 19 December 1977 a directive concerning mutual assistance by the competent authorities of Member States with regard to direct taxes.

137. In this connection, it would also be desirable to reproduce the OECD Council's Recommendation on Tax Avoidance and Evasion:

1. **RECOMMENDS** the Governments of Member Countries:

- a) To strengthen, where necessary, their legal, regulatory or administration provisions and their powers of investigation for the detection and prevention of tax avoidance and evasion, with regard to both their domestic and international aspects, and to exchange experiences with respect to such action;
- b) To facilitate, improve and extend exchanges of information between their national tax administrations, with a view to combating tax avoidance and evasion, notably by making more intensive use of international conventions or instruments in force and by seeking new arrangements of a bilateral or multilateral character, with due regard to the provision of adequate safeguards for taxpayers;
- c) To exchange experiences on a continuing basis on tax avoidance and evasion practices, on techniques for detecting and preventing them and on ways and means of improving tax compliance in general.

2. **INSTRUCTS** the Committee on Fiscal Affairs to pursue its work with a view to facilitating the achievement of the above aims and to submit to the Council, as appropriate, specific proposals for increased cooperation between Member countries in this field.

138. The OECD Committee on Fiscal Affairs has been devoting considerable attention to international tax evasion and avoidance, and one of its working parties is specifically responsible for investigating the related issues. The OECD adopted on 21 September 1977 a recommendation³⁹ requesting Member States to strengthen their machinery for combating international tax evasion and avoidance, to encourage the exchange of information between national tax administrations and to compare their experience with regard to the practices and techniques used. Also, on 29 June 1979, the Committee on Fiscal Affairs adopted a Model Convention for Mutual Administrative Assistance in the Recovery of Tax Claims.

C. Mutual administrative assistance

139. Increasingly, tax treaties are stipulating assistance in collecting taxes. So far, a similar provision has not been included in the United Nations tax treaty model. Such an article would have two main advantages. Firstly, it increases the chance of collecting taxes from taxpayers living abroad. Secondly, it reduces tax evasion possibilities through emigration. It goes without saying

³⁹ Described in paragraph 55.

that a State has to be sure that the aim of assistance in collection of taxes is suitable and desirable within its treaty policy before it inserts such a provision in a treaty.

140. A State which wishes to introduce such an article has to consider at least the following issues. In the first place, a State needs to possess a legislative framework which allows the implementation in practice of this provision. Secondly, the tax administration should be capable and able to collect the tax revenues. Furthermore, it should be considered whether the mutual advantages would justify the new obligations between the two Contracting States. It should be noted, in this respect, that reciprocity with equal revenue is not necessary. However, it might be an element a State might try to obtain. Other important aspects to consider are the size of the economic relationships, the efficiency to collect the tax revenue in both States and the legal protection of the taxpayer.

141. If two States would like to insert a similar article, it would be desirable to include the following issues. Firstly, the scope of the article of assistance in the collection of taxes. To which direct taxes and persons will it apply? For persons, the scope could be stretched to residents instead of just citizens. Secondly, the legislation which can be used to collect the revenue. Usually the legislation of the requested State will be applied. This will normally imply that the requested State will be limited in its measures to collect the revenue on the basis of its own law. Further, the requested State has normally no obligation to use executorial instruments, if the requesting State does not have these instruments at its disposal. The time limit of appeal to court will usually be found in the legislation of the requesting State. It should be considered that the taxes of the requesting State may not have the same preferential status as in the requested State. Exceptions on the obligations to assist can be found in the argument that the requesting State has not used all possible measures of collecting the revenues or that the request interferes with the interest of the requested State. Thirdly, the settlement of the costs which have been made for the collection. The requested State will have to pay normally for the ordinary costs. Unreasonably high costs are likely to be paid by the requesting State. A settled currency rate can be a useful tool to help settle these costs. Fourthly, the exchange of information concerning the collection of the revenue should be considered as well. Finally, the notification of the documents requesting a collection abroad have to be worked out.

142. Moreover, a Multilateral Convention on Mutual Administrative Assistance in Tax Matters has been developed within the Council of Europe, based on a first draft prepared by the OECD Committee on Fiscal Affairs. The multilateral convention was opened for signature on 25 January 1988 and is open to the Member States of the Council of Europe and the Member Countries of the OECD. The Convention has been signed by only a few countries, including several of the Nordic countries, and it has not been ratified by some of the countries that signed it. A sufficient number of signatures has been obtained, however, to bring the Convention into force in 1995. The current signatories include Denmark, Finland, Iceland, the Netherlands, Norway, Poland, Sweden and the United States of America.

143. The Multilateral Convention generally requires that each Contracting State provide administrative assistance in tax matters to each other Contracting State. The Convention provides

for three basic categories of assistance, with regard to a wide range of taxes: exchange of information, assistance in the collection of taxes, and service of documents. With respect to the first category, each Contracting State is required to make available to the other States all information in its possession that is “foreseeably relevant” to the other States’ tax administration and collection efforts. Each State must also utilize all means available to it in administering and enforcing its own tax laws to obtain foreseeably relevant information not in its possession if so requested by other States. Also, subject to various procedural limitations, the Convention requires each State to enforce tax claims of the other States as though the taxes were those of the enforcing State. The Convention’s provisions on service of documents require each State to utilize its domestic laws for this purpose, as though the tax liability were owed to the serving State. A copy of the Convention may be seen in the Annexes.

PART TWO

**UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION
BETWEEN DEVELOPED AND DEVELOPING COUNTRIES**

PREFACE

1. In order to take advantage of the accumulated technical expertise embodied in the reports of the meetings of the Group of Experts and also the texts of different model conventions for the purpose of the negotiation of bilateral tax treaties between developed and developing countries, the Ad Hoc Group of Experts on International Cooperation in Tax Matters has basically used the United Nations Model Double Taxation Convention between Developed and Developing Countries as its main reference text.

2. The articles and the commentary thereon in the United Nations Model Convention formulated by the Group of Experts contain suggestions concerning specific provisions that could be embodied in a bilateral tax treaty. Each article, therefore, takes the form of a possible text of a treaty article. Furthermore, each article is followed by observations which summarize the relevant discussion in the Group of Experts, mention the decisions taken and indicate the manner in which the provisions of the article may be interpreted.

3. In some cases, it is stated that the article in the United Nations Model Convention reproduces a provision in the OECD Model Convention. This may indicate that the text of the article remains unchanged except for minor drafting changes. When the text of an article in the United Nations Model Convention reproduces the provisions of an article of the OECD Model Convention, it should be construed as having the same meaning and being subject to the same reservations as that article, and should be interpreted in the light of the OECD commentary in effect when the United Nations Model Convention was prepared, unless a contrary interpretation is indicated in the United Nations Model Convention commentary. Because the OECD Model Convention has continued to evolve over time, it may be advisable for the reader to refer to the articles and commentaries in the OECD Model Convention to ascertain the position at the relevant time.

4. Problems may arise in the case of terms used in the OECD Model Convention and the guidelines which are not defined either in the United Nations Model Convention or in the OECD Commentary and have not been classified by the Group of Experts. Participants from developing countries in the Meeting of the Drafting Committee for the 1980 edition of the United Nations Model Convention cited as examples of such terms “landed property”, “partnership”, “general commission agent”, “jouissance shares”, “jouissance rights”, “mining shares” and “industrial, commercial or scientific equipment”. It was mentioned, for instance, that in the Republic of Korea there was no legal concept of “landed property” distinct from the concept of immovable property and that the expression in the Korean language which was most similar to the English term “partnership” did not correspond to the concept of partnership as used in the United Nations Model Convention. It may be relevant to note that the OECD Committee on Fiscal Affairs adopted on 20 January 1999 the report of the Working Group entitled “The Application of the OECD Model Tax Convention to Partnerships”. The report deals with the application to partnerships of the provisions of the OECD Model Tax Convention and, indirectly, of bilateral tax conventions based on that model. The Committee recognizes, however, that many of the principles discussed in that report may also apply, *mutatis mutandis*, to other non-corporate entities. Pending definition of such terms

by the Group of Experts, the negotiating parties should endeavour to reach mutually acceptable definitions.

5. The articles in the United Nations Model Convention are not intended as a substitute for negotiations. They are not to be construed as binding provisions or as formal recommendations of the United Nations or as representing either the maximum or minimum concession that either potential contracting party should grant or demand in the give-and-take of the negotiating process. In preparing its own negotiating strategy, a participating country may wish to review the provisions of bilateral double taxation treaties entered into by the other country in order to survey concessions granted in the past, departures from the specific provisions herein propounded, and so on.⁴⁰

6. Like all model conventions, the United Nations Model Convention is not enforceable. Its provisions are not binding and should not be treated as formal recommendations of the United Nations. They aim at facilitating the negotiation of tax treaties by eliminating the need for elaborate analysis and protracted discussion of every issue *ab origine* in the case of each treaty. They are designed to constitute a framework for the negotiators, who can proceed with their work, secure in the knowledge that the articles of the United Nations Model Convention are the outcome of dispassionate in-depth examination of the issues involved by top-level experts from both developed and developing countries who, by agreeing to become members of the Group of Experts in their personal capacity, have committed themselves to expressing entirely objective opinions based solely on technical considerations.

7. The United Nations Model Convention represents a compromise between the source principle and the residence principle. However, it gives more weight to the source principle than does the OECD Model Convention, which contains a more restrictive definition of a permanent establishment and, in the areas of shipping profits, dividends, interest and royalties, relies more strongly on taxation at source at relatively lower rates or sometimes exclusive taxation by the country of residence. (The allocation of greater taxing power to the source country in the United Nations Model Convention does not mean that the withholding tax rates in the OECD Model Convention on dividends, interest or royalties are too low as a matter of principle and that the Contracting States should always strive for higher rates). As a correlative to the principle of taxation at source, the articles of the United Nations Model Convention are predicated on a recognition by the source country that taxation of income from foreign capital: (1) should take into account expenses allocable to the earnings of that income so that such income is taxed on a net basis; (2) should not be imposed at so high a rate as to unduly discourage investment; and (3) should take into account the appropriateness of a sharing of revenue with the country providing the capital. In addition, the United Nations Model Convention embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either foreign tax credit or exemption, as in the OECD Model Convention.

8. In applying the provisions of the United Nations Model Convention, a country should bear in mind the fact that the relationship between treaties and domestic law may vary from country to country and that it is important to take into account the relationship between tax treaties and domestic law. The status of a double taxation convention in the national laws of States varies widely because of the differing national methods of adopting international treaty obligations. The

⁴⁰ Bilateral double taxation treaties are published by the United Nations on a regular basis in the series entitled *International Tax Agreements*

fundamental issue is whether a State takes the view that national law and international law are part of the same system of law or are separate systems. Some States consider international law and treaties to take primacy over national laws. Many States provide in their domestic law for the primacy of their parliament or legislature, although most of these States, in practice, give primacy to international agreements in almost all circumstances. Many treaty provisions rely for their operation on terms defined by the domestic legislation of the Contracting States. In applying those provisions, many States look to the current meaning of those terms (the ambulatory approach), whereas some States look to the meaning of those terms at the time the treaty went into force (the static approach). It is relevant to mention that paragraph 2 of article 3 of the United Nations Model Convention clearly favours the ambulatory approach.

9. Tax treaties affect the tax rules prevailing under the domestic tax laws of the Contracting States by providing which Contracting State shall have jurisdiction to subject a given income item to its national tax laws and under what conditions and with what limitations it may do so. Consequently, a country wishing to enter into bilateral tax treaty negotiations should analyse carefully the applicable provisions of its domestic tax laws in order to assess the impact of the proposed treaty on their operation. Exercise of the taxing power is one of the fundamental attributes of sovereignty, often requiring sensitive political and economic choices. To the extent that treaty negotiations require a re-examination of those choices, they are likely to be complex and time consuming. To conclude a successful treaty negotiation, the treaty partners need to find ways of meshing two tax systems that may embody different goals and may employ different technical features. In some cases, the Contracting States may have quite different rules for taxing international income. One State may use the credit method for relieving double taxation, whereas the other State may use the exemption method or may not provide any form of unilateral relief. One State may have bank secrecy legislation that it wishes to maintain, whereas the other State may insist on an exchange of information provision in the proposed treaty that is inconsistent with bank secrecy. One State may tax contributions to pension funds and allow a recovery of those contributions free of tax, whereas the other State may allow a deduction for pension plan contributions and tax distributions from those funds fully. One State may tax partnerships as separate juridical persons, whereas the other State may treat them as conduits for the participating partners. In negotiating a tax treaty, the Contracting States should take into account all of these and many other aspects of the tax systems of the two States, the differences in the economies of the two States and the relative importance of particular industries in the Contracting States. (The allocation of greater taxing power to the source country in the United Nations Model Convention does not necessarily imply the difference in the economies of the two States and the relative importance of particular industries in the Contracting States). Hence, a simple side-by-side comparison of two actual treaties, or of a proposed treaty against a model treaty, will not enable meaningful conclusions to be drawn as to whether a proposed treaty reflects an appropriate balancing of interests. In many cases the differences in language are of little substantive importance, whereas in other cases, they reflect fundamental differences.

10. A bilateral tax treaty is the result of a negotiated settlement between two Contracting States that may have conflicting objectives. In the case of conflict, some compromise is necessary for the treaty negotiations to continue. To achieve its goal with respect to one provision of a treaty, a State may be compelled to offer some concessions with respect to another provision. A State may have concluded that it must obtain its desired outcome on certain issues or it will not proceed with the

negotiations. For example, a State may conclude that a treaty without an effective anti-abuse provision and an exchange of information provision is simply not worth having. Many States welcome such provisions in a treaty. If a State is unwilling to accept those provisions, however, the treaty negotiations may fail. If the process of give and take continues, it may result in a treaty that is less than ideal from the perspective of either country but is the best treaty that the two States could devise, given their difference on certain issues. Ultimately, a negotiated treaty is not likely to be ratified by the two sides unless both sides believe that the treaty represents the best outcome available to them and serves their national interests.

11. Domestic tax laws may exert an important influence on the content of bilateral tax treaties. Thus, although there was general agreement in the OECD about the principles embodied in the OECD Model Convention and although most bilateral tax treaties conform by and large with the latter, there are often substantial variations from one treaty to another, due to differences in the domestic laws and treaty policies of the various Contracting States. The OECD Model Tax Convention is drafted on the principle that the application of the provisions of a convention is a matter for the internal law of the Contracting States. The Convention is therefore largely silent about issues of application, as is the OECD Commentary to the Convention.

12. States differ widely in their approaches to providing rules and procedures for operating double taxation conventions. One issue that emerges is whether a State should use a consistent set of rules and procedures applicable to all double taxation conventions, or whether different rules and procedures should apply to each double taxation convention. Another issue is whether the rules and procedures should be the same for all forms of income. There is a trend among States towards the adoption of general regulations applicable to all double taxation conventions. These regulations are sometimes promulgated at the administrative level. Another approach is to adopt implementing provisions through domestic legislation. One developed country, for instance, has adopted provisions in its tax legislation that treat all claims for foreign tax relief alike, whether the relief claimed is under a double taxation convention or under domestic legislation.

13. Behind these differing practices and approaches is a fundamental question: Is the application of a double taxation convention a matter of tax law or of the general administrative law of the State? In a sense, of course, it is both. However, in some States the application of a double taxation convention is regarded as part of the general administration, whereas in other States, the procedures for application may be specific to taxes, or specific to the double taxation convention alone. These different approaches may also be relevant in determining whether disputes about the application of a double taxation convention should go to a tax court or an administrative court. If the application of tax treaties is governed by administrative law, it may be subject to the general administrative law principles of the country.

14. The United Nations Model Convention is divided into chapters. Chapter I contains suggested texts concerning the scope of the treaty, and Chapter II defines terms used in bilateral tax treaties. Chapter III (taxation of income), Chapter IV (taxation of capital) and Chapter V (methods for elimination of double taxation) constitute what may be regarded as the main operative segments of the Model Convention. Chapter VI contains special provisions and Chapter VII contains final provisions. A detailed summary of the Model Convention follows.

The reading of what follows is based on the United Nations Model Double Taxation Convention between Developed and Developing Countries, its articles and commentaries thereon.

SUMMARY OF THE CONVENTION

TITLE AND PREAMBLE

CHAPTER I

Scope of the Convention

Article 1:	Persons covered
Article 2:	Taxes covered

CHAPTER II

Definitions

Article 3:	General definitions
Article 4:	Resident
Article 5:	Permanent establishment

CHAPTER III

Taxation of income

Article 6:	Income from immovable property
Article 7:	Business profits
Article 8:	Shipping, inland waterways transport and air transport (alternative A)
Article 8:	Shipping, inland waterways transport and air transport (alternative B)
Article 9:	Associated enterprises
Article 10:	Dividends
Article 11:	Interest
Article 12:	Royalties
Article 13:	Capital gains
Article 14:	Independent personal services
Article 15:	Dependent personal services
Article 16:	Directors' fees and remuneration of top-level managerial officials
Article 17:	Artistes and sports persons
Article 18:	Pensions and social security payments (alternative A)
Article 18:	Pensions and social security payments (alternative B)
Article 19:	Government service
Article 20:	Students
Article 21:	Other income

CHAPTER IV

Taxation of capital

Article 22: Capital

CHAPTER V

Methods for elimination of double taxation

Article 23A: Exemption method

Article 23B: Credit method

CHAPTER VI

Special provisions

Article 24: Non-discrimination

Article 25: Mutual agreement procedure

Article 26: Exchange of information

Article 27: Members of diplomatic missions and consular posts

CHAPTER VII

Final provisions

Article 28: Entry into force

Article 29: Termination

TITLE OF THE CONVENTION

Convention between (State A) and (State B)
with respect to taxes on income and on capital¹

PREAMBLE OF THE CONVENTION²

CHAPTER I

SCOPE OF THE CONVENTION

Article 1

PERSONS COVERED

This Convention shall apply to persons who are residents of one or both of the Contracting States.

Observations

The Group agreed in 1999 to change the title of article 1 from ‘Personal scope’ to ‘Persons covered.’ Like the OECD Model Convention, the United Nations Model Convention applies to persons who are “residents of one or both of the Contracting States.”

Article 2

TAXES COVERED

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital, or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

- (a) (in State A):
- (b) (in State B):

¹ States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.

² The Preamble of the Convention shall be drafted in accordance with the constitutional procedures of the Contracting States.

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of significant changes made to their tax laws.

Observations

The same income or capital may be subject in the same country to various taxes, either taxes which differ in nature, or taxes of the same nature levied by different political subdivisions or local authorities. Hence, double taxation cannot be wholly avoided unless the methods for the relief of double taxation applied in each Contracting State take into account all the taxes to which such income or capital is subject. Consequently, the terminology and nomenclature relating to the taxes covered by a Convention must be clear, precise and as comprehensive as possible. As noted by the OECD Committee on Fiscal Affairs, this is necessary in order to “ensure identification of the Contracting States’ taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States’ domestic laws are modified, by means of the periodic exchange of lists and through a procedure for mutual consultation.”

CHAPTER II

DEFINITIONS

Article 3

GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:
 - (a) The term “person” includes an individual, a company and any other body of persons;
 - (b) The term “company” means any body corporate or any entity which is treated as a body corporate for tax purposes;
 - (c) The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
 - (d) The term “international traffic” means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
 - (e) The term “competent authority” means:
 - (i) (in State A):
 - (ii) (in State B):
 - (f) The term “national” means:
 - (i) any individual possessing the nationality of a Contracting State;
 - (ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.

2. As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Observations

A number of general definitions are normally necessary for the understanding and application of a treaty, although terms relating to more specialized concepts are usually defined or interpreted in special provisions. There are other terms whose definitions are not included in the

treaty but are left to bilateral negotiations by the parties to the treaty. The United Nations Model Convention groups in its article 3 a number of general definitions required for the interpretation of the terms used in that instrument. These terms are “person”, “company”, “enterprise of a Contracting State”, “international traffic” and “national.” Article 3 leaves space for the designation of the “competent authority” of each Contracting State. The terms “resident” and “permanent establishment” are defined in articles 4 and 5 respectively, while the interpretation of certain terms used in the articles on special categories of income (e.g., immovable property, dividends) is clarified in the articles concerned. The parties to a treaty are left free to agree bilaterally on a definition of the term “a Contracting State” and “the other Contracting State”. They are also free to include in the possible definition of a Contracting State a reference to continental shelves. It was observed that countries that define the residence of a corporation by reference to its place of incorporation rather than its place of effective management might prefer to use the term “resident” where the term “place of effective management” appears in the definition of “international traffic.”

Under paragraph 2, any term in the treaty that is not defined by the convention takes its meaning from the domestic law of the State imposing the tax, whether or not a tax law, unless the context demands otherwise. However, where a term is defined differently for the purposes of different laws, the meaning given to that term for the purposes of the laws imposing the taxes to which the Convention applies prevail over all others, including those given for the purposes of other tax laws. The relevant domestic law is the law in force when the tax is imposed, not the law as of the time when the treaty was signed or became effective. The relevant context includes the intention of the Contracting States when the treaty was signed and the meaning of the undefined term under the domestic law of the other Contracting State.

Paragraph 2 only applies if the context does not require another interpretation. The context consists in particular of the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State (an implicit reference to the principle of reciprocity on which the Convention is based). The wording of the articles heretofore allows the competent authorities some leeway.

It has also been decided to leave the definitions of “a Contracting State” and “the other Contracting State” to be worked out in bilateral negotiations by the parties to the treaty, who might wish to include a reference to continental shelves in the possible definition of “a Contracting State” and were free to include a definition of any other term they deemed important.

Article 4

RESIDENT

1. For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

- (a) He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);
- (b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has a habitual abode;
- (c) If he has a habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
- (d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

Observations

Article 4 of the United Nations Model Convention reproduces article 4 of the OECD Model Convention, with one substantive change, the addition in 1999 of the criterion “place of incorporation” to the list of criteria in paragraph 1 for taxation as a resident. According to the OECD Committee on Fiscal Affairs, the concept of “resident of a Contracting State” has various functions and is of importance in three cases:

- “a) in determining a treaty’s personal scope of application;
- “b) in solving cases where double taxation arises in consequence of double residence;
- “c) in solving cases where double taxation arises as a consequence of taxation in the State of residence and the State of source or situs.”

Clearly, it is highly desirable that bilateral treaties should contain a definition of the concept of residence that is acceptable to both Contracting States. Under article 4, paragraph 1, the internal law definition of residence of those States will remain applicable unless there is a conflict between those laws with the result that both States claim a person as a resident. In that case the person’s residence will be determined according to the treaty definitions in paragraphs 2 and 3.

The OECD Model Convention, article 4 of which is intended to define the meaning of the term “resident of a Contracting State” and to solve cases of double residence, makes referral to domestic laws the preference criterion to be used for determining the residence of individuals and bodies corporate. However, the article also lists in decreasing order of relevance a number of

subsidiary criteria to be applied when an individual is a resident of both Contracting States and the preceding criteria do not provide a clear-cut determination of his status as regards residence. If none of these criteria suffices to determine the status of an individual as regards residence, the article provides that the question shall be settled by the competent authorities of the Contracting States by mutual agreement. In the case of bodies corporate, the article provides, in paragraph 3, that their status as regards residence shall be determined by a single criterion, namely, their “place of effective management.”

The latter term is used in several provisions of the OECD Model Convention, as is the term “place of management.” Neither term is defined explicitly in the Convention itself or in the commentary thereon, nor is it made clear whether the two terms are to be construed as having the same meaning or two different meanings. It is, however, understood that when establishing the place of effective management, circumstances which may, *inter alia*, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view, and the place where the most important accounting books are kept.

It is considered that the definition of the term “resident of a Contracting State” provided in article 4 of the OECD Model Convention and the criteria set forth therein for determining status as regards residence in various situations, constituted an acceptable means of solving cases of double taxation. It was observed that using the place of effective management as a tiebreaker rule might not be acceptable to countries that define the residence of a corporation by reference to its place of incorporation. In such circumstances, double taxation might be avoided through resort to the competent authority procedures set forth in article 25.

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.
2. The term “permanent establishment” includes especially:
 - (a) A place of management;
 - (b) A branch;
 - (c) An office;
 - (d) A factory;
 - (e) A workshop;
 - (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.
3. The term “permanent establishment” likewise encompasses:

- (a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;
- (b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any twelve-month period.

4. Notwithstanding the preceding provisions of this article, the term “permanent establishment” shall be deemed not to include:

- (a) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;
- (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;
- (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;
- (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.
- (f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs (a) to (e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 7 applies — is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

- (a) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

- (b) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that State or insures risks situated therein through a person other than an agent of independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

Observations

Article 5 of the United Nations Model Convention incorporates several provisions of article 5 of the OECD Model Convention (either unchanged or substantially amended) and some new provisions.

The concept of permanent establishment is used in bilateral tax treaties principally for the purpose of determining the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. Such treaties provide that an enterprise of one Contracting State shall be taxable on its profits in the other State only if it maintains a permanent establishment in the latter State and only to the extent that the profits earned by the enterprise in that State are attributable to that permanent establishment. The permanent establishment principle frees from taxation at the source not only occasional business transactions, but also continuing trading activities which do not entail the presence of a permanent establishment in the source country. The term “permanent establishment” was already used in the 1928 Model Conventions of the League of Nations. The United Nations Model Convention reaffirms the concept of permanent establishment and supplements it with the concept of a “fixed base”, which is used in the case of professional services or other activities of an independent character.³

³ In 2000, the OECD has omitted article 14 from its Model Convention.

Concerning the application of the OECD definition of permanent establishment to tax treaties with developing countries, a 1965 report of the OECD Fiscal Committee sets forth the following considerations:

“In the tax treaties between capital exporting countries and in the OECD draft, the problem posed by differences in the rules of source or in the allocation of income is solved in part by tax exemption based upon the so-called permanent establishment principle. Under this rule, income derived by an enterprise of one country from activities conducted in another country is not subject to tax in the other country unless conducted through a permanent establishment there. This does not dispose of the problem created by different rules of source, except in those cases where an enterprise of one country is engaged in business activities in the other in such a form as not to constitute a permanent establishment.

“In general, trade relations between developing and industrialized countries involve the flow of natural resource products from the developing to the industrialized country and of processed and manufactured goods from the industrialized to the developing country. Enterprises in developing countries do not engage in significant business activity in industrialized countries. Given these trading relationships, it would seem that the permanent establishment principle would favour the industrialized countries. However, with increasing industrialization in developing countries, sales and buying activity in developed countries may be facilitated by the permanent establishment concept. It may also make it possible for firms in capital exporting countries to maintain repair parts, supplies, etc. in a developing country which may otherwise not be feasible. Accordingly, there is a place for the permanent establishment principle in tax conventions with developing countries, although it may be necessary to adapt it to a certain extent to the differing relations between developing and industrialized countries.

“The need for supplementing the permanent establishment principle with rules for allocating income seems all the greater in that the permanent establishment test as such does not dispose of the kind of source problems to which attention has been called above. Developing countries tend to adopt rules which will maximise the income subject to their tax in view of their need for revenue and their limited resources, and this may well be a major source of double taxation. The adoption of rules of source, with appropriate formulae for allocating income in various types of situations, may be more important in relations between developing and industrialized countries than between industrialized countries.”⁴

The Group of Experts, while accepting the concept of permanent establishment as contained in the OECD Model Convention, sought to adapt it to a certain extent to the requirements of relations between developing and developed countries. It agreed, therefore, to recommend as a suggested text for an article in a bilateral tax treaty defining the term “permanent establishment” a text incorporating a number of provisions of article 5 of the UN Model Convention. The commentary on article 5 of the UN Model Convention is therefore relevant. The Group of Experts

⁴ Organisation for Economic Cooperation and Development, *Fiscal Incentives for Private Investment in Developing Countries: Report of the Fiscal Committee* (Paris, 1965), paragraphs 172-174.

has not adopted so far, however, the December 2000 amendments to the OECD commentary on article 5 dealing with electronic commerce.

Paragraph 1 of article 5 reproduces article 5, paragraph 1, of the OECD Model Convention.

Paragraph 2 of article 5 reproduces the whole of paragraph 2 of article 5 of the OECD Model Convention.

Paragraph 3 of article 5 covers a broader range of activities than article 5, paragraph 3, of the OECD Convention. In subparagraph 3(a), the term “installation project” used in the OECD Model Convention is replaced by the term “assembly or installation project” which, unlike the OECD article, covers “supervisory activities” in connection with “a building site, a construction, assembly or installation project.” Moreover, while article 5 of the OECD Model Convention states that “a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months,” article 5 of the United Nations Model Convention reduces the duration of that period to six months. In special cases, the six-month period in paragraph 3, subparagraphs (a) and (b) of article 5 could be reduced to a period of not less than three months in bilateral negotiations.

Some developing countries support a more elaborate version of subparagraph 3(a), which would read as follows:

“The term permanent establishment should likewise encompass a building site or construction or assembly project or supervisory activities in connection therewith, where such site, project or activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or activity exceed 10 per cent of the sale price of the machinery or equipment.”

Other members, however, believe that such a provision would not constitute an adequate solution, particularly if the machinery is delivered by an enterprise other than the one doing the construction work.

Paragraph 3 of article 5 contains a new subparagraph (b) dealing with the furnishing of services, including consultancy services, which are not covered specifically in the OECD Model Convention in connection with the concept of permanent establishment. The Group believes that management and consultancy services should be covered in the article because the provision of such services in developing countries by corporations of industrialized countries often involves very large sums of money. Accordingly, profits from such services should be taxed by developing countries in certain circumstances.

Concerning the time limit established in paragraph 3, subparagraphs (a) and (b), of article 5, some developing countries would prefer to remove the time limit altogether for two main reasons: first, because construction, assembly and similar activities could as a result of modern technology be of very short duration and still result in a considerable profit for the enterprise carrying on those

activities; and, second, because the period during which the foreign personnel involved in the activities remained in the source country was irrelevant to the definition of the right of developing countries to tax the corresponding income. Other developing countries believe that any time limit should have been removed because such a limitation was apt to be used by enterprises of capital exporting countries to evade taxation in the source country. The view has been expressed that there is no reason why a construction project should not be treated in the same manner as persons covered by article 17 of the OECD Model Convention, who are taxed at the place where their activities are performed irrespective of the duration of those activities. Nevertheless, the goal of the treaty is to promote international trade and development, and the idea behind the time limit is that business enterprises of one Contracting State should be encouraged to initiate preparatory or ancillary operations in the other Contracting State without becoming immediately subject to the tax of the latter State, so as to facilitate a more permanent and larger commitment at a later stage. It is noted that this justification for special treatment of construction sites would not justify an exemption when an enterprise of one Contracting State regularly engages in construction projects of short duration in the other Contracting State.

Most members agree that monetary limitations, if set by analogy with those applied to services of individuals in a number of tax treaties, would be meaningless in the area of the corporate services here discussed, while other members are opposed to any monetary limitations. On the other hand, some members believe that the physical presence of representatives of a foreign corporation in the source country for a minimum period, such as six months, would be a reasonable limitation which would, as a practical matter, cover most of the important situations and would preclude administrative difficulties in the case of merely sporadic activities.

Some members from developed countries believe that the time limit approach would be an acceptable solution if the words “for the same or a connected project” were inserted after the word “continue.” They believe that it is not desirable to add together unrelated projects in view of the uncertainty which that step involves and the undesirable distinction it creates between an enterprise with, for example, one project of three months’ duration and another with two projects, each of three months’ duration, one following the other. In this respect, other members find that the injection of a “project” limitation would be either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months’ duration.

There is general agreement that only profits from services attributable to a permanent establishment in the source country should be taxable by it.

Paragraph 4 of article 5 reproduces article 5, paragraph 4, of the OECD Model Convention, with two substantive amendments, namely, the deletion of the term “delivery” in subparagraphs (a) and (b). The term “delivery” is deleted because the presence of a stock of goods for prompt delivery facilitates the sales of the product and thereby the earning of profit in the host country by the enterprise having the facility. A continuous connection and hence the existence of such a supply of goods should constitute a permanent establishment, leaving as a separate matter the determination of the proper amount of income attributable to the permanent establishment. The Group believes that it is preferable to leave open for bilateral negotiations the question of whether cases involving

deliveries made from stocks of goods should be included in or excluded from the definition of permanent establishment. Some developed countries contend that, since in the normal case only a small amount of income would be allocated if the only activity is delivery from a stock of goods, it serves no purpose to make this change.

Paragraph 5 of article 5 of the United Nations Model Convention departs substantially from and is considerably broader in scope than article 5, paragraph 5, of the OECD Model Convention, which the Group considered to be too narrow in scope because it states that only one type of agent should be deemed to create an establishment of a non-resident enterprise, exposing it to taxation in the source country. Some developing countries believe that a narrow formula might encourage tax evasion by permitting an agent who was in fact dependent to represent himself as acting on his own behalf. The Group therefore added paragraph 5(b), providing that a dependent agent without authority to make contracts for the principal is a permanent establishment if the agent habitually maintains a stock of goods from which goods are regularly delivered on behalf of the enterprise. It is the understanding of the Group that the phrase “authority to conclude contracts in the name of” in subparagraph 5(a) of article 5 means that the agent has legal authority to bind the enterprise for business purposes and not only for administrative purposes (e.g., conclusion of lease or electricity and manpower contracts).

Paragraph 6 of article 5 of the United Nations Model Convention does not correspond to any provision of the OECD Model Convention. It was included because it was the common feeling of the Group that the OECD definition of permanent establishment was not adequate to deal with certain aspects of the insurance business. Members from developing countries pointed out that if an insurance agent was independent, the profits would not be taxable in accordance with the provisions suggested in paragraph 7 of article 5 (based on article 5, paragraph 6, of the OECD Model Convention); and if the agent was dependent, no tax could be imposed because insurance agents normally had no authority to conclude contracts as would be required under the provisions contained in paragraph 5(a) of article 5 (based on article 5, paragraph 5, of the OECD Model Convention). Those members expressed the view that taxation of insurance profits in the country where the premiums were being paid was desirable and should take place independently of the status of the agent. They therefore suggested that the article should include a special provision relating to insurance business.

Once agreement was reached on the principle of including a special provision on insurance, the discussion in the Group focused mainly on cases involving representation through “an independent agent.” Members from developing countries felt that it would be desirable to provide that a permanent establishment existed in such cases because of the nature of the insurance business, the fact that the risks were situated within the country claiming tax jurisdiction, and the facility with which persons could, on a part-time basis, represent insurance companies on the basis of an “independent status,” making it difficult to distinguish between dependent and independent insurance agents. Members from developed countries, on the other hand, stressed that in cases involving independent agents, insurance business should not be treated differently from such activities as the sale of tangible commodities. Those members also drew attention to the difficulties involved in ascertaining the total amount of business done when the insurance was handled by a number of independent agents within the same country. In view of the difference in approach, the

Group agreed that the case of representation through independent agents should be left to bilateral negotiations, which could take account of the methods used to sell insurance and other features of the insurance business in the countries concerned.⁵

The first sentence of paragraph 7 of article 5 reproduces article 5, paragraph 6, of the OECD Model Convention in its entirety, with a few minor drafting changes. The second sentence of paragraph 7 constitutes a new provision whose inclusion stemmed from a proposal by members from developing countries to broaden the scope of the definition of a permanent establishment by treating as a dependent agent an agent who habitually secures orders exclusively or almost exclusively for an enterprise of the other Contracting State or an affiliated enterprise **and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises.** The portion highlighted here was specifically added in 1999 to remove the anomaly or doubt to the effect that when an agent, although acting in an independent capacity, acted for only one enterprise and devoted his time and activity wholly or almost wholly on behalf of that enterprise, he lost his independent status. As redrafted, it has been made clear that to determine the status of an agent as not being of an independent status, it would be necessary to take into account the entirety of the commercial and financial relations between the enterprise and the agent which will show that they differ from those expected between independent enterprises at arm's length. Hence, as worded, the mere fact that the number of enterprises for which an agent acted as an agent of an independent status fell to one, will not change his status from being an agent of independent status to that of a dependent status.

It was stated by one member that the confinement of the activities of an agent wholly or almost wholly to those undertaken on behalf of one enterprise must be pursuant to an agreement with that enterprise for the new language of paragraph 7 of article 5 to apply. Some members from developing countries felt that the existence of such an agreement should not be a requirement for the application of the second sentence of paragraph 7 of article 5, for in practice it would annul it. As a result, this limitation on the new language of paragraph 7 was not adopted.

Paragraph 8 of article 5 reproduces article 5, paragraph 7, of the OECD Model Convention.

With the advent of electronic commerce, it has become possible for an international enterprise to maintain a virtual office in a country through a commercial web site that serves most of the purposes of an office made of bricks and mortar. The question arises, in interpreting the language of article 5, whether such a virtual office constitutes a permanent establishment. Unless article 5 is interpreted or amended so as to treat a virtual office as a permanent establishment, source taxation of business profits derived through electronic commerce may be foreclosed. However, this point is controversial as no consensus has emerged thereon.

⁵ For an illustration of the tax avoidance potential of the "independent agent" exception for insurance, see *Taisei Fire and Marine Insurance Co.*, 104 T.C.535 9 (1995). That case also illustrates problem of exemption re-insurance.

Over the past five years, the OECD has engaged in extensive study of tax treaty issues relating to electronic commerce. In December 2000, the OECD adopted some significant changes in its commentary relating to the question whether a virtual office can be treated as a permanent establishment, and it has indicated that it intends to make additional changes in its commentary relating to Articles 5 and 7. It has also undertaken a study of whether the permanent establishment concept, which was adopted a century ago when international communication was slow and expensive, remains relevant to a world in which communication is inexpensive and nearly instantaneous. The Group of Experts intends to develop its own position on issues relating to electronic commerce after a full review of the work of the OECD. That position will be embodied in amendments to the United Nations Model Convention commentaries and, if necessary, in amendments to the articles in the United Nations Model Convention.

CHAPTER III
TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.
2. The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.
3. The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.
4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Observations

The right to tax income from immovable property, including income from agriculture and forestry, is given to the country in which such property is situated (source country) under article 6 of the United Nations Model Convention. The principle of taxing income from immovable property at source has been universally upheld.

The taxation of income from immovable property should have as its objective the taxation of profits rather than gross income. Account should therefore be taken of the expenses involved in earning income from real property or from agriculture or forestry. That objective, however, should not preclude the use of a withholding tax on rents from real property, based on gross income; in such cases, the rate should take into account the fact that expenses were involved in the income earning. It is considered that it would be equally satisfactory if, when a withholding tax on gross rents is used, the owner of the real property could elect to have the income from the property taxed on a net basis under the regular income tax. Article 6 is not intended to preclude a country which taxes income from agriculture or other immovable property on an estimated or similar basis from utilizing that method.

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State, but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken in the determination of the profits of a permanent establishment for amounts charged (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.

5. For the purpose of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provision of this article.

[NOTE: 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 was not resolved. It should therefore be settled in bilateral negotiations.]

Observations

Article 7 of the United Nations Model Convention consists of several provisions of Article 7 of the OECD Model Convention, either unchanged or substantially amended, and some new provisions.

A crucial question in international tax practice is the measurement of the business profits of an enterprise that are subject to taxation in a foreign country. There is general acceptance of the so-called “arm’s length” rule embodied in the OECD Model Convention. According to this rule, the profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market. The profits so attributable may be the profits shown on the books of the establishment if those books are kept in accordance with accepted accounting practices and have not been manipulated to minimize taxation in the country where the permanent establishment is located. The arm’s length rule permits the tax authorities of the country where the permanent establishment is located to rectify the accounts of the enterprise, so as to reflect properly income that the establishment would have earned if it were an independent enterprise dealing with its head office at arm’s length.

The application of the arm’s length rule is particularly important in connection with the difficult and complex problem of the deductions to be allowed to the permanent establishment. It is also generally accepted that in calculating the profits of a permanent establishment, allowance should be made for actual expenses, wherever incurred, for the purposes of the business of the permanent establishment, including executive and general administrative expenses. Apart from what may be regarded as ordinary expenses, there are some classes of expenditures that give rise to special problems. These include deemed interest and royalties etc. “paid” by the permanent establishment to its head office in return for money “loaned” or patent rights “licensed” by the latter to the permanent establishment. They further include commissions (except for the reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the establishment. In these cases, it is considered that the deemed payments should not be allowed as deductions in computing the profits of the permanent establishment. On the other hand, an allocable share of actual payments of interest and royalties, paid by the enterprise to third parties should be allowed.

According to the OECD Model Convention, only profits attributable to the permanent establishment should be taxable in the source country. In some cases the “attribution principle” has

been amplified by the so-called “force of attraction” rule, which permits the enterprise, once it carries out business through a permanent establishment in the source country, to be taxed on business profits in that country arising from transactions outside the permanent establishment.

In the light of the foregoing considerations, article 7 of the United Nations Model Convention relating to the taxation of business profits generally corresponds to the provisions of article 7 of the OECD Model Convention, either unchanged or substantially amended, although article 7 of the United Nations Model Convention also includes some new provisions. The commentary on article 7 of the OECD Model Convention is therefore relevant *mutatis mutandis* to article 7 of the United Nations Model Convention.

Paragraph 1 of article 7 reproduces article 7, paragraph 1, of the OECD Model Convention, with the addition of the provisions contained in clauses (b) and (c). In the discussion preceding the adoption of paragraph 1 of article 7 several members from developing countries expressed support for the “force of attraction” rule, although they would limit the application of that rule to business profits covered by article 7 of the OECD Model Convention and not extend it to income from capital (dividends, interests and royalties) which are expressly covered by other treaty provisions. The members supporting the application of the “force of attraction” rule also indicated that neither sales through independent commission agents nor purchase activities would become taxable to the principle under that rule. Some members from developed countries pointed out that the “force of attraction” rule had been found unsatisfactory and abandoned in recent tax treaties concluded by them because of the undesirability of taxing income from an activity that was totally unrelated to the establishment and that was in itself not extensive enough to constitute a permanent establishment. They also stressed the uncertainty that such an approach would create for taxpayers. Members from developing countries pointed out that the proposed “force of attraction” approach did remove some administrative problems in that it made it unnecessary to determine whether particular activities were or were not related to the permanent establishment or whether the income involved was attributable to it. The administrative benefit is especially important with respect to transactions that are conducted directly by the home office and are similar in nature to those conducted by the permanent establishment.

However, after discussion, there was a proposal to limit the “force of attraction” rule, so that it would apply to sales of goods or merchandise and other business activities in the following manner: if an enterprise has a permanent establishment in the other Contracting State for the purpose of selling goods or merchandise, income from sales of the same or a similar kind in that State may be taxed in that State even if the sales are not conducted through the permanent establishment; a similar rule applies to income from activities of the enterprise that are located in the taxing State and are of the same or similar kind as activities of the permanent establishment. The “force of attraction” rule shall not apply when an enterprise is able to demonstrate that the sales or business activities were carried out for reasons other than obtaining treaty benefits. This limitation recognizes the fact that an enterprise may have legitimate business reasons for choosing not to carry out sales or business activities through its permanent establishment.

Paragraph 2 of article 7 reproduces article 7, paragraph 2, of the OECD Model Convention. In the discussion relating to that paragraph, a member from a developed country pointed out that his

country was having some problems with inconsistent determinations of the profits properly attributable to a permanent establishment, especially with regard to “turn-key” contracts. Under a turn-key contract, a contractor agrees to construct a factory or similar facility and make it ready for operation. When the facility is ready for operation, it is handed over to the purchaser, who can then begin operations. The international tax problems occur when the facility is constructed in one country by a contractor resident in another country. The actual construction activities carried on in one country clearly constitute a permanent establishment within that country if of sufficiently long duration. Turn-key contracts, however, often are concluded before the creation of the permanent establishment and involved many components other than normal construction activities. They also include the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, are sometimes completed before construction activities actually start (hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment is situated.

The question thus arose as to how much of the total profits of the turn-key contract is properly attributable to the permanent establishment and thus taxable in the country where it is situated. A member from a developed country said that he knew of instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was his view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits include items of income dealt with separately in other articles of the Convention and are taxable in that country accordingly.

The Group recognized that the problem described above was a complex and potentially controversial one involving many interrelated issues, such as source of income rules and the definitions of permanent establishment and profits of an enterprise. The Group therefore decided to leave the problem to consideration in bilateral negotiations.

The first sentence of paragraph 3 of article 7 reproduces the entire text of article 7, paragraph 3, of the OECD Model Convention. The rest of the paragraph consists of provisions formulated by the Group of Experts in the original United Nations Model Convention. These provisions stemmed from a proposal by members from developing countries who felt that it would be helpful to include all necessary definitions and clarifications in the text of the article, especially with a view to assisting developing countries not represented in the Group. Some of those members also felt that provisions prohibiting the deduction of certain expenses should be included in the text of a bilateral tax treaty to make it clear that taxpayers were fully informed about their fiscal obligations. In the course of the discussion it was pointed out that additions to the OECD text would ensure that the permanent establishment would be able to deduct interest, royalties and other expenses incurred by the head office on behalf of the establishment. The Group agreed that if billings by the head office included its full costs, both direct and indirect, then there should not be a further allocation of the executive and administrative expenses of the head office, since that would produce a duplication of such charges on the transfer between the head office and the permanent establishment. It was pointed out that it was important to determine how the price was fixed and what elements of cost it included. Where an international wholesale price was used, it would normally include indirect costs.

There was general agreement within the Group that any duplication of costs and expenses should be prevented.

Paragraph 4 of article 7 reproduces the provision of article 7, paragraph 4, of the OECD Model Convention.

In the discussions leading to the 1980 United Nations Model Convention, the Group could not reach a consensus on provisions relating to the matters covered by article 7, paragraph 5, of the OECD Model Convention. Since no compromise could be worked out, the Group included in the article 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 or merchandise for the enterprise should be settled in bilateral negotiations. The members from developing countries considered that that paragraph should either be omitted or restated to provide that in the case of a permanent establishment engaged in purchasing and other activities, profits derived from purchasing activities should be attributed to the permanent establishment. Furthermore, some members from developing countries felt that when purchasing constituted the sole activity of an enterprise in the source country, a permanent establishment would exist in that country and that since the purchasing activity contributed to the generation of the over-all profit of the enterprise, there should be an allocation of the portion of the over-all profit attributable to the permanent establishment. The members from developed countries believed that it would be desirable to incorporate the provisions of article 7, paragraph 5, in the text of article 7.

Paragraph 6 of article 7 reproduces article 7, paragraph 6, of the OECD Model Convention.

Paragraph 7 of article 7 reproduces article 7, paragraph 7, of the OECD Model Convention.

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Article 8 (alternative A)

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 8 (alternative B)

1. Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by __ per cent. (The percentage is to be established through bilateral negotiations).
3. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.
5. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Observations

The OECD Model Convention contains a major exception to the taxation of business profits on the basis of the principle of permanent establishment, namely, the case of profits from international sea and air transport. The latter profits are wholly exempt from tax at source and are taxed exclusively in the State in which the place of effective management of the enterprise engaged in international traffic is situated.

The exemption from tax in the source country of foreign enterprises engaged in international shipping traffic is predicated largely on the premise that the income of these enterprises is earned on the high seas, that exposure to the tax laws of numerous countries is likely to result in double taxation or at best in difficult allocation problems, and that exemption in places other than the home country ensures that the enterprises will not be taxed in foreign countries if their overall operations turn out to be unprofitable. Considerations relating to international air traffic are similar. Since many developing countries with water boundaries do not have resident shipping companies but do have ports used to a significant extent by ships from other countries, they have traditionally disagreed with the principle of such an exemption of shipping profits.

The United Nations Model Convention provides two alternative texts for the taxation of profits from shipping, inland waterways transport and air transport. Alternative A of article 8 adopts the text of article 8 of the OECD Model Convention. Alternative B of article 8, in addition to permitting tax in the country of effective management or residence of an air transport or shipping enterprise, provides that the other country may also tax such profits if the shipping activities of an enterprise are more than casual.

The commentary on all of the paragraphs of article 8 of the OECD Model Convention is, therefore, relevant to article 8 (alternative A). With respect to article 8 (alternative B), the commentaries on paragraphs 2, 3 and 4 of the OECD Model Convention are relevant.

With regard to the taxation of profits from the operation of ships in international traffic, several members from developed countries supported the position taken in Article 8 of the OECD Model Convention. In their view, shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend; taxation at the place of effective management was also preferable from the viewpoint of the various tax administrations. They argued that if every country taxed a portion of the profits of a shipping line, computed according to its own rules, the sum of those portions might well exceed the total income of the enterprise. According to them, that would constitute a serious problem, especially because taxes in the developing countries were often excessively high, and the total profits of shipping enterprises were frequently quite modest. However, certain members from developed countries said they found taxation of shipping profits at the source acceptable.

Members from developing countries asserted that those countries were not in a position to forego even the limited revenue to be derived from taxing foreign shipping enterprises as long as their own shipping industries were not more fully developed. They recognized, however, that considerable difficulties were involved in determining a taxable profit in such a situation and in allocating the profit to the various countries concerned. Various methods for the determination and allocation of shipping profits were discussed.⁶

Although certain members from developed countries expressed no serious objection to that proposal, a large number of members from developed countries said they still preferred the principle of exclusive taxation by the State in which the place of effective management of the enterprise is situated. Since no consensus could be reached on a provision concerning the taxation of shipping profits that could be included in the article, it was decided that the question of such taxation should be left to bilateral negotiations.

Article 8B, allowing the taxation of shipping profits in the country where those profits originated (source country) if shipping activities in that country are more than casual, establishes an operative rule for the shipping business that is not qualified by the provisions of articles 5 and 7 relating to business profits governed by the permanent establishment rule. Such taxation thus covers

⁶ For further details, see *Tax Treaties between Developed and Developing Countries* (United Nations publication, Sales No. E.69.XVI.2), part one, paragraphs 67-68 and *ibid.*, *Third Report* (United Nations publication, Sales No. E.72.XVI.4) part one, paragraphs 18-31.

both regular or frequent shipping visits and irregular or isolated visits, provided the latter are planned and not merely fortuitous. The phrase “more than casual” means a scheduled or planned visit of a ship to a particular country to pick up freight or passengers. The overall net profits, in general, should be determined by the authorities of the country in which the place of effective management of the enterprise is situated (country of residence). The final conditions of the determination might be decided in bilateral negotiations. In the course of such negotiations, it might be specified, for example, whether the net profits were to be determined before the deduction of special allowances or incentives which could not be assimilated to depreciation allowances but could be considered rather as subsidies to the enterprise. It might also be specified in the course of the bilateral negotiations whether direct subsidies paid to the enterprise by a Government should be included in net profits. The method for the recognition of any losses incurred during prior years, for the purpose of the determination of net profits, also might be worked out in the negotiations. In order to implement that approach, the country of residence would furnish a certificate indicating the net shipping profits of the enterprise and the amounts of any special items, including prior year losses, which in accordance with the decisions reached in the negotiations were to be included in, or excluded from, the determination of the net profits to be apportioned or otherwise specially treated in that determination. The allocation of profits to be taxed might be based on some proportional factor specified in the bilateral negotiations, preferably the factor of outgoing freight receipts (determined on a uniform basis with or without the deduction of commissions). The percentage reduction in the tax computed on the basis of the allocated profits is intended to achieve a sharing of revenues that reflects the managerial and capital inputs originating in the country of residence.

With regard to the taxation of profits from the operation of aircraft in international traffic, several members from developing countries, although agreeing to the consensus, pointed out that no consideration had been given to the very substantial expenditure that developing countries incurred in the construction of airports. They considered that it would appear more reasonable to situate the geographical source of profits from international transportation at the place where passengers or freight were booked.

A member from a developing country suggested that the income attributable to international traffic may not include payments, such as, for lodging or any activity of transport different from exploitation of ships or aircraft, since they do not form part of activity of international transportation.

A member from a developing country suggested that the provisions of article 8 may be extended to cover rail or road transport. The Group observed that very few cases of rail or road transport involved double taxation. Consequently, it declined to include a reference to rail or road transport in the article. It suggested, however, that Contracting States may, if considered necessary, address rail or road transport during bilateral negotiations.

Article 9

ASSOCIATED ENTERPRISES

1. Where:

- (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

3. The provisions of paragraph 2 shall not apply where judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default.

Observations

Article 9 of the United Nations Model Convention deals with associated enterprises. This article deals with adjustments to profits that may have to be made for tax purposes when transactions have been entered into between associated enterprises, being parent and subsidiary companies as also companies under common control, on other than arm's length basis. Article 9 of the United Nations Model Convention contains a new paragraph 3, which is not found in the OECD Model Convention.

Article 9 should be considered in conjunction with article 25 on mutual agreement and article 26 on exchange of information, just as in the case of the OECD Model Convention.

Paragraph 2 of article 9 requires a country to make an appropriate adjustment or a correlative adjustment to reflect a change in the transfer price made by a country under article 9, paragraph 1.

In 1999, the Group of Experts introduced a new paragraph 3 in article 9 to provide that the provisions of paragraph 2 shall not apply when the judicial, administrative or other legal proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph

1, one of the enterprises is liable to penalty with respect to fraud, gross negligence or wilful default. This approach means that a taxpayer may be subject to non-tax and tax penalties. Some members of the Group of Experts pointed out that cases involving such penalties are likely to be exceptional and that this provision will not be applied in a routine manner.

With regard to transfer pricing of goods, technology, trade marks and services between associated enterprises in cases where the transfers may not have been made on “arm’s length” principles, the Group of Experts has recommended that it would be desirable to follow the OECD Transfer Pricing Guidelines.

Article 10

DIVIDENDS

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:
 - (a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;
 - (b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term “dividends” as used in this article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent

establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Observations

A 1965 report of the OECD Fiscal Committee contains the following considerations concerning dividends:

“Profits realized by an investor in a developing country through a subsidiary are normally taxed as business profits in that country. It is also common for a developing country to impose an additional tax (usually by withholding at the source) on the dividends paid out of those profits. If the investor is in a country that uses the exemption method in dealing with foreign income, then any tax imposed by the developing country on the dividends is a burden on the investor and reduces his yield. If the investor is from a country that uses the credit approach, the withholding tax may or may not be a net additional burden on the investor, depending on the level of tax rates in the two countries and the method used in computing the credit for foreign taxes. Thus, in a treaty between a developing country and a capital exporting country (using the exemption or credit approach) it would be appropriate for limitations to be imposed on withholding taxes on dividends. The limit might be lower, possibly, in a treaty with a country using the exemption method than with one using the credit method, but one cannot be categorical. It would have to depend on the facts in each case, on the level of rates in the developing and capital exporting country, as well as on other factors.

“With respect to dividends received from portfolio investment in a developing country, a different treaty provision may be appropriate. Such dividends do not receive the same tax treatment either in exemption or credit countries which dividends from direct investment receive. Exemption countries normally do not exempt such dividends from tax, and the credit countries, with the notable exception of the United Kingdom and Ireland in certain cases, ordinarily do not grant a credit for the underlying corporate tax imposed by the foreign country. Under these circumstances a treaty reduction on the amount of withholding tax which a developing country imposes may not contribute much towards improving capital flows to it. What might be appropriate is the adoption of a credit mechanism by countries that use the exemption method for direct investment and liberalization of the credit allowed by other countries.”⁷

⁷ Organisation for Economic Cooperation and Development, *op. cit.*, paragraphs 176-178.

It was considered that limits on the taxation of dividends in the source country were necessary in order to avoid the heavy tax burden which might result from the combination of the source country's dividend withholding tax and its basic corporate tax rate applied to the profits from which the dividends are paid. It was possible that the combined effective tax rate levied by the source country might reach a level that significantly exceeds the effective tax rate in the beneficiary's home country.

In the light of these and other considerations, article 10 of the United Nations Model Convention dealing with dividends has reproduced the provisions of article 10 of the OECD Model Convention with three substantive changes, namely, firstly, the deletion of the phrases "5 per cent" in paragraph 2, subparagraph (a), and "15 per cent" in paragraph 2, subparagraph (b); secondly, their replacement by the phrase "___ per cent (the percentage is to be established through bilateral negotiations)," and thirdly, the replacement of the phrase "25 per cent" in that paragraph by the phrase "10 per cent." The commentary on article 10 of the OECD Model Convention is relevant *mutatis mutandis* to article 10.

Paragraph 1 of article 10 reproduces the provisions of article 10, paragraph 1, of the OECD Model Convention. The paragraph provides that dividends may be taxed in the State of the beneficiary's residence. It does not prescribe, however, that dividends should be taxed exclusively in that State and leaves open the possibility of taxation by the State of which the company paying the dividends is a resident, that is, the State in which the dividends originate (source country). When the United Nations Model Convention was first considered, many members from developing countries felt that as a matter of principle dividends should be taxed only by the source country. According to them, if both the country of residence and the source country were given the right to tax, the country of residence should grant a full tax credit regardless of the amount of foreign tax to be absorbed and, in appropriate cases, a tax-sparing credit. One of those members emphasized that there was no necessity for a developing country to waive or reduce its withholding tax on dividends, especially if it offered tax incentives and other concessions. However, the Group reached a consensus that dividends may be taxed both by the State of the beneficiary's residence and the source country. Current practice in developing/developed country treaties generally reflects this consensus. Double taxation is eliminated or reduced through a combination of exemption or tax credit in the residence country and reduced withholding rates in the source country.

Paragraph 2 reproduces the provisions of article 10, paragraph 2, of the OECD Model Convention with three substantive changes mentioned above. The Group of Experts decided to replace "25 per cent" with "10 per cent" in subparagraph (a) as the minimum capital required for direct investment dividend status in light of the fact that in some developing countries non-residents are limited to a 50 per cent ownership, so that 10 per cent represented a significant portion of such permitted ownership.

In subparagraphs (a) and (b) the phrase "___ per cent (the percentage is to be established through bilateral negotiations)" was used because the Group was unable to reach a consensus on maximum rates for source taxation of dividends. The members from developing countries, who basically preferred the principle of the taxation of dividends exclusively in the source country,

considered that adoption of the maximum rates prescribed by the OECD Model Convention would entail too large a loss of revenue for the source country. Nevertheless they were not opposed to taxation in the beneficiary's country of residence provided that any reduction in withholding taxes in the source country benefited the foreign investor rather than the treasury of the Government of the beneficiary's country of residence, as was the case under the traditional-tax-credit method whenever the reduction lowered the cumulative tax rate of the source country below the rate of the beneficiary's country of residence.

The OECD Model Convention, while recognizing source jurisdiction based on payment alone, greatly restricts the amount of withholding tax to be applied by the source jurisdiction. It also gives no attention to a determination of what expenses in the residence country are attributable to the dividends.⁸ This lack of attention presumably is because the expenses of a shareholder in the residence country allocable to the receipt of a dividend traditionally are not regarded as deductible in the source country, unlike expenses allocable to interest or royalties. Hence the level of source country withholding taxes on dividends has not been fixed in treaties with regard to shareholders' expenses.

Although the Group of Experts was unable to reach a consensus on an exact rate, it concluded that a reduction in the direct investment dividend rate could be justified whether the developed country uses a credit system or exemption system to reduce double taxation.

If the developed (residence) country uses a credit system, the negotiations could appropriately seek a limitation on withholding tax rates at source that would, in combination with the basic corporate tax rate of the source country, produce a combined effective rate that does not exceed the tax in the residence country.

If the developed country uses an exemption system for double-taxation relief, it could, in bilateral negotiations, seek a limitation on withholding rates on several grounds: (a) that the exemption itself stresses the concept of not taxing inter-corporate dividends, and a limitation of the withholding rate at source would be in keeping with that concept; (b) that the exemption and resulting departure from tax neutrality with domestic investment are of benefit to the international investor, and hence a limitation of the withholding rate at source would be in keeping with this step, since that limitation would also benefit the investor.

The Group of Experts concluded that with respect to portfolio investment dividends, both the source country and the residence country should be in a position to tax dividends paid on the shares involved, although the relatively small amount of portfolio investment and its distinctly lesser importance compared with direct investment might make the issues concerning its tax treatment less intense. However, it was decided not to recommend a maximum rate because some source countries may have varying views on the importance of portfolio investment and on the figures to be inserted.

⁸ This matter was not considered by the Group of Experts.

Current developed/developing country treaty practice indicates a range of direct investment and portfolio investment withholding tax rates. In many cases, dividend withholding rates in these treaties have been higher than in treaties among OECD countries. Thus, while the OECD direct and portfolio investment rates are 5 per cent and 15 per cent, developed/developing country treaty rates have traditionally ranged between 5 per cent and 15 per cent for direct investments and 15 per cent and 25 per cent for portfolio investments.

Recently, some developing countries have taken the position that short-term loss of revenue occasioned by low withholding rates is justified by the potential increase in foreign investment in the medium and long terms. Thus, several modern developed/developing country treaties contain the OECD Model rates for direct investment or even lower rates.

In most treaty negotiations between developed and developing countries, the maximum withholding rates on dividends are fixed partly or wholly to achieve a compromise with respect to potential revenue losses that is acceptable to both parties. The following technical factors nevertheless are often considered in fixing the rate: (a) the corporate tax system of the country of source (e.g., the extent to which the country follows an integrated or classical system) and the total burden of tax on distributed corporate profits resulting from the system; (b) the extent to which the country of residence credits the tax on the dividends and the underlying profits against its own tax, and the total tax burden imposed on the taxpayer, after relief in both countries; (c) the extent to which credit is given in the country of residence for taxes spared in the country of source; and (d) the achievement from the source country's point of view of a satisfactory balance between raising revenue and attracting foreign investment.

Also, several special features appear in developed/developing country treaties: (a) the maximum allowable tax rates are not necessarily the same for both partners, with the higher rates applying to dividends sourced in the developing country; (b) in some cases, maximum tax rates are not fixed at all; (c) reduced maximum rates apply only to income from new investment in some cases; (d) the lowest maximum rates or exemption apply in some cases to only preferred types of investments (e.g., "industrial undertakings" or "pioneer investments"); and (e) the agreements sometimes stipulate that dividends qualifying for reduced maximum rates must have been paid with respect to stock held for a specified period. In treaties involving states that have adopted an imputation system of corporation taxation (i.e., integration of company tax into shareholder's company tax or individual income tax) instead of the classical system of taxation (i.e., separate taxation of shareholder and corporation), specific provisions may ensure that the advanced credits and exemptions granted to domestic shareholders are extended to shareholders resident in the other Contracting State.

Paragraphs 3, 4 and 5 of article 10 reproduce the provisions of Article 10, paragraphs 3, 4 and 5 of the OECD Model Convention.

The inclusion of a branch profits tax provision was a key topic at the 1987 and 1991 meetings of the Group of Experts and was further discussed in the 1997 meeting (Eighth Meeting). It was considered that since only a few countries had a branch profits tax, the paragraph on that topic might be better placed in the commentary and not in the main text. It would be left to the

Contracting States during the course of bilateral negotiations to incorporate in their bilateral tax treaties a provision relating to the branch profits tax if they desired. The developing countries were generally not opposed to the principle of a branch profits tax. One member from a developed country could not support the principle because such a tax appears to conflict with his country's policy of taxing business profits only once. Some members, while noting the justification of a branch profits tax as a means for achieving neutrality in relation to the forms of business (subsidiary versus branch operation), maintained that the neutrality principle should be followed logically throughout the Model Convention.

In the view of a member from a developed country, a branch profits tax should permit a deduction for all deemed expenses of the permanent establishment as if the permanent establishment were a distinct and separate enterprise dealing wholly independently with the head office. That result is contrary to paragraph 3 of article 7 of the United Nations Model Convention. Another member from a developed country noted that his country imposed two separate branch profits taxes: (a) a tax analogous to a dividend withholding tax is imposed on the "dividend equivalent amount," which is intended to approximate the amount that the branch would distribute as a dividend to its parent if it were a subsidiary; and (b) a second tax, analogous to a withholding tax on interest paid by a subsidiary resident in that country to its foreign parent, is imposed on the excess of the amount of interest deducted by the branch in computing its net income for corporate tax purposes over the amount of interest actually paid by the branch. The principal purpose of that system was to minimize the effect of tax considerations on the foreign investor's decision whether to operate in the country in branch or subsidiary form.

If one or both of the Contracting States impose branch profits taxes, they may include in the Convention a provision on the following lines:

Notwithstanding any other provision of this Convention, where a company which is a resident of a Contracting State has a permanent establishment in the other Contracting State, the profits taxable under article 7, paragraph 1 may be subject to an additional tax in that other State, in accordance with its laws, but the additional charge shall not exceed ___ per cent of the amount of those profits.

The suggested provision does not recommend a maximum tax rate for a branch profits tax. The most common practice is to use the direct investment dividend rate [e.g., the tax rate in paragraph 2 (a)]. At the 1991 meeting of the Group of Experts there was agreement among the supporters of branch profits taxation that in view of the principles enunciated in support of the system, the rate of tax on branch profits should be the same as that on dividends from direct investments. However, in several treaties the maximum branch profits tax rate was the maximum rate for portfolio investment dividends (typically a higher rate) and in some treaties the branch tax rate was lower than the direct investment dividend rate. Although a branch profits tax is on business profits, the provision may be included in article 10, rather than in article 7, because the tax is intended to be analogous to a tax on dividends.

The branch profits tax may be imposed only on profits that are attributable to the permanent establishment. A provision common in current treaty practice is to provide further that the tax may

be imposed on such profits only “after deducting therefrom income taxes and other taxes on income imposed thereon in that other State.” Other treaties do not contain this clause because the concept is already included in their branch profits tax under domestic law.

Attention was drawn at the Group’s 1991 meeting to the fact that there could arise a potential conflict between a branch profits tax provision and a treaty’s non-discrimination clause. Since most branch profits taxes represented a second level of tax on the profits of the foreign corporation that was not imposed on a domestic corporation carrying on the same activities, the tax could be viewed, as a technical matter, as prohibited by article 24 (non-discrimination). However, those countries that imposed that tax did so as an analogue to the dividend withholding tax paid on dividends from a subsidiary to its foreign parent. They viewed it, therefore, as appropriate to include in the non-discrimination article an explicit exception allowing the imposition of the branch tax. The non-discrimination article in several treaties with branch profits tax provisions contains the following paragraph:

“Nothing in this Article shall be construed as preventing either Contracting State from imposing a tax described in paragraph ... [branch profits tax provision] of Article 10 (Dividends).”

However, the branch profits tax provision suggested above makes this provision unnecessary because it applies notwithstanding any other provision of this Convention and thus takes precedence over other treaty provisions, including article 24 (Non-discrimination).

Some members of the Group of Experts pointed out that there are many artificial devices entered into by persons to take advantage of the provisions of article 10 through, *inter alia*, creation or assignment of shares or other rights in respect of which a dividend is paid. While substance over form rules, abuse of rights principle or any similar doctrine could be used to counter such arrangements, Contracting States which may want to specifically address the issue may include a clause on the following lines in their bilateral tax treaties during negotiations, namely:

The provisions of this article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this article by means of that creation or assignment.

Article 11

INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent

authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term “interest” as used in this article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits and, in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this article.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the debt-claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.

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

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Observations

Interest, which, like dividends, constitutes income from movable capital, may be paid to individual savers who have deposits with banks or hold savings certificates, to individual investors who have purchased bonds, to individual suppliers or trading companies selling on a deferred payment basis, to financial institutions that have granted loans or to institutional investors holding bonds or debentures. Interest may also be paid on loans between associated enterprises.

At the domestic level, interest is usually deductible from the figures used for calculating profits. In this context, any tax on interest is paid by the beneficiary unless a special contract provides that the tax should be paid by the payer of the interest. Contrary to what occurs in the case of dividends, interest income is not liable to double taxation, once in the hands of the payer and again in the hands of the beneficiary. If the payer is obliged to withhold a certain portion of the

interest as a tax, the interest thus withheld represents an advance on the amount of tax to which the beneficiary will be liable on his aggregate income or profits at the end of the fiscal year. At that time, the beneficiary can deduct the amount withheld by the payer from the amount of tax due from him and obtain reimbursement of any sum by which the amount withheld exceeds the amount of the tax that is finally payable. This mechanism prevents the beneficiary from being taxed twice on the same interest.

At the international level, another set of circumstances usually prevails. When the beneficiary of the interest is a resident of one country and the payer of the interest is a resident of another, the same interest sometimes is subject to taxation in both countries. This double taxation may considerably reduce the net amount of interest received by the beneficiary or, if the payer has agreed to bear the cost of the tax deductible at the source, will increase the financial burden on the payer.

Under the United Nations Model Convention the maximum rate of tax to be charged on interest is to be established by the Contracting States through bilateral negotiations. In contrast, the OECD Model Convention sets a maximum of 10 per cent for the tax withheld at source. That latter convention provides, however, for taxation at source when the person paying the interest has in a Contracting State a permanent establishment or fixed base in connection with which the indebtedness on which the interest is paid was incurred.

A 1965 report of the OECD Fiscal Committee states the following considerations concerning the tax treatment of interest:

“The tax status of interest in the industrialized country is substantially the same as that of dividends from portfolio investment. Consequently, the same general conclusions might be drawn, namely, that a limitation of withholding taxes on interest or the exemption of interest, which is common in treaties between capital exporting countries, also is not justified. However, there are additional considerations involved. Withholding is often on a gross basis and does not take into account the costs incurred by a lender. A limitation on the withholding rate compensates for the fact that it is on a gross basis. Moreover, banks and other institutions which make loans to developing countries often insist that the interest called for in the loan instrument shall be free of any taxes imposed in the country of the borrower. If the interest is subject to tax, then the borrower must assume the burden involved. There may be various factors responsible for such provision in a loan contract. It may simply be a convenient device for increasing the rate of interest that would otherwise be obtainable although in general one might expect lenders to charge whatever the traffic will bear. In addition, such a clause offers assurance to the lender that there will be no diminution in the yield from the loan as a result of changes in the tax policy of the developing country. The exemption provision in the contract may also help to widen the market for the loan instrument if the lender should later wish to sell it. Thus, exemption of interest in a tax treaty may have the effect of reducing the cost of borrowed capital. But it should also be noted that a treaty provision which provides tax exemption for interest and not for dividends may create administrative difficulties for developing countries. Investors will tend to make more loan than equity capital available to their controlled enterprises and

administrators will have to determine when there is an excess of indebtedness. In view of these factors it seems clear that there can be no hard and fast rule with respect to the tax treatment to be accorded interest in conventions between developing and industrialized countries.”⁹

Within the Group of Experts, there was strong feeling on the part of members from developing countries that the source country should have the exclusive, or at least the primary, right to tax interest. According to that view, it is incumbent on the residence countries to prevent double taxation of that income through exemption, credit or other relief measures. These members reason that interest should be taxed where it is earned, that is, where the capital is put to use. The taxing of interest by the source country also would have a significant effect on the economies of the developing countries because apart from its contribution to the revenues, the taxation at source would also reduce the outflow of the foreign exchange.

Some members from developed countries believe that the home country of the investor should have the exclusive right to tax interest, because, in their view that would promote the mobility of capital and give the right to tax to the country that is best equipped to consider the characteristics of the taxpayer. They also point out that an exemption of foreign interest from the tax of the investor’s home country might not be in the best interests of the developing countries because it could induce investors to place their capital in the developing country with the lowest tax rate. Members from developing countries contested that view and stated that tax rates were only one of the factors involved in investments. Members from developed countries also drew attention to the fact that under current conditions, the greater part of international loan capital was provided by banks, pension funds and other large financial institutions, and that imposition of high withholding taxes on such loans would either make the investment unattractive to institutional lenders, which in any case preferred loans to domestic borrowers, or increase the cost of the loan to the borrower.

During the discussions, it was stressed that in certain developing countries, interest payable to non-residents is taxed on a net basis if the lender is engaged in business in the country through a permanent establishment; otherwise it is taxed on a gross basis. This pattern of taxation is intended to take account of the fact that, in the international field, interest mainly relates to payments to financial institutions and that the gross income figure does not necessarily correspond to net income. Members from those countries generally were of the opinion that interest, other than interest earned through a permanent establishment, should be taxed on a gross basis, both for administrative convenience and for substantive reasons. They generally agreed that withholding taxes on interest income should be set at a rate corresponding to the usual corporate tax rate on net income. They conceded that the tax on interest could be higher than that on business income under their recommended approach. In that respect, one member from a developing country stressed the importance of taxing on a gross basis as a matter of practical administration, though recognizing that the actual rate on gross interest used should take account, to the extent feasible, of the fact that expenses may be involved in the earning of the interest.

⁹ Organisation for Economic Cooperation and Development, *op. cit.*, paragraph 179.

The taxation of interest under article 11 of the United Nations Model Convention differs with one substantive change from the corresponding provision in the OECD Model Convention. The change is the deletion of the phrase “shall not exceed 10 per cent of the gross amount of the interest” from the first sentence of paragraph 2 and its replacement by the phrase “shall not exceed ___ per cent of the gross amount of the interest (the percentage is to be established through bilateral negotiations).” As a result, the commentary to the United Nations Model Convention generally incorporates the OECD commentary to article 11.

Paragraph 1 of article 11 reproduces the provisions of article 11, paragraph 1, of the OECD Model Convention.

Paragraph 2 reproduces the provisions of article 11, paragraph 2, of the OECD Model Convention with the substantive change mentioned above. The members from developing countries agreed to the solution of taxation by both the country of residence and the source country embodied in article 11, paragraphs 1 and 2, of the OECD Model Convention but found the ceiling of 10 per cent of the gross amount of the interest mentioned in paragraph 2 thereof unacceptable. It may be noted in that connection that within OECD the 10 per cent ceiling has been considered “a reasonable maximum” in the light of the fact that the source country was already entitled to tax profits on income produced in its territory by investments financed out of funds borrowed abroad. Since the Group was unable to reach a consensus on an alternative higher ceiling, the matter was left to bilateral negotiations.

The decision not to provide a maximum withholding rate can be justified under current treaty practice. The withholding rates for interest adopted in developed/developing country treaties range more widely than those for dividends, between complete exemption and 25 per cent. There is, however, a tendency on the part of some developing countries to reduce the interest withholding rate to attract foreign investment. Thus, several developing countries have adopted rates at or below the OECD rate (10 per cent).

A precise level of withholding tax for a source country should take into account a number of factors including the following: the fact that the capital originated in the residence country; the possibility that a high source rate might cause lenders to pass the cost of the tax on to the borrowers, which would mean that the source country would increase its revenue at the expense of its own residents rather than the foreign lenders; the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment; the fact that a lowering of the withholding rate has revenue and foreign exchange consequences for the source country; and the fact that interest flows mainly in one direction, namely, from developing to developed countries.

It may be of interest to note that the withholding rates imposed on interest in developing countries seem to be somewhat lower than those imposed on dividends. Some developing countries impose no tax. A 15 per cent rate is fairly common; there are also instances of 10 and 20 per cent rates, but very few countries impose rates between 30 and 40 per cent.

When the general rate in a tax treaty with a developing country is above the OECD maximum rate (10 per cent), there is a tendency to provide lower ceilings or even exemption for interest in the following categories:

- (a) Interest paid to governments or local governments, or to governmental agencies;
- (b) Interest guaranteed by governments or government agencies;
- (c) Interest paid to central banks;
- (d) Interest paid on loans used to finance the provision of special equipment or public works;
- (e) Interest paid on certain government-approved types of investment (e.g., paid in connection with the provision of export finance);
- (f) Interest paid to banks or other financial institutions;
- (g) Interest paid on long-term loans;
- (h) Interest paid or deemed paid on sales of goods or services on credit.

It has also been suggested that exemption of interest may also be extended to loans granted to foreign governments, central and government banks, and government organizations which promote exports.

In the Group's 1992 report, some members referred to the desirability of exempting interest income from source country tax if it is received by government agencies on the ground that exemption would facilitate the financing of development projects, especially in developing countries. According to this view, the rate of interest paid on development projects should not be complicated by tax issues. In that regard, the view of some developing countries was that the financing of such projects would be further enhanced if the lender's country of residence also exempted the interest income from tax.

The predominant treaty practice clearly is to exempt interest income derived by a Contracting State from source country taxation. The methods for achieving this goal, however, differ widely. In some instances, interest income is exempted if it is paid by a government or to a government. In other instances, only interest paid to a government is exempt. Also the definition of "government" for purposes of the exemption is not uniform. It may or may not include, for example, local authorities, agencies, instrumentalities, central banks, and financial institutions owned by the government.

With respect to loans from banks and other financial institutions, a major justification for a reduced withholding rate is the high costs often associated with these loans. If those costs are significant, a moderate withholding tax rate on gross interest income may result in a high effective tax rate on net income. In addition, if the lender cannot get a tax credit for the withholding tax in the residence country, the borrower may bear the economic burden of the tax by paying a higher interest rate. In some cases, through a gross-up feature in the loan agreement, the borrower is made legally liable for the withholding tax. One possible way to prevent a shifting of the tax to the borrower is to allow a lender having a permanent establishment in the source country to elect to treat its interest income as business profits under article 7. In that situation, the tax would be imposed on net income rather than gross income, and a residence country using the credit method for granting relief from

double taxation probably would not impose any special limitations on the credit. However, this approach would raise computational and administrative issues for banks and tax administrators. Another way to deal with the issue is to make the withholding rate low enough to produce usable foreign tax credits in the residence country.

The Group of Experts observed that long-term loans often call for special government guarantees owing to the difficulty of forecasting long-term political, economic and monetary outcomes. Moreover, the governments of the majority of developed countries, in order to promote full employment in their capital goods industries or public works enterprises, have granted privileged treatment for long-term credits in the form of credit insurance or interest-rate reductions. Such privileged treatment might be granted through direct loans by government agencies or through loans made by private banks that are provided by the government with credit facilities or interest terms more favourable than those obtainable in the marketplace. The governments of developed countries are unlikely to be willing to sacrifice revenue by subsidizing loans if the corresponding advantages are cancelled out or reduced by heavy taxation in the source country. To encourage such subsidies, a developing country may wish to agree by treaty to exempt interest paid on certain loans made by the other Contracting State and also to exempt interest on long-term loans made by private banks when the loans are guaranteed or refinanced by an agency of that State.

There was no consensus on the proper treatment of interest paid or deemed to be paid with respect to an extension of credit on the sale of goods and services. It is a common practice for sellers to extend credit to purchasers without any formal interest charge if payment is made within some short period, such as 30 days. When long-term credit is extended, a typical pattern is to charge interest to the purchaser, although the interest rate may not reflect the rate that would prevail on comparable loans obtained from financial institutions. It is considered that the proper treatment of interest paid or deemed to be paid on such credit sales should be considered under article 11 rather than under article 7 (business profits). No consensus was reached, however, on the proper treatment of such interest income under article 11.

Some members of the Group of Experts suggested that the rate on interest paid with respect to credit sales should be reduced or eliminated for reasons similar to those applicable in the case of interest earned by financial institutions. They suggested that the seller very often merely passes on to the customer, without any additional charge, the price he himself has to pay to a bank or an export finance agency to finance the credit. In such circumstances, the interest is akin to a cost incurred in making a sale rather than income derived from invested capital. It was also suggested that determining an appropriate withholding rate would present serious complications. It may be considered necessary, for example, to specify separate withholding rates for short-term and long-term credit sales and to determine the implied interest rate when no explicit rate is stated. In some cases, a government or government agency directly or indirectly finances the credit sales. As discussed above, a government might be reluctant to provide a special credit arrangement to its exporters if the benefits of that arrangement go to a foreign government rather than to the exporter.

The factors suggesting an exemption or lower withholding rate for interest paid on credit sales may cause some countries to decide not to pursue the taxation of such interest. These factors, however, might not appear sufficiently persuasive to some negotiators to overcome the presumption in favour of taxing interest income under article 11. The Group of Experts concluded, therefore, that the treatment of interest on deferred payment or credit sales should be considered in the context of the article 11 but should be settled through negotiations between the parties.

Paragraphs 3, 4, 5 and 6 of Article 11 reproduce the provisions of Article 11, paragraphs 3, 4, 5 and 6, of the OECD Model Convention. It has been suggested that definition of “interest” in the bilateral tax treaty may be provided similar to that in the domestic legislation of the Contracting States, so as to encompass other operations and concepts similar to interest as contemplated in the said legislation.

Article 12

ROYALTIES

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the beneficial owner of the royalties is a resident of the other Contracting State, the tax so charged shall not exceed ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term “royalties” as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed base, or with (b) business activities referred to in (c) of paragraph 1 of article 7. In such cases the provisions of article 7 or article 14, as the case may be, shall apply.

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

establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Observations

When the user of a patent or similar property is resident in one country and pays royalties to the owner thereof who is resident in another country, the amount paid by the user is generally subject to withholding tax in the user's country, that is, in the source country. The source country imposes its withholding tax on the gross royalty payments. It thus does not take into account any related expenses that the owner may have incurred in developing or acquiring the property.

If the owner of a patent or similar intangible property spent large sums in developing or acquiring that property, the net income derived from its royalty income may be only a small percentage of its gross royalties. Consequently, even a moderate withholding tax in the source country can result in a high tax on net income. Indeed, the tax might exceed net income in some circumstances. This possibility complicates the choice of appropriate withholding rates in the source country. That choice is further complicated by the possibility that a high withholding rate would cause a foreign owner of intangible property to increase the royalty rate it charges to users in the source country. Whether an owner would have the market power to raise its royalty rate would depend on the facts and circumstances of each case. In general, however, an owner would be expected to charge whatever the market would bear without reference to the amount of any withholding tax.

In some other circumstances, high withholding rates in the source country on royalties may make good economic sense. In many cases, the marginal costs, including opportunity costs, to an owner of exploiting its intangible property in a country may approach zero. If the owner has already recovered its costs or those costs are fixed or unavoidable, it will not be discouraged from making its property available to users in the source country as long as the withholding rate is not confiscatory. Assume, for example, that an owner of an established trade name is prepared to make that trade name available for use in a particular country by licensing it to an affiliated company. A high withholding rate in the source country should not make the license unattractive from an economic perspective as long as the rate did not make the license unprofitable. Similarly, an owner of a patent on a pharmaceutical product typically would have an economic incentive to license that product for use in a particular country even if the withholding rate on the royalty was high, assuming that the marginal costs of giving the license are trivial. More generally, a royalty that constitutes an economic rent may be taxed at high rates without creating economic inefficiencies.

In light of the uncertain economic impact of withholding taxes on royalties, the proper treatment of royalties is complex. An additional complexity is introduced if the user may make a lump sum payment for the use of the patent or similar property, in addition to or as a substitute for regular royalty payments. In that situation, it is not entirely clear whether the lump-sum payment should be characterized as a royalty or as a payment for an ownership right in the intangible property. Additional issues arise in distinguishing royalty payments from payments for technical services.

The OECD Model Convention lays down the principle of exclusive taxation of royalties in the State of the beneficial owner's residence. In accordance with this principle, it generally provides that royalties arising in a Contracting State and paid to a resident of the other Contracting State are taxable only in that other State. The OECD Model provides, nevertheless, that the source country may impose a tax on royalties if the right or property in respect of which the royalties are paid is "effectively connected" with a permanent establishment located in that country. This treatment of royalties was not adopted.

The taxation of royalties under article 12 of the United Nations Model Convention departs from the corresponding provision in the OECD Model Convention in some important respects. There are a number of substantive changes in paragraphs 1, 3 and 4, and new paragraphs 2 and 5 have been inserted. The remaining paragraphs have been renumbered accordingly. Because of these changes, the commentary on article 12 of the United Nations Model Convention adopts only some provisions of the OECD commentary.

During the discussion in the Group of Experts, the members from developing countries expressed the view that in order to facilitate the conclusion of tax treaties between those countries and developed countries, the primary right to tax royalties should be given to the country where that income arose, that is, to the source country. Those members observed that patents and processes were usually licensed to developing countries after they had been fully exploited elsewhere. According to them, although it would be going too far to assert that such properties were made available to developing countries only when they had become obsolete, it would be no overstatement to say that they frequently arrived at a late stage, when the expenses incurred in connection with their development had already been largely recouped.

Members from developed countries considered that it would be unrealistic to assume that enterprises selected the oldest patents for licensing to developing countries. In their view, an enterprise normally would license its patents to foreign subsidiaries and therefore would select the most up-to-date inventions, in the hope of expanding existing markets or of opening new ones. They contended that patents are instruments for promoting industrial production and an enterprise would have an economic incentive to make the industrial production of its affiliates as profitable as possible. Several developed countries hold as a matter of principle that the country of residence of the owner of a patent or similar property should have the exclusive or primary right to tax royalties paid thereon.

Because there is no consensus concerning a specific rate for the withholding tax to be charged on royalties on a gross basis, the rate should be established through bilateral negotiations. This situation is reflected in paragraph 2 of article 12. The following considerations might be taken into account in such negotiations:

First, in establishing a withholding tax on the gross royalty in a tax treaty, the country of source should recognize both current expenses allocable to the royalty and expenditures incurred in the development of the property giving rise to the royalty. In addition, the source country should consider that expenditures incurred in the development of a particular property may be properly allocable in some circumstances to profits derived currently or in the past or future from other property. Furthermore, the country of source should take into account that expenditures not directly incurred in the development of a particular property might have contributed significantly to that development.

Second, as a technical matter, if an expense ratio were agreed upon in fixing a gross rate in the source country, it would appear as a consequence that the country of the recipient, if following a credit method, would apply that expense ratio as the basis for determining the application of its credit, whenever feasible.

Assume, for example, that the Contracting States agreed that on average one-third of gross royalty income represents a recovery of development and other expenditures. As a result, the source country reduced its withholding rate from 30 percent to 20 percent. In determining whether that withholding tax of 20 percent qualifies for a tax credit, the residence country also should assume that one-third of the royalty represented return of expenses and two-thirds represented net profits. This issue should be addressed, therefore, in applying the provisions of article 23B (Credit method).

In addition, various members of the Group mentioned factors that might influence the determination of the appropriate withholding tax on gross royalties in a treaty between a developed and developing country. Those factors include the following:

- (a) The need for revenue and conservation of foreign exchange by the developing country;
- (b) The fact that royalty payments flow almost entirely from developing countries to developed countries;
- (c) The extent of assistance that developed countries should, for a variety of reasons, extend to developing countries, and the special importance of providing such assistance in the context of royalty payments;
- (d) The desirability of preventing a shifting of the tax burden to the licensees through the license arrangement;
- (e) The ability that taxation at source provides to a developing country to make selective judgments by which, through reduced taxation or exemption, it could encourage those license arrangements it considers desirable for its development;

- (f) The lessening of the risks of tax evasion if there is at least some taxation at the source;
- (g) The fact that the country of the licensor frequently supplies the facilities and activities necessary in the development of the patent and thus undertakes the risks associated with the patent;
- (h) The fact that the country of the licensor may have obtained substantial collateral benefits from having the development of technology conducted within its borders and may have provided tax incentives to the licensor in the hope of obtaining those benefits;
- (i) The desirability of obtaining and encouraging a flow of technology to developing countries;
- (j) The desirability of enlarging the field of activity of the licensor in the utilization of its research;
- (k) The benefits that developed countries obtain from world development in general;
- (l) The relative importance of revenue sacrifice; and
- (m) The relationship of the royalty-rate decision to other decisions in the negotiations.

There is a special problem involving the broad definition of royalties under paragraph 3 of article 12, which includes “information concerning industrial, commercial or scientific experience.” A member from a developed country explained that in his view the problem was that the definition made an imperfect distinction between revenues that constitute royalties in the strict sense and payments received for brain work and technical services, such as surveys of any kind (engineering, geological research etc.). The member also mentioned the problem of distinguishing between royalties akin to income from capital and payments received for services. Given the broad definition of “information concerning industrial, commercial or scientific experience,” certain countries tended to regard the provision of brain work and technical services as the provision of “information concerning industrial, commercial or scientific experience” and to regard payment for it as therefore taxable as royalties under article 12.

In order to avoid those difficulties, a member from a developed country proposed that the definition of royalties be restricted by excluding payments received for “information concerning industrial, commercial or scientific experience.” It may be relevant to note that paragraph 2 of article 12 of the OECD Model Convention (corresponding to paragraph 3 of the United Nations Model Convention) was amended by deleting the words “or the use of, or the right to use, industrial, commercial or scientific equipment.”¹⁰ The member also suggested that there be a protocol annexed

¹⁰ Report of the OECD: “The Revision of the Model Convention” adopted by the Council of the OECD on 23 July 1992.

to the treaty making it clear that such payments should be deemed to be profits of an enterprise to which article 7, dealing with business profits, would apply, and that payments received for studies or surveys of a scientific or technical nature, such as geological surveys, or for consultancy or supervisory services, should be deemed to be profits of an enterprise to which the provisions of article 7 would apply. It was pointed out that the effect of those different provisions would be to ensure that the source country could not tax such payments unless the enterprise had a permanent establishment, as defined by the treaty, situated in that country, and that taxes should be payable only on the net income element of such payments attributable to that permanent establishment.

In order to resolve the problem of the definition of royalties, the Group agreed to consider income from consulting activities as business profits and to include in article 5, paragraph 3, a new subparagraph (b) which provides that the term permanent establishment should likewise encompass “the furnishing of services, including consultancy services, by an enterprise through employees or other personnel, where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any twelve-month period.”

It is considered that income from film rentals should not be treated as industrial and commercial profits but should be dealt with in the context of royalties. The tax would thus be levied on a gross basis but expenses would be taken into account in fixing the withholding rate. With regard to expenses, various factors could be regarded as peculiarly relevant to film rentals. As a general rule, the expenses of film producers might be much higher and the profits lower than in the case of industrial royalties. On the other hand, a considerable part of film expenses represent high salaries paid to actors and other participants who were taxed solely by the country of residence, and not by the source country, and might therefore not justify any great reduction of the withholding tax at source. However, the amounts involved are, nevertheless, real costs for the producer and should be taken into account, while, at the same time, all countries involved should join in efforts to make sure that such income does not escape tax. Further, although the write-off of expenses in the country of residence does not mean that the expenses should not be taken into account at source, at some point old films could present a different expense situation. It has also been suggested that the definition of “royalties” in the bilateral tax treaty may also include those incomes for the use or right to use the intangible property as also for the filming/shooting videos and tapes or other means of reproduction for the use or in connection with television and payment for reception or the right to receive for transmission of visual images or sound or both transmitted to the public via satellite or cable, optic fibre or similar technology, as also whatever gains arise from the sale of the rights or ownership with reference to the above-mentioned activities.

Some members believe that because copyright royalties represent cultural efforts, they should be exempted from tax by the source country. The grounds for an exemption for cultural efforts that result in the earning of income are unclear. Others argue that since tax on that income would be levied by the residence country, the reduction at source would not benefit the author. Other members are in favour of exempting copyright royalties at the source, not necessarily for cultural reasons, but because the residence country is in a better position to evaluate the expenses and personal circumstances of the creator of the royalties, including the period of time over which the books or other copyrighted items were created. A reduction of the withholding rate in the source

country might be appropriate if the tax otherwise would be too high to be absorbed by the tax credit of the residence country. However, some source countries might not be willing to accept a lowering of the withholding rate for that reason. Further, the party dealing with the source country might be the publisher and not the author, and arguments supporting the exemption of the author's income because of his personal situation obviously do not apply to the publisher.

Paragraphs 3, 4 and 6 of article 12 reproduce the provisions of article 12, paragraphs 2, 3 and 4 of the OECD Model Convention with some modifications. First, the United Nations Model Convention retains the words "or the use of, or right to use industrial, commercial or scientific equipment" in paragraph 3, although those words were dropped from the OECD Model in 1992. There is also a minor change in paragraph 4 of article 12, namely the addition of "and 2" after "the provisions of paragraph 1."

As to paragraph 5, providing that royalties have their source in the country of residence of the payer, a member from a developed country suggested that some countries might wish to substitute a rule that would identify the source of a royalty as the State where the property or right giving rise to the royalty (the patent etc.) was used. If the two parties in bilateral negotiations differed on the appropriate rule, a possible solution would be a rule that generally would accept the place of residence of the payer as the source of royalty but would adopt a place of use rule if one of the parties used that rule in its domestic legislation.

Article 13

CAPITAL GAINS

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.
2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.
3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:
 - (a) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of

management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.

- (b) For the purpose of this paragraph, “principally” in relation to ownership of immovable property means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.

5. Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of ___ per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.

6. Gains from the alienation of any property other than that referred to in paragraphs 1, 2, 3, 4 and 5 shall be taxable only in the Contracting State of which the alienator is a resident.

Observations

The taxation of capital gains is contained in the first three paragraphs of article 13 followed by a new amended paragraphs (paragraphs 4 modified in 1999), paragraph 5 and by the text of article 13, paragraph 4, of the OECD Model Convention, renumbered as paragraph 6 and adjusted to take into account the insertion of the new paragraphs. The commentary on article 13 of the United Nations Model Convention is relevant.

Paragraph 4 of article 13 allows a Contracting State to tax gains on an alienation of shares of a company or on an alienation of interests in other entities when the property of the company or other entity consists principally of immovable property located in that State. The paragraph is not found in the OECD Model Convention. It is designed to prevent avoidance of taxes on the gains from the sale of immovable property through the use of real-estate holding companies and similar devices. Taxing the gain derived from the sale of an interest in such an entity is necessary, due to the ease with which taxpayers otherwise would avoid tax on the sale of immovable property. In some cases, the ownership of the shares carries the right to occupy the immovable property. In order to achieve its objective, paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State.

In 1999, the Group of Experts decided to amend paragraph 4 to expand its scope to include interests in partnerships, trusts and estates that own immovable property directly or indirectly. The Group also agreed to narrow the scope of that paragraph by excluding entities if the immovable property they own consists principally of immovable property that they have used in their business activities. However, this exclusion will not apply to an immovable property management company, partnership, trust or estate. In order to fulfil its purpose, paragraph 4 must apply whether the company, partnership, trust or estate owns the immovable property directly or owns it indirectly through one or more interposed entities. Contracting States may agree in bilateral negotiations that paragraph 4 also should apply to gains from the alienation of other corporate interests or from the alienation of rights forming part of a substantial participation in a company. For the purpose of

paragraph 4, the term “principally” in relation to the ownership of immovable property by an entity means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the entity.

With regard to paragraph 5, a number of members considered that a Contracting State should retain the right to tax the gain on the sale of shares of a company resident in that State whether the sale occurred within or outside the State. It was recognized, however, that for administrative reasons the right to tax should be limited to a sale of substantial participation in a company. The determination of what was a substantial participation was left to bilateral negotiations. For example, an agreed percentage of voting power might be used to determine what constituted “substantial participation” in a company.

The Group noted that some countries might take as their negotiating position that the Contracting State where the company was resident should tax the alienation of shares in that company only when a substantial portion of the assets were located within that State. Other countries might prefer that paragraph 5 be omitted entirely.

A 1992 addition to the commentary on OECD article 13, paragraph 4 (corresponding to paragraph 6 of article 13 of the United Nations Model Convention) is relevant:

“If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price and par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated profits and not as a capital gain. The article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in article 10: such taxation is permitted because such difference is covered by the definition of the term “dividends” contained in paragraph 3 of article 10 and interpreted in paragraph 28 of the commentary relating thereto. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with article 11 ...”

The Group noted further that some countries might feel it undesirable to add to the situations mentioned in paragraphs 1, 2 and 3 only the situations mentioned in paragraphs 4 and 5, especially when they considered that tax avoidance situations of special interest to them required attention. Such countries might wish to replace paragraphs 4, 5 and 6 of article 13 by the following paragraph:

“Gains from the alienation of any property, other than those gains mentioned in paragraphs 1, 2 and 3, shall be assessed and taxed in accordance with the laws in force in either or both of the Contracting States.”

Article 14

INDEPENDENT PERSONAL SERVICES

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

- (a) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or
- (b) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State.

2. The term “professional services” includes especially independent scientific, literary, artistic, educational or teaching activities as well as the independent activities of physicians, lawyers, engineers, architects, dentists and accountants.

Observations

The OECD Model Convention previously contained separate articles on independent personal services (article 14)⁴³ and dependent personal services (article 15). The provisions of article 14 are similar to those of article 7 on business profits and are based on the same principles. In 2000, the OECD Model Convention was modified to eliminate article 14, with the understanding that income previously taxable under article 14 would now be taxable under article 7. Under the prior version of the OECD Model Convention, article 14 would now be taxable under article 7. Under the prior version of the OECD Model Convention, article 14 would subject income derived by an individual in respect of professional services or other activities of an independent character to taxation in the source country only where the individual has a “fixed base” in that country for the purpose of performing his activities. The OECD believed that the concept of a fixed base and a permanent establishment are very similar, but it felt that there was some uncertainty as to whether the various special rules of article 5 applied under article 14. It was thought to be unclear, for example, whether the rules respecting agents constituting a permanent establishment applied in determining whether a person providing independent services had a fixed base. It was also thought to be unclear whether the exclusions for various activities of a preliminary character were applicable in determining whether a taxpayer had a fixed base. By eliminating article 14, the OECD made clear that the rules defining a fixed base are identical to the rules defining a permanent establishment. It was also thought to be unclear whether a corporation or other legal entity could perform activities of an independent character within the meaning of article 14.

⁴³ In 2000, OECD has omitted article 14 from its Model Convention.

Originally, the Group of Experts agreed to recommend two substantive changes in the text of article 14 of the 1977 version of the OECD Model Convention. Those changes would have added two exceptions, in addition to the fixed-base exception, to the basic principle that income derived by a resident of a Contracting State in respect of professional services or other similar independent activities should be taxed only in that State. These two additional exceptions, relating to the length of stay in the source country and the amount of remuneration earned in that country, were embodied in subparagraphs (b) and (c), respectively, of paragraph 1, article 14, as adopted in 1980. However, in 1999, the Group of Experts decided to omit the third criterion, namely, that source taxation was permitted if the amount of remuneration exceeded a threshold amount. As a result, the United Nations Model Convention currently provides that income derived from independent personal services may be taxable only if the taxpayer has a fixed base or is present in the source country for a period exceeding the threshold number of days.

In the course of the discussion preceding the adoption of article 14, some members from developing countries expressed the view that it would not be justifiable to limit taxation by the source country by the criteria of existence of a fixed base and length of stay, and that the source of income should be the only criterion. In contrast, some members from developed countries felt that the exportation of skills, like the exportation of tangible goods, should not give rise to taxation in the country of destination, unless the person concerned had a fixed base in that country comparable to a permanent establishment; they therefore supported the fixed base criterion. They also considered that taxation in the source country would be justified by the continued presence in that country of the person rendering the service. Some members from developing countries also expressed support for the fixed base criterion.

Other members from developing countries expressed a preference for the length of stay criterion.

Several members from developing countries proposed a third criterion, namely, that of the amount of remuneration. Under that criterion remuneration for independent personal services could be taxed by the source country if it exceeded a specified amount, regardless of the existence of a fixed base or the length of stay in that country. In 1999, the Group of Experts observed that any monetary ceiling limit probably would become meaningless over a period of time due to inflation and would only have the effect of limiting the amount of potentially valuable services that the country will be able to import. Moreover, the provision to this effect appeared only in six per cent of the existing bilateral tax treaties finalized between 1980 to 1997. The Group of Experts, accordingly, decided to delete subparagraph (c) of paragraph 1 of article 14, as contained in the 1980 Model.

Article 15

DEPENDENT PERSONAL SERVICES

1. Subject to the provisions of articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the

employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable only in the first-mentioned State if:

- (a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and
- (b) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and
- (c) The remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State.

3. Notwithstanding the preceding provisions of this article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Observations

The 1965 report of the OECD Fiscal Committee mentioned earlier describes the following considerations concerning dependent personal services:

“The OECD draft convention provides for the taxation of income from dependent personal services in the country where the services are performed. However, if the services involved are supplied by an employee of a foreign enterprise, he must be present in the country for a period of six months or more before he becomes taxable. Such a rule, if used in conventions between developing and capital exporting countries, may seem to favour the latter. However it is important to note that skilled personnel are one of the great needs of developing countries. Such persons are in demand everywhere. If they are to become involved in the tax systems of developing countries after relatively brief stays in such countries, it may constitute a barrier to their going to such countries. This has been recognized by the tax laws of some developing countries, and it is not uncommon for them to grant exemption in such cases unilaterally. It is conceivable that the personal service article will bear modification, perhaps by lengthening the duration that a technician may remain in a host country without becoming subject to tax there. However, due consideration will have to be given to the desirability of permitting individuals to be wholly free of taxes.”⁴⁴

In connection with the taxation of remuneration of dependent personal services, the commentary on article 15 in the United Nations Model Convention is therefore relevant.

⁴⁴ Organisation for Economic Cooperation and Development, op. cit., paragraph 175.

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

1. Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other State.
2. Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.

Observations

As in the case of the United Nations Model Convention, the OECD Model Convention contains a separate article on directors' fees, which applies solely to payments received in the recipient's capacity as a member of the Board of Directors of a company. The article, which is based on the assumption that it might sometimes be difficult to ascertain where the services in question are performed, stipulates that such payments may be taxed in the Contracting State where the company concerned is a resident.

An article in a bilateral tax treaty relating to the taxation of directors' fees and remuneration of top-level managerial officials may be based on the text of article 16 of the United Nations Model Convention, which, unlike the OECD Model Convention, is supplemented by the addition of a second paragraph dealing with payments received by top-level managerial officials. The whole of the OECD Model commentary on article 16 is therefore relevant to paragraph 1 of article 16.

The Group observed that the top-level managerial positions of a company resident in a Contracting State might be occupied by persons resident in the other Contracting State. In that situation, the principle applicable by the first Contracting State to the taxation of directors' fees also should apply to the taxation of the remuneration paid to such top-level managerial officials. The term "top-level managerial positions" refers to a limited group of positions that involve primary responsibility for the overall direction of the affairs of the company, apart from the activities of the directors. The term covers a person acting as both a director and a top-level manager.

Article 17

ARTISTES AND SPORTS PERSONS

1. Notwithstanding the provisions of articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sports person, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or a sports person in his capacity as such accrues not to the entertainer or sports person himself but to another person, that income may, notwithstanding the provisions of articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or sports person are exercised.

Observations

The OECD Model Convention contains an article (article 17) which covers the activities of sportsmen as well as those of entertainers, and provides that the activities of such persons shall be taxed in the State in which the activities are exercised. Article 17 constitutes an exception to the rules laid down in article 7 of the OECD Model Convention (formerly article 14) relating to the taxation of independent personal services, and paragraph 2 of article 15 of that Convention on dependent personal services. Paragraph 2 of article 17 is designed to help counter certain tax avoidance devices. Under a common device, the remuneration for the performance of an entertainer or sports person is paid, not to the entertainer or sports person himself, but to another person, e.g., a so-called artiste company. In the absence of paragraph 2, the source country would not be able to tax the income either as personal service income of the entertainer or sports person because the income is not earned by that person, and it would not be able to tax the artiste company, because the company would not have a permanent establishment in that country.

It is considered that the term “sportsperson” which, unlike the term “entertainer” is not followed in paragraph 1 by illustrative examples, is nevertheless likewise to be construed in a broad manner consistent with the spirit and the purpose of the article 17. It has been suggested that income earned by artistes and sportspersons by the direct use, rent or other forms of assets in relation to the exercise of their professional activities should also be treated as professional income and chargeable as such.

Article 18

PENSIONS AND SOCIAL SECURITY PAYMENTS

Article 18 (alternative A)

1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

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

Article 18 (alternative B)

1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment, may be taxed in that State.
2. However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.
3. Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Observations

The United Nations Model Convention stipulates that private pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

During the discussion, several members of the Group of Experts from developing countries expressed the view that pensions should not be taxed exclusively in the beneficiary's country of residence. They pointed out that since pensions were in substance a form of deferred compensation for services performed in the source country, they should be taxed at source as normal employment income would be. They further observed that pension flows between some developed and developing countries were not reciprocal and in some cases represented a relatively substantial net outflow for the developing country. Several members said they favoured exclusive taxation of pensions at source but would be willing to grant an exemption from source taxation for amounts equivalent to the personal exemptions allowable in the source country. Other members were generally of the view that pensions should be taxed only in the beneficiary's country of residence. They suggested that because the amounts involved were generally not substantial, developing countries would not suffer measurably if they agreed to taxation in the country of residence. Those members also made the point that the country of residence was probably in a better position than the source country to structure its taxation of pensions to the taxpayer's ability to pay.

A question was raised as to how pension payments would be taxed in the case of employees who had performed services consecutively in several different countries, a fairly common practice among employees of transnational corporations. If such employees were taxed in each jurisdiction in which they had previously worked to earn the pension, then each pension payment might be taxed in a number of jurisdictions. It also was observed that it would be very difficult for the head office of a company to allocate each pension among the various countries where the pensioner had worked during his years of employment. It was generally agreed therefore that taxation of pension at source should be construed to mean taxation at the place where the pension payments originated, not the place where the services had been performed.

The Group was unable to reach a consensus that would have enabled it to recommend an article suggesting the manner in which pension payments (but not including social security

payments) should be taxed, that is, whether tax jurisdiction over such payments should be recognized as belonging to the source country or the country of residence or to both. Hence the two alternatives suggested by the Group in article 18 (alternative A) and article 18 (alternative B) respectively.

Neither article 18 nor article 19 of the OECD Model Convention refers specifically to pensions that are part of a social security system. That omission is due to the fact that some States consider such pensions to be similar to government pensions and therefore liable to taxation under the source principle, whereas other States hold the view that such pensions should be assimilated to private pensions and should be taxable only in the State of residence of the recipient. That being so, the Committee on Fiscal Affairs of the OECD suggests in the Commentary on article 18 that States advocating the application of the source principle might seek in bilateral negotiations to include in the article modelled on article 18 in their bilateral treaties a paragraph drafted along the following lines: “Notwithstanding the provisions of paragraph 1, pensions and other payments made under the social security legislation of a Contracting State may be taxed in that State.”⁴⁵

The premise for assigning to the source country the exclusive right to tax payments under a government pension plan (a public pension plan that is part of the social security system) is predicated on the rationale that those payments are wholly or largely financed out of the tax revenues of that country. That premise is likely to be valid if the potential beneficiaries do not make any contributions to the plan or if the payments are supplemented by the tax revenues of the source country. It is not likely to be valid, however, if the social security system functions on the basis of the capitalization principle rather than the distribution principle.

Article 19

GOVERNMENT SERVICE

1. (a) Salaries, wages and other similar remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.
- (b) However, such salaries, wages and other similar remuneration shall be taxable only in the other Contracting State if the services are rendered in that State and the individual is a resident of that State who:
 - (i) is a national of that State; or
 - (ii) did not become a resident of that State solely for the purpose of rendering the services.

⁴⁵ Organisation for Economic Cooperation and Development, *Model Tax Convention on Income and on Capital* (Paris, 1992), commentary on article 18, paragraph 2.

2. (a) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(b) However, such pensions shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.
3. The provisions of articles 15, 16 and 18 shall apply to salaries, wages and other similar remuneration and to pensions, in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Observations

The United Nations Model Convention allows the State paying the remuneration in respect of government services to tax that remuneration. Such an approach is in conformity with the rules of international courtesy and mutual respect between sovereign States and with the provisions of the Vienna Conventions on Diplomatic and Consular Relations.⁴⁶ However, taking into account the fact that, as a result of the growth of the public sector in many countries, government activities abroad have been considerably extended, the United Nations Model Convention allows the State where the services are performed to tax the remuneration in the case of remuneration paid by one Contracting State to an individual in respect of services rendered in the other Contracting State if the individual is a resident of the latter State and also a national of that State and did not become a resident of that State solely for the purpose of rendering the service.

The United Nations Model Convention, in the case of public pensions, generally gives the Contracting State making the pension payments the exclusive right to tax those pensions. As an exception to that rule, the right to tax a pension is granted to the Contracting State where the recipient of a pension is resident if that person is also a national of that State. According to the OECD Committee on Fiscal Affairs, this approach is likewise in keeping with the Vienna Conventions on Diplomatic and Consular Relations, according to which the receiving State is allowed to tax remuneration paid to certain categories of personnel of foreign diplomatic missions and consular posts who are permanent residents or nationals of that State.

The taxation of remuneration in respect of government service and social security payments is contained in the text of article 19 of the United Nations Model Convention and the whole of the commentary on article 19 is relevant.

Although the provisions of article 19 generally were acceptable, the Group of Experts observed that some developing countries might desire to limit, by reference to a ceiling amount, the restriction in paragraph 2(b) on the taxation of pensions by the Government making the pension payments when the recipient is a resident or a national of another country. The Group also felt that

⁴⁶ Ibid., commentary on article 19, paragraph 1.

some developing countries might prefer that payments dealt with in article 19 should be taxed only by the beneficiary's country of residence.

Article 20

STUDENTS

Payments which a student or business apprentice, who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training, receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Observations

Article 20 of the United Nations Model Convention, as presently worded, reproduces substantially article 20 of the OECD Model Convention. In 1999, the Group of Experts agreed to drop what had been paragraph 2 of the 1980 version of the Model Convention. That paragraph guaranteed to students and apprentices the same exemptions and reliefs granted to domestic taxpayers. In its current form, article 20 of the United Nations Model Convention provides that payments received by students or business apprentices for the purpose of their maintenance, education or training and from sources outside the State where the student or business apprentice concerned is staying shall be exempted from tax in that State. This provision extends to individuals who leave home to study or train in the other Contracting State and thereby lose their residence status in their home State. It does not extend, however, to an individual who was once a resident of a Contracting State but who subsequently moved his residence to a third State before visiting the other Contracting State.

Some members of the Group felt that students or business apprentices should be exempted from tax on income received from employment in the Contracting State which they were visiting during their period of study or training. However, it was recognized that this exemption could in some situations be regarded as discriminatory against local students or business apprentices receiving employment income. It was observed that some countries in bilateral negotiations might wish to expand the exemption in article 20 by adding a paragraph permitting a further exemption (beyond that generally applicable as a personal exemption or similar allowance under the internal law of the Contracting State) of employment income under certain conditions. That further exemption would be limited, however, by some income ceiling or by confining the exemption to amounts required for maintenance and support. In setting a ceiling amount, some countries might wish to utilize as a guide the additional costs incurred as a result of the fact that the students or business apprentices were visitors. If such further exemption were to be permitted, it would be appropriate to place a time limit on the exemption. Presumably students would be given a longer time limit than apprentices.

Article 21

OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles shall be taxable only in that State.
2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.
3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may be taxed in that other State.

Observations

The United Nations Model Convention contains a separate article (article 21) on “other income.” This article reproduces Article 21 of the OECD Model Convention in its entirety and also has an additional paragraph 3 containing a general provision relating to items of income of a resident of a Contracting State not dealt with in the preceding articles and arising in the other Contracting State. The article covers not only income of a class not expressly dealt with in the preceding articles, but also income from sources not expressly mentioned therein. The scope of the article is not confined to income arising in a Contracting State but extends also to income from third States.

In sharp contrast to the OECD Model Convention, the United Nations Model Convention does not assign the exclusive right to tax “other income” to the State of residence of the recipient. Paragraph 3 of article 21 is intended to permit the country where the income arises to tax such income if its law so provides, whereas paragraph 1 permits taxation in the country of residence. Residency is determined under the rules of article 4. The primary right to tax in the residence country generally is denied when the income is associated with the activity of a permanent establishment or fixed base that a resident of a Contracting State has in the other Contracting State. In such cases, a primary right to tax is given to the Contracting State where the permanent establishment or fixed base is situated; the residence State retains the right to tax as well but must relieve the double taxation that results.

An article in a bilateral tax treaty relating to the taxation of income other than that covered in the preceding articles may be based on the text of article 21 of the United Nations Model Convention which contains a new paragraph 3 providing a general rule relating to items of income of a resident of a Contracting State not dealt with in the preceding articles and arising in the other Contracting State. Consequently the commentary on article 21 of the United Nations Model Convention is relevant.

The Group observed that the provisions of paragraph 3 would permit the country where the income arises to tax such income if its law so provides whereas the provisions of paragraph 1 would permit taxation in the country of residence. The concurrent application of the provisions contained in the two paragraphs might result in double taxation. In such a situation, the provisions of article 23A or 23B, as appropriate, would be applicable, as in other cases of double taxation. The Group further observed that in some cases paragraphs 2 and 3 might overlap in such cases; however, they produce the same result.

CHAPTER IV

TAXATION OF CAPITAL

Article 22

CAPITAL

1. Capital represented by immovable property referred to in article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.
2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.
3. Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
- [4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.]

(The Group decided to leave to bilateral negotiations the question of the taxation of the capital represented by immovable property and movable property and of all other elements of capital of a resident of a Contracting State. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.)

Observations

The United Nations Model Convention, article 22, deals with taxes on capital, to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties. If the negotiating parties decide to include an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.

If in a case the provisions of paragraph 4 are applied to elements of movable property under usufruct, double taxation subsists because of the disparity between domestic laws, the States concerned may resort to the mutual agreement procedure or settle the question by means of bilateral negotiations.

This article does not provide any rule about the deductions of debts. The laws of different countries are too diverse to allow a common solution to the treatment of debt. Paragraph 4 of article 24 addressed the problem that might arise in the treatment of debts when the taxpayer and the creditor are not residents of the same State.

CHAPTER V

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23 A

EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.
2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of articles 10, 11 and 12, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.
3. Where in accordance with any provision of this Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Article 23 B

CREDIT METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State; and as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State. Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.
2. Where, in accordance with any provision of this Convention, income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

Observations

The United Nations Model Convention takes the same approach as the OECD Model Convention concerning methods for the elimination of double taxation and has reproduced the two alternative versions of article 23 of the OECD Model Convention, namely article 23 A on the exemption method and article 23 B on the credit method.

The Group agreed that, generally speaking, the method by which a country would give relief from double taxation depended primarily on its general tax policy and the structure of its tax system. Owing to the differences that existed in the various tax systems as regards the objectives pursued, it was further agreed that bilateral tax treaties provide the most flexible instrument for reconciling conflicting tax systems and for the avoidance or mitigation of double taxation.

Members from developing countries felt that, as regards relief measures to be applied by developing countries, the methods of tax exemption, tax credit (including tax-sparing credit) could be used as appropriate. The exemption method was considered eminently suitable when exclusive tax jurisdiction over certain income was allotted to the country of source under a treaty; it might take therein the form of an exemption with progression. The main defect of the foreign tax credit method, from the point of view of developing countries, is that special tax concessions granted by them may in large part enure to the benefit of the treasury of the capital-exporting country rather than to the foreign investor for whom the benefits were designed. When the investor's home country applied the principle of the foreign tax credit, the most effective method of preserving the effect of the tax incentives and concessions extended by developing countries would be the application of a tax-sparing credit in addition to the regular tax credit.

The effectiveness of the tax incentive measures introduced by most developing countries depends upon the interrelationships between the tax systems of the developing countries and those of the capital-exporting countries where the investment originates. It may be of primary importance to developing countries to ensure that the tax incentive measures shall not be made ineffective by taxation in the capital-exporting countries using the foreign tax credit system. This undesirable result is to some extent avoided in bilateral tax treaties through a "tax-sparing credit", by which a developed country grants a credit not only for the tax paid but for the tax spared by incentive legislation in the developing country. It is also avoided by the exemption method. The members of the Group of Experts from developing countries considered it necessary to underline their understanding that either the exemption method or the tax-sparing clause is, for these countries, a basic and fundamental aim in the negotiation of tax treaties. On the other hand, some members noted that studies have shown that tax factors may not themselves be decisive in the process of investment decisions. For a detailed discussion of this subject, please see pages 265-268 of the *United Nations Model Double Taxation Convention between Developed and Developing Countries*.

CHAPTER VI
SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of article 1, also apply to persons who are not residents of one or both of the Contracting States.
2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.
3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
4. Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
6. The provisions of this article shall, notwithstanding the provisions of article 2, apply to taxes of every kind and description.

Observations

Article 24 of the United Nations Model Convention reproduces article 24 of the OECD Model Convention. In 1999, the definition of the term “national” which had previously been included in this article was moved to article 3 as was also done in the OECD Model Convention. The provisions in article 24 on non-discrimination establish the principle that for purposes of taxation, discrimination on the grounds of nationality is forbidden and that subject to reciprocity the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.

Long before the emergence of the classical type of double taxation treaty at the end of the nineteenth century, the principle of non-discrimination in fiscal matters had been embodied in many different types of international agreements under which each Contracting State undertook to grant nationals of the other Contracting State the same treatment as its own nationals (consular or establishment conventions, treaties of friendship or commerce etc.). In view of the long standing acceptance of the principle of non-discrimination in international fiscal relations, which in the twentieth century has been included in virtually all bilateral treaties for the avoidance of double taxation, the Group had no difficulty in agreeing that the principle should be embodied in the articles.

A question was raised as to whether paragraph 4 of that article was suitable for inclusion in a tax treaty between developed and developing countries. It was suggested that paragraph would not be acceptable to a country that disallowed a deduction for disbursements made to a foreign owned corporation unless the corporation was being taxed in that country. After substantial discussion, the feeling of the Group was that the special circumstances mentioned above ought not to be the basis for treaty guidelines of broad application. If a country felt that paragraph 4 was inconsistent with its domestic rules on deductions, it should raise the issue in bilateral negotiations.

Some members from developing countries proposed that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises were treated alike; they said that change represented a notable departure from the general principle of taxing foreign persons on the same basis as nationals but that the problems of tax compliance in cases in which foreign ownership was involved and the politically sensitive position of foreign-owned enterprises in developing countries warranted the change. Therefore, they proposed that paragraph 5 of article 24 of the OECD Model Convention be amended to read as follows:

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

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

Several members from developed countries expressed reservations concerning the proposed change and pointed out that they considered the OECD non-discrimination article as the backbone of the Convention. They recalled that the antecedents of the non-discrimination article in the present OECD Model Convention dated from the nineteenth century. They felt that if such a fundamental principle were to be altered, it would have a significant effect on international tax relations generally. Further, because the proposed change was motivated in part by problems with tax compliance involving foreign ownership of enterprises, most particularly by problems with transfer pricing, it was suggested that the problems might be dealt with more properly in other parts of the tax convention, such as in article 9 dealing with associated enterprises.

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

It may be noted that some countries have provided explicitly by treaty that measures reasonably designed to combat tax evasion and avoidance do not constitute a violation of the non-discrimination rule. Contracting States wishing to include such a provision in their treaty through bilateral negotiations might consider adoption of the following language:

“Nothing in this article relates to any provision of the taxation laws of a Contracting State reasonably designed to prevent the avoidance or evasion of taxes, provided that such provisions (other than provisions in international agreements) do not discriminate between citizens or residents of the other Contracting State and those of any third State.”

Article 25 MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the

competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

Observations

Difficulties of interpretation or application are likely to occur in connection with the implementation of a bilateral tax treaty, as in connection with the implementation of any treaty. These difficulties might impair or impede the normal operation of the provisions of the treaty as originally conceived by the negotiating parties. Hence the need for a mutual agreement procedure for resolving any disagreement arising out of the implementation of the treaty in the broadest sense of the term. Such a mutual agreement procedure is clearly a special procedure-outside the domestic law. The mutual agreement procedure is designed not only to furnish a means of settling questions relating to the interpretation and application of the Convention, but also to provide (a) a forum in which residents of the States involved can protest actions not in accordance with the Convention and (b) a mechanism for eliminating double taxation in cases not provided for in the Convention.

The United Nations Model Convention sets forth in article 25 a mutual agreement procedure for resolving difficulties arising out of the application of the Convention in the broadest sense of the term. Under such a procedure, the competent authorities of the two Contracting States are to endeavour by mutual agreement to resolve the situation of taxpayers subjected to taxation not in accordance with the provisions of the Convention. They are also invited and authorized to resolve by mutual agreement problems relating to the interpretation or application of the Convention and, furthermore, to consult together for the elimination of double taxation in cases not provided for in

the Convention. Concerning the practical operation of the mutual agreement procedure, the competent authorities are merely authorized to communicate with each other directly, without going through diplomatic channels and, if it seems advisable to them, to have an oral exchange of opinion through a joint commission appointed especially for the purpose. It has been suggested that the Contracting States may provide an arbitration clause through which the controversies concerning the interpretation or the application of the Convention may be resolved.

The OECD Model Convention commentary on article 25 states that in practice the mutual agreement procedure applies most frequently to cases of double taxation that the Convention was specifically intended to avoid. Disagreements over the proper application of the arm's length standard, embodied in article 9, have created many cases that have gone to the competent authorities for resolution. Among the most common cases cited in the OECD commentary are the following:

1. Questions relating to attribution to a permanent establishment of a proportion of the executive and general administrative expenses incurred by the enterprise, under paragraph 3 of article 7;
2. The taxation in the State of the payer "in case of a special relationship between the payer and the beneficial owner" of the excess part of interest and royalties, under the provisions of article 9, paragraph 6 of article 11 or paragraph [6] of article 12;
3. Cases of application of legislation to deal with thin capitalization when the State of the debtor company has treated interest as dividends, insofar as such treatment is based on clauses of a convention corresponding for example to article 9 or paragraph 6 of article 11;
4. Cases where lack of information as to the taxpayer's actual situation has led to misapplication of the Convention, especially in regard to the determination of residence (paragraph 2 of article 4), the existence of a permanent establishment (article 5), or the temporary nature of the services performed by an employee (paragraph 2 of article 15).

The commentary also notes that "on the whole the mutual agreement procedure has proved satisfactory" and that "the most recent treaty practice shows that article 25 represents the maximum that Contracting States are prepared to accept." The commentary adds that it must, however, be admitted that the procedure "is not yet entirely satisfactory from the taxpayer's viewpoint ... because the competent authorities are required only to seek a solution and are not obliged to find one."

In the light of the foregoing and in view of the need to provide for a mutual agreement procedure, article 25 of the United Nations Model Convention, reproduces the text of article 25 of the OECD Model Convention with one substantive change, namely, the addition of the second and third sentences of paragraph 4 of article 25. It may be relevant to note that the OECD eliminated the second sentence of paragraph 4 in 1995, which had been in the OECD Model since 1963. The commentary on article 25 of the OECD Model Convention is relevant *mutatis mutandis* to article 25. According to the Group, the procedure is designed not only to provide a means of settling questions relating to the interpretation and application of the treaty, but also to provide a forum in which residents of the States involved can protest actions not in accordance with the treaty and a

mechanism for eliminating double taxation in cases not provided for in the treaty. The mutual agreement procedure applies in connection with all articles of the Convention and in particular to article 7 on business profits, article 9 on associated enterprises, article 11 on interest, article 12 on royalties and article 23 on methods for the elimination of double taxation. However, some countries may need to modify this grant of power to their competent authorities in conformity with their domestic laws.

With regard to paragraph 4 of article 25, the Group emphasized the following essential elements in respect of income and expense allocations, including transfer pricing:

1. Transactions between related entities should be governed by the standard of “arm’s length dealing.” As a consequence, if an actual allocation is considered by the tax authorities of a treaty country to depart from that standard the taxable profits may be re-determined;
2. Taxpayers are entitled to invoke the mutual agreement procedure when they consider that such action by one or both of the tax authorities regarding such re-determination is contrary to the arm’s length standard;
3. The implementation of the mutual agreement procedure is delegated to the competent authorities of the treaty countries, with adequate powers to ensure full implementation and with the expectation that such implementation will enable the mutual agreement procedure to be an effective instrument for carrying out the purpose of the treaty. The Group stressed that such delegation included power to establish time limits within which matters should be presented by the interested parties to the appropriate competent authority. This delegation of the power to set time limits would make unnecessary the last sentence of paragraph 1 of article 25 of the United Nations Model Convention, which limits to three years the time for presenting a case under that article.

N.B. For more detailed suggestions on procedural and substantive aspects of the mutual agreement procedure, see part three, chapters I and II.

Article 26

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, in so far as the taxation thereunder is not contrary to the Convention, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State, it shall be disclosed only to persons or authorities (including courts and

administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

- (a) To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;
- (b) To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
- (c) To supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public).

Observations

The aim of double taxation treaties is to promote international movements of capital and persons through the elimination of international double taxation without creating enhanced opportunities for tax evasion and avoidance. The issue of tax evasion, although obviously important to developed countries, is even more important to developing countries. Experience has shown quite clearly that a tax administration which relies only on the information available to it within its national jurisdiction is not equipped to deal effectively with the problems posed by tax evasion. The provisions of a tax treaty between a developing and a developed country providing for taxation of net income (or some reasonable approximation of net income) cannot operate appropriately if the developing country is unable to obtain, within a reasonable time, reliable outside information about the fiscal affairs of foreign enterprises engaged in business activities within its borders. To serve the goal of preventing international double taxation, therefore, a bilateral tax treaty should include provisions ensuring cooperation between the Contracting States with respect to the supply of information necessary to apply the provisions of the treaty or to enforce the domestic laws of the Contracting States concerning taxes covered by the treaty. Obviously cooperation on the exchange of information is also helpful in achieving the treaty goal of mitigating international tax evasion and avoidance.

The United Nations Model Convention deals with the subject of information exchange in article 26, which provides for the exchange of information concerning taxes covered by the Convention as is necessary for carrying out the provisions of the Convention or of the domestic laws of the Contracting States; the exchange of information is not restricted by article 1 of the Convention, so that the information may include particulars about non-residents. It has also been suggested that the exchange of information may extend to all the taxes levied in the Contracting States and not restricted to those mentioned in the Convention.

The information obtained under article 26 may be disclosed only to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. A Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. Information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons, provided that the tax authorities would make similar investigations or examination for their own purposes. Contracting States do not have to supply information the disclosure of which would be contrary to public policy.

Mention may be made here of the Convention on Administrative Assistance in Tax Matters concluded by the Nordic countries, which contains detailed provisions on the exchange of information. The Nordic Multilateral Convention is divided into five parts, the most essential of which are those concerning the procurement of information and tax enforcement, including assistance in collecting taxes due. The Convention also contains general provisions, provisions concerning the service of documents and special provisions. In addition to the income and capital taxes dealt with in the conventions for the avoidance of double taxation between the Nordic countries, the Nordic Multilateral Convention covers inheritance or estate taxes, gift taxes, certain indirect taxes (such as motor vehicle taxes and value added taxes), social security and some other public charges and advance payments of taxes. The Nordic Multilateral Convention originally provided that the assistance could take the form of tax collection and enforcement, service of documents and exchange of information, either automatically or on request. The 1976 Additional Agreement extended the scope of an exchange of information system to cover the spontaneous exchange of information. It also made it possible for tax officials of one Nordic country to take part in tax investigations in another Nordic country if the tax matter is of a substantial interest to that former country.

Under the Nordic Multinational Convention, requests for assistance (including the provision of information) cannot be made unless the requesting State in accordance with its own legislation would be able to provide corresponding assistance to the requested State. Information must be processed in accordance with the legislation of the requested State and requests for procurement of information may be refused when a business, manufacturing or professional secret would be disclosed if the request were complied with. If a tax matter is of substantial interest to a requesting State, its representatives may be allowed to be present at an investigation of that tax matter in the requested State. Information revealed in the course of the investigation is to be treated as secret and must not be disclosed to persons or authorities including courts and other judicial authorities, other than those concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes which are the subject of the Convention. The competent authority is required, in so far as it is possible on the basis of available statements of income or similar information, to send to the competent authorities in each of the other Contracting States, as soon as possible after the end of each calendar year and without being specially requested to do so, information concerning individuals and legal persons resident in that State regarding:

- (a) Dividends paid by joint stock companies and similar legal persons;
- (b) Interest on bonds and similar securities;
- (c) Balances with banks, savings banks and similar institutions and interest on such balances;
- (d) Royalties and other charges paid periodically for the utilization of copyrights, patents, designs, trade marks or other such rights or property;
- (e) Wages, salaries, fees, pensions and annuities;
- (f) Damages, insurance payments and other similar compensation obtained in connection with trade or business activities; and
- (g) Other income or property to the extent set out in a further agreement which may be concluded between the competent authorities of the Contracting State for the implementation of the Convention.

Another multinational convention of note is the Mutual Administrative Assistance in Tax Matters Convention prepared by the OECD and the Council of Europe. It opened for signature in 1988 and went into force in 1995. It has been ratified by the Nordic countries plus the Netherlands, Poland and the United States. In addition to providing for a broad exchange of information, it also provides for mutual assistance in serving of process and in collection of taxes due.

It is considered that the exchange of information constitutes a valuable means of preventing tax evasion. In that perspective, article 26 of the United Nations Model Convention generally corresponds to the provisions of article 26 of the OECD Model Convention with three substantive changes in paragraph 1, namely, the insertion of the phrase “in particular for the prevention of fraud or evasion of such taxes” in the first sentence, the insertion of the words “However, if the information is originally regarded as secret in the transmitting State” at the beginning of the fourth sentence and the addition of a new sentence (sixth and last sentence). The latter sentence is the key to the approach advocated by the Group; it would stress the importance of the competent authorities in implementing fully the provisions on the exchange of information and would give them the necessary authority to do so. In other words, it would obligate the competent authorities to implement fully the provisions on the exchange of information.

The Group observed that the reference to fraud or evasion in paragraph 1 was intended to focus attention on the importance of exchanges of information that would assist the treaty partners in combating such practices. Because a number of countries were concerned with the need for information to assist in the administration of specific statutory provisions against tax avoidance and others were concerned with the need for information to assist in detecting other aspects of tax avoidance, the Group considered it advisable to include the reference in the last sentence of paragraph 1 to exchanges of information regarding tax avoidance where the treaty partners deemed it appropriate. The reference in the same sentence to the consultations aimed at developing appropriate conditions, methods and techniques was designed to enable the treaty partners to work out the modalities for exchanges of information between them.

During the course of the discussion, members from developing countries observed that the proliferation of transnational corporations and the ever-growing sophistication and complexity of the forms taken by international business transactions was resulting in increasing tax avoidance and

evasion. The view was expressed that such a situation might have reached a point that it might negate completely the effects of treaties for the avoidance of double taxation. In this context, the question is raised whether steps should be taken outside and in addition to the existing framework of tax treaties. One member from a developing country, supported by other members from developing countries, suggested that the quickest and most effective way of ensuring the exchange of information required to combat tax evasion efficiently would be through the conclusion of a multilateral agreement dealing specifically with the exchange of information and mutual assistance in tax administration.

In discussing the problems of tax havens, the Group indicated, that as a protection against improper manipulation of treaty benefits, consideration should be given in bilateral negotiations to the inclusion of a separate article along the following lines:

“Each of the Contracting States should endeavour to collect on behalf of the other Contracting State such taxes imposed by that other Contracting State to the extent necessary to ensure that any exemption or reduced rate of tax granted under the treaty by that other Contracting State should not be enjoyed by persons not entitled to such benefits.”

[N.B. For further discussion of the question of the exchange of information, see part three, chapter III.]

Article 27

MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

Observations

Article 27 of the United Nations Model Convention relating to members of diplomatic missions and consular posts reproduces the text of article 27 of the OECD Model Convention. Consequently the whole of the commentary on the latter article is relevant to article 27.

CHAPTER VII

FINAL PROVISIONS

Article 28

ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at _____ as soon as possible.
2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:
 - (a) (in State A):
 - (b) (in State B):

Article 29

TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year _____. In such event, the Convention shall cease to have effect:

- (a) (in State A):
- (b) (in State B):

Observations on articles 28 and 29

Articles 28 and 29 of the United Nations Model Convention relating to the entry into force and termination of the Convention reproduce the texts of articles 29 and 30 of the OECD Model Convention. The whole of the commentary on those articles is therefore relevant to articles 28 and 29.

Some Contracting States may wish to address the possibility that a State may adopt domestic legislation that would override a part of the Convention. These States may seek a provision such as the following:

“When the competent authority of one of the Contracting States considers that the law of the other Contracting State is or may be applied in a manner that eliminates or significantly limits a benefit provided by the Convention, that State shall inform the other Contracting State in a timely manner and may request consultations with a view to restoring the balance of benefits of the Convention. If so requested, the other State shall begin such consultations within . months of the date of such request.

“If the Contracting States are unable to agree on the way in which the Convention should be modified to restore the balance of benefits, the affected State may terminate the Convention in accordance with the procedures of Article 29, notwithstanding the requirement of that Article that the Convention remain in effect until after the year _____ or take such other action regarding this Convention as may be permitted under the general principles of international law.”

It may be relevant to mention that a treaty override in violation of international law creates negative effects on mutual trust among Contracting States. It should be noted that the right to terminate a treaty under customary international law, as embodied in the Vienna Convention on the Law of Treaties, is available only for a material breach of a treaty and only after protest has been made to the offending State through appropriate channels.

Terminal clause

[N.B. The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the treaty shall be drafted in accordance with the constitutional procedures of both Contracting States.]

PART THREE

**SUGGESTIONS RELATING TO THE APPLICATION
OF THE ARTICLES OF THE UN MODEL CONVENTION
AND PROCEDURAL ASPECTS
OF TAX TREATY NEGOTIATIONS**

I. PROCEDURAL ASPECTS OF MUTUAL AGREEMENT PROCEDURE PROVIDED FOR IN ARTICLE 25

In order to assist the competent authorities in applying the mutual agreement procedure provided for in article 25, several possible arrangements are described below and certain factors relevant to their use are discussed. This enumeration of arrangements is not intended to be exhaustive and can be extended as appropriate in the light of experience. For a detailed discussion of the subject, please see the commentary on article 25 on pages 322–351 of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (June 2001).

A. General considerations

The procedural arrangements should be suitable to the number and types of issues expected to be dealt with by the competent authorities and to the administrative capability and resources of those authorities. The arrangements should not be rigidly structured but instead should embody the degree of flexibility required to facilitate consultation and agreement rather than hinder them by elaborate procedural requirements and mechanisms. However, even relatively simple procedural arrangements must incorporate certain minimum rules that inform taxpayers of their essential rights and obligations under the mutual agreement procedure. Such minimum rules should answer the following questions:

- 1) At what stage in a tax matter can the taxpayer invoke action by the competent authority under the mutual agreement procedure?
- 2) Must any particular form be followed by a taxpayer in invoking action by the competent authority?
- 3) Are there time limits applicable to a taxpayer's invocation of action by the competent authority?
- 4) If a taxpayer invokes action by the competent authority, is he bound by the decision of the competent authority and must he waive recourse to other administrative or judicial processes?
- 5) In what manner, if at all, may a taxpayer participate in the competent authority proceedings? What requirements regarding the furnishing of information by a taxpayer are involved?

B. Mutual sharing of information on adjustments

For the competent authority procedure to operate effectively, the competent authorities of a Contracting State must provide the competent authorities of the other State with certain relevant information about adjustments it has made or intends to make to the income and expenses of taxpayers residing in that other State. The information might cover adjustments proposed or concluded, the related entities involved, and the general nature of the adjustments.

Generally, most competent authorities are likely to conclude that automatic transmittal of such information is not needed or desirable. The competent authority of the country making an

adjustment may find it difficult or time-consuming to gather the information and prepare it in a form suitable for transmission. In addition, the other competent authority may find it burdensome merely to process a volume of data routinely transmitted by the first competent authority. Moreover, a tax-paying corporation can usually be counted upon to inform its related entity in the other country of the proceedings, and the latter entity is thus in a position to inform its competent authority. For this reason, the functioning of a consultation system is aided if a tax administration considering an adjustment possibly involving an international aspect gives the taxpayer warning as early as possible.

Some competent authorities, while not desiring to be informed routinely of all adjustments in the other country, may desire to receive, either from their own taxpayers or from the other competent authority, early notice of serious cases or of the existence of a significant degree or pattern of activity respecting particular types of cases; similarly, they may be prepared to transmit such information to their counterpart in the other country. In this event, a process should be worked out for obtaining this information. Some competent authorities may want to extend this early warning system to less serious cases, thus covering a larger number of cases.

C. Time for invoking consultation between competent authorities

The competent authorities must decide the stage at which the competent authority consultation process may be invoked by a taxpayer. For example, suppose an adjustment is proposed by State A that would increase the income of a parent company in State A and the adjustment would have a correlative effect on a related entity in State B. May the company go to its competent authority in State A, asserting that the adjustment is contrary to the treaty, and ask that the bilateral competent authority process commence? Must it wait until State A has actually made the adjustment? Must it wait until it has pursued any appeals that may be available to it within the tax department? Must it wait until all matters have been settled in court and an adjustment has become final?

Probably most competent authorities, at least in the early stages of their experience, prefer that the process not be invoked at the point of a proposed adjustment and probably not even at the point that the adjustment has been made by the tax department. A proposed adjustment may never result in final action, and even a concluded adjustment may or may not trigger a claim for a correlative adjustment. Even if a correlative adjustment is required to avoid double taxation, it may be provided by the other Contracting State without problems. As a consequence, many competent authorities may decide that the competent authority procedure should not be invoked until the taxpayer has claimed a correlative adjustment (or other tax consequence) in the other Contracting State and that State disposes of the claim in a manner that creates (or potentially creates) double taxation. The problem with delaying the invocation of the procedure this long is that the State making the initial assessment may want to limit competent authority consultations to the issue of how to devise an appropriate correlative adjustment in the other State. It may not be willing to discuss modifications to the concluded adjustment, particularly if the adjustment was sustained or established after lengthy litigation. The other State, however, may wish to determine whether the initial assessment comports with its understanding of the relevant legal standard.

Thus, some competent authorities may prefer that the bilateral process be invoked earlier, perhaps at the proposed adjustment stage. Such involvement may make the process of consultation easier, in that the first country will not have an initial fixed position. Other competent authorities may be willing to let the taxpayer decide when to invoke the process and thus they may stand ready to have the process invoked at any point starting with the proposed adjustment.

At a minimum, taxpayers must be informed when they can invoke the mutual agreement procedure. They also should be given instructions on the manner in which a request for competent authority relief should be submitted. It is likely that a simple form normally would be suitable for this purpose.

D. Correlative adjustments and other relief mechanisms

The basic principle underlying correlative adjustments is that items of income and expense of a multinational enterprise should be treated consistently in the two Contracting States. Under most tax treaties, if one country makes an adjustment in the tax liabilities of an entity under the rules governing the allocation of income and expense, thereby increasing the tax liabilities of that entity, and if the effect of this adjustment, when reflected in the tax accounts of a related entity in the other country, would require a change in the tax liabilities of the related entity, then a correlative adjustment should be made by the second country at the related entity's request if the initial adjustment is in accord with the treaty standard governing allocation of income and expense. The purpose of such a treaty provision is to avoid economic double taxation. The key aspect of a treaty provision requiring a correlative adjustment is that the initial adjustment itself must conform to the appropriate arm's length standard.

Although some countries generally are willing to agree that a correlative adjustment should be made, they may believe it appropriate to allow the competent authority's discretion to deny a correlative adjustment in cases that involved fraud, evasion, intent to avoid taxes or gross abuse. These countries may take the view that, if a correlative adjustment were required in such situations and the taxpayer were thus given, in effect, an almost automatic guarantee against the consequence of double taxation, the taxpayer would generally have little to lose in initially utilizing clearly improper allocations. To this effect, the United Nations Model Convention has made a special provision in paragraph 3 of article 9 that eliminates the requirement of making a correlative adjustment when the taxpayer has been found through judicial, administrative or other legal proceedings to be liable for a penalty for fraud, gross negligence or wilful default, on account of its method of making its initial allocations of income and expenses.

The merits of this rule denying a correlative adjustment are debated. On the one hand, proponents of the rule suggest that if the competent authorities possess such discretion and there is a risk to the taxpayer of economic double taxation, the taxpayer is more likely to be deterred from acting fraudulently. On the other hand, opponents of the rule suggest that it is inconsistent with the goal of eliminating double taxation — a key objective of tax treaties. In their view, matters such as fraud should be left to other provisions of law. The proponents of that latter position may concede, nevertheless, that some modicum of discretion should be available to deal with outrageous cases.

Aside from the penalty aspects of denying a correlative adjustment, some countries may be reluctant to make correlative adjustments a matter of right but would prefer that the entire matter be left to the discretionary agreement of the competent authorities. In their view, the requirement that a Contracting State grant a correlative adjustment is a strong invitation to the other State to make a large number of initial adjustments. The requirement that the initial adjustment conforms to an arm's length standard, however, may provide a sufficient safeguard against overly aggressive initial adjustments.

To be effective, a treaty with a correlative adjustment provision must provide that any procedural or other barriers to the making of the correlative adjustment under domestic law are to be overridden by the agreement of the competent authorities. Thus, such provisions as statutes of limitations and finality of assessments have to be adjusted to permit the correlative adjustment to be made.

In conjunction with providing correlative adjustment relief, a State may consider other relief mechanisms. In particular, a State may wish to mitigate or eliminate the tax effects that otherwise would result when a taxpayer is required to adjust its books of account as a result of a correlative adjustment. For example, assume that Company A, a resident of State A, sells goods to Company B, a resident of State B, for 3,000 when the market price is 4,000. On audit, State A increases Company A's income by 1,000. That 1,000, however, is held by Company B. If that 1,000 is transferred from Company B to Company A, the 1,000 would be taxable to Company A as a dividend, resulting in Company A being taxed twice on that 1,000. To avoid that result, State A may wish to allow Company A not to treat the receipt of 1,000 as a dividend. Instead, Company A may be treated as if it has sold the goods to Company B for 4,000, receiving 3,000 in cash and a note for 1,000. The subsequent payment of 1,000 to Company A would be treated as a payment on that note.

The relief suggested above may be provided either under a State's domestic tax law or through the competent authority machinery. In general, it seems more appropriate that the relief be granted through domestic legislation in that it technically is not an issue relating to double taxation. The relief is sufficiently related to the initial correlative adjustment, however, that States may wish to address the issue of relief through the competent authority mechanism. In light of paragraph 3 of article 9 of the United Nations Model Convention, this special relief should not be granted through the competent authority mechanism if the taxpayer has engaged in fraud.

Taxpayers have sometimes suggested that they should be given relief from a transfer price adjustment if they were prevented by currency restrictions or other governmental rule from paying an arm's length price. Assume, for example, that Company A, a resident of State A, licenses valuable technology to Company B, a resident of State B, for a royalty of one per cent. The arm's length price generally is 50 per cent. Under the laws of State B, however, companies are prohibited from paying royalties in excess of one per cent. Company A increases the royalty rate to 50 per cent, resulting in an additional assessment of tax of 5 million. The question is whether Company A should be entitled to relief, by treaty or domestic law, from that additional assessment.

The case for treaty relief in this situation depends on whether the arm's length royalty rate, under these facts and circumstances, is actually 50 per cent. If Company A can demonstrate that an unrelated person would have licensed the valuable technology to Company B for a royalty of one per cent, then the adjustment of 50 per cent is improper under the treaty. In reality, however, it is unlikely in the extreme that Company A would license its valuable technology to an unrelated person at such a low rate unless it was compensated by the unrelated person in some other way. Special treaty relief in these circumstances, therefore is unwarranted. Domestic relief that had the effect of reducing or eliminating the adjustment also would seem unwarranted. It might be appropriate, however, for a State to allow deferral of payment of tax in hardship cases as long as interest at a market rate was payable currently, appropriate security for payment was established, and the related persons were required to adopt a consistent method of accounting, under which a deduction for the royalty due but not paid would be deferred until the deferred tax payment was made.

E. Operating procedures

Taxpayer participation. All Contracting States are likely to favour some degree of taxpayer participation in the competent authority procedures. At a minimum, the States would allow taxpayers to present relevant information to the competent authority of their State of residence and to respond to requests for information from their competent authority. Some States may be prepared to allow taxpayers to present legal briefs or even to make an appearance before the competent authority.

Taxpayers have sometimes sought the right to be involved directly in the actual consultations between the Contracting States. Allowing this degree of taxpayer participation is likely to extend and distort the consultative process. It will extend it because taxpayers are likely to want a solution that minimizes their current and future taxes, whereas the interests of the Contracting States may be in achieving an appropriate policy framework for settling the current matter and related future matters. It may distort the process by converting it into a quasi-judicial procedure in which alleged rights of the taxpayer are being vindicated. A tax treaty, however, is an agreement between sovereign States and should be interpreted to advance the tax policy goals of the States, not the private interests of particular taxpayers.

The competent authorities ought to require taxpayers, as a condition for invoking the competent authority procedure, to submit the relevant information needed to decide the matter. In addition, some competent authorities may require, where appropriate, that data furnished by a taxpayer be prepared as far as possible in accordance with internationally accepted accounting standards so that the data provided will have some uniformity and objectivity. Progress has been made in developing uniform international accounting standards, and the work of competent authorities should be aided by this development.

Timing issues. If a time limit on the invocation of the competent authority procedure is to be imposed, the limit should be promulgated, and the point at which the time begins to run should be defined. Article 25, paragraph 1, provides that a case "must be presented within three years from the

first notification of the action resulting in taxation not in accordance with the provisions of the Convention.” This paragraph establishes the notification date as the starting point and sets three years as the time limit. In bilateral negotiations, the Contracting States might wish to give the competent authorities the power to waive these limits in appropriate cases. The three-year limit may be inappropriate if the Contracting States want taxpayers to exhaust domestic remedies before invoking the competent authority mechanism.

Methods of consulting. The competent authorities must decide how their consultation is to proceed. Presumably, the nature of the consultation with respect to a particular case will depend on the character of the case and the likelihood that similar cases are forthcoming. The competent authorities should keep the consultation procedure flexible and should leave every method of communication open, so that the method appropriate to the matter at hand can be used. At the same time, they should not be so unstructured in their approach that they are required to engage in extensive negotiations over procedural matters whenever a competent authority issue arises.

Several alternative methods of consultation between competent authorities are available. They include:

- 1) Informal consultation between the competent authorities in person or by telephone, e-mail, written letters, or other forms of communication;
- 2) Delegation of the initial responsibility for consultation to technical personnel or auditors of each country, with an expectation that the conclusions reached by these people would be given great weight by the competent authorities;
- 3) The appointment of a joint commission to deal with complicated cases or with a series of related cases; and
- 4) Formal meetings in person of the competent authorities at some appropriate forum.

Competent authorities should organize their consultative process so that they can act expeditiously and avoid undue delay. They should not set rigid time limits for action, however, because some cases are far more complex and politically sensitive than others. The method of consulting depends in part on whether the competent authorities feel compelled to reach an agreement that avoids double taxation. At a minimum, the treaty requires consultation and an endeavour to find a solution to economic double taxation. The language of article 25, nevertheless, does not require that the competent authorities actually reach agreement. If the States want to ensure that international double taxation is eliminated, they must provide in article 25 some language mandating agreement, such as a provision for binding arbitration. Alternatively, they might provide arbitration as an alternative method to be pursued at the discretion of the States. In the United Nations and OECD Model Conventions, the competent authorities are mandated to reach agreement only in the case of an individual subject to double taxation as a result of being a resident of both Contracting States.

In practice, most competent authority procedures involving developing countries have resulted in the elimination of double taxation. The solution may be a compromise, for compromise is an essential aspect of the process of consultation and negotiation. In reality, therefore, a requirement that the competent authorities reach agreement probably would not impose significant hardship on the Contracting States. Some countries, however, consider the formal adoption of a requirement to reach agreement as a step possessing significant juridical consequences and are not disposed to adopt such a requirement. In the light of the actual practice of developing countries, a mandatory agreement rule is probably not needed to prevent international double taxation in the overwhelming majority of cases.

For some countries, the process of agreement between competent authorities might be facilitated if competent authorities could call upon outside experts to give an advisory opinion or otherwise to assist in the resolution of an extremely difficult case or a case that has reached an impasse. These experts might be persons currently or previously associated with other tax administrations and possessing the requisite experience and technical competence.

Effect of agreement. In developing their competent authorities procedure, States must decide on the legal effect of a taxpayer's invocation of that procedure. In particular, they must determine whether a taxpayer is bound by the decision of the competent authorities in the sense that it gives up rights to alternative review procedures, such as recourse to domestic administrative or judicial procedures. Some competent authorities may desire that their actions be binding because they do not want to go through the effort of reaching agreements with their counterparts in the other State only to have the taxpayer reject the result if he feels he can do better in the courts or elsewhere. Other competent authorities may not want to bind taxpayers because they think that taxpayers might respond by unduly delaying the invocation of the competent authority process for strategic reasons. If the competent authorities want their procedure to be exclusive and binding, they must establish the necessary rules under the general delegation of authority granted to them in article 25, paragraph 4. In particular, they might require the taxpayer to waive recourse to alternative domestic procedures as a condition for invoking the competent authority procedure.

In some cases, a State wishing to make competent authority decisions final may not be in a position to do so under domestic law. Article 25, paragraph 4 gives competent authorities the power to "develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure." A State may consider, however, that its domestic law requires a more explicit statement of authority to permit the competent authority procedure to be binding. For example, the State may view article 25, paragraph 1, referring to remedies under national laws, as requiring it to give effect to those remedies if they exist. Or it may interpret its prior practices as settling the interpretation of article 25 in favour of a preservation of domestic appeal rights. In that event, the State may wish to negotiate specific language in article 25 that makes clear that it does have the authority to make the determinations of the competent authorities final. In some cases, a change in domestic legislation also may be required.

F. Publication of competent authority procedures and determinations

The competent authorities should make public the procedures they have adopted with regard to their consultation procedure. The description of the procedures should be as complete as is feasible and at the least should contain the minimum procedural aspects discussed above.

Where the consultation procedure has produced a substantive determination in an important area that can reasonably be viewed as providing a guide to the viewpoints of the competent authorities, the competent authorities should develop a procedure for publication in their countries of that determination or decision with sufficient detail to make the published decision useful to taxpayers confronting similar issues. Of course, some aspects of a competent authority procedure must be kept confidential, to protect, for example, commercial secrets. The legitimate rights of taxpayers to confidentiality with respect to their business affairs and the right of the public to understand the developing body of law can be balanced by lagging publication by some months and by editing out unnecessary details.

The competent authority procedure should not become a vehicle for developing a private body of tax law. A basic requirement of a fair legal regime is that taxpayers be informed of the laws under which they are governed. An excessive privacy with respect to the decisions of the competent authorities can result in only a favoured few understanding important aspects of the relevant tax law. In addition, excessive secrecy can create an environment in which corruption can flourish.

II. SUGGESTIONS FOR TRANSFER PRICING⁴⁷

From a financial perspective, transfer pricing is perhaps the most important tax issue in international taxation. Over 60 per cent of international trade is carried out within multinational enterprises (MNEs). The expression MNE in this context not only covers major corporate entities, but also smaller companies with one or more subsidiaries or permanent establishments in countries other than the country where the parent company or head office is located.

Parent companies of large corporate groups usually have sub-holdings and intermediary holdings in several countries. In many cases, the organizational structure of an MNE differs significantly from the way unrelated companies conduct their business. Examples include the following: (1) The research and service activities of an MNE are concentrated in a centre that operates for the benefit of some or all of the companies that make up the MNE; (2) The intangible property developed by the members of an MNE is transferred to one or more members of the MNE group and is managed on a global basis, with royalties charged to members utilizing the intangibles; (3) the MNE establishes a finance company that operates as an internal bank for allocating capital among members of the MNE; and (4) The MNE establishes a company to produce parts and other intermediate goods in one country and establishes another company, operating in a different country, to assemble those parts into a final product that is sold in the marketplace.

MNEs have adopted a variety of different management systems. At one extreme, some MNEs employ a highly centralized system, with all of the important business decisions made at the head office. At the other extreme, some MNEs use a highly decentralized system, with profit responsibility allocated to individual members of the corporate group. Most MNEs have a management system that falls between these extremes. That is, they centralized some management functions in the parent corporation and allocate significant decision-making authority to their subsidiaries.

According to the OECD Committee on Fiscal Affairs, transfer prices for transactions among associated enterprises “are significant for both taxpayers and tax administrations because they determine in large part the income and expenses, and therefore taxable profits, of associated enterprises in different jurisdictions.”⁴⁸ Over the past several decades, intra-company trade has been increasing significantly, with the result that transfer pricing has become an increasingly important issue for taxpayers and for governments. On the one hand, MNEs have become increasingly sophisticated in using transfer prices to minimize their taxes. On the other hand, many governments, individually and collectively, have become increasingly attuned to the potential revenue gains from reforming their transfer pricing rules and to the potential losses if other governments take aggressive action to deal with transfer pricing issues and they decline to act.

⁴⁷ This section is based in large part on transfer pricing guidelines issued by the OECD Committee on Fiscal Affairs, Organisation for Economic Cooperation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, 1995).

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The increased attention given to transfer pricing in recent years is due in part to changes in the way that MNEs are conducting their business. Those changes test the limits of the arm's length principle. For example, some MNEs engage in what is sometimes called "global manufacturing." A final product, such as an automobile, is no longer produced primarily in one country. Instead, various modules that make up an assembled product are produced in several countries. Another example, from the financial services industry, is the development of global trading in commodities and financial instruments. The trading takes place 24 hours a day in locations all over the world, with each of the locations sharing in the capital and trade name of the common enterprise. Both of these developments and many more have been made possible by technological advances in information technology and communications. Under both the United Nations and OECD Model Tax Conventions, each enterprise of a multinational enterprise (MNE) is treated as a separate entity, and the income of each enterprise is determined as though an MNE's various enterprises dealt with each other at arm's length. An enterprise located in one Contracting State is "associated" with an enterprise located in the other Contracting State if the two enterprises meet the general requirements set forth in subparagraph (a) or (b) of paragraph 1 of article 9. That provision provides that two enterprises are "associated" if:

- “(a) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- (b) The same persons participate directly or indirectly in the management, control or capital of [both enterprises].”⁴⁹

An MNE may be concerned about setting appropriate transfer prices for a variety of reasons. One reason is internal allocation of resources. For example, in allocating capital within the firm and in rewarding its employees, the MNE may want to understand which parts of its business are profitable, and which of the profitable ones are most profitable. Another reason is public accountability. For example, if all of its affiliated companies are not wholly owned, it may have fiduciary duties to minority shareholders or to persons buying shares on an organized stock exchange. Of course, an MNE also must determine the profits of each member of its corporate group for tax purposes.

National States care about the transfer prices set by an MNE in order to protect their source and residence jurisdiction. Whereas a particular MNE is concerned primarily about measuring accurately the profits earned by each of its members, a State's primary concern is the elimination of systemic biases in the way transfer prices are set that would work to their detriment. A State typically is not overly concerned, for example, if the MNE overstates the income subject to its tax jurisdiction. As a result, States with very low tax rates tend to be less concerned about transfer pricing than high tax states. A State should not be overly concerned with various imperfections in a pricing method, as measured by reference to the arm's length standard, if it is able, nevertheless, to obtain its proper cumulative share of income to tax from all taxpayers within its jurisdiction. For example, a pricing rule that understated the profit derived from overhead expenses might be

⁴⁹ Ibid., paragraph 12.

acceptable to a State if the various errors from using that system were offsetting sometimes overstated and sometimes understated the taxable income of taxpayers subject to its tax jurisdiction.

Some subnational jurisdictions in the United States, Canada and elsewhere use formulas to allocate the total taxable income of an MNE group among its members. They acknowledge that the formula is not an accurate way of determining the separate accounting income of the individual members of a corporate group. The method is acceptable to them, however, because their goal is to determine their proper share of the overall taxable income of the MNE group without reference to how that income might be allocated to particular members of the group.

An MNE group is unlikely to find that a general allocation formula serves its business purposes. A formula, for example, might not be acceptable to the financial community that is monitoring the performance of individual members of a corporate group. An MNE, nevertheless, may choose to use formulas in limited circumstances. For example, it may use a general formula to allocate interest expense, research and development costs, and certain other hard-to-allocate expenses among members of the MNE group.

A common definition of a “transfer price” is “the amount charged by one segment of an organization for a product or service that it supplies to another segment of the same organization.” One business reason for charging transfer prices is to permit managers of an MNE group to evaluate the performance of each member of the group. By charging prices for goods or services transferred within an MNE, the managers of the MNE are able to make efficient decisions about buying goods or services inside or outside the MNE.

Most MNEs transfer goods or services internally based on transfer prices that they set under some methodology. The choice of methods depends on the business objectives of the enterprise in allocating costs to particular members. In some cases, the best solution for business purposes may be the adoption of the market price as the transfer price, assuming there is a competitive open market for the goods or services transferred internally. If those prices do not exist, as is often the case, the MNE faces a problem similar to the problem faced by a tax department in constructing an appropriate transfer price in the absence of market prices for the same or comparable goods or services.

When the members of an MNE group are each responsible for earning a profit on their activities, they sometimes negotiate with each other in a way that is analogous to negotiations between independent parties. Those negotiated prices may be useful to a tax department in determining the proper arm’s length price for tax purposes. An MNE group, however, cannot solve all problems of income allocation through simulated bargaining. It still encounters problems relating to the allocation of various fixed costs, such as overhead and, most importantly, relating to the use within the group of valuable intangible property that has been developed within the group. In addition, the outcomes of the simulated bargains have important career implications for individual managers, so it is to be expected that some allocations will be based on internal politics. Finally, an MNE group is primarily interested in measuring the contribution of its members with respect to after-tax profits, whereas a tax department is primarily interested in determining the pre-tax profits

of a firm. To the extent that an internal pricing mechanism takes account of tax savings, therefore, its utility to a tax department is reduced.

Tax considerations may have a major impact on the way an MNE group sets its internal transfer prices. If the commercial system is in conflict with the pertinent tax regulations, companies may either adopt the system required under those regulations, or may maintain two systems, one for commercial purposes and the other for tax purposes. Some States may require an MNE group to use the books it has kept for financial accounting purposes in reporting its taxable income, although they typically would permit or require the MNE group to make certain adjustments in those books. For internal management purposes, however, an MNE group typically is free to use whatever internal accounting mechanisms it wishes.

As used by the United Nations and the OECD, the expression “transfer pricing” in the context of multinational enterprises is a neutral term and should not be considered as expressing any pejorative meaning. Paragraph 3 of the Preface of the 1979 OECD Report on Transfer Pricing and Multinational Enterprises states: “the consideration of transfer pricing problems should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.” The 1995 report of the OECD makes this even more clear by using the title “Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations.”

The point is that transfer pricing is an essential element of income measurement for related entities. The fact that transfer prices may be used to shift taxable income from a high taxing jurisdiction to a low taxing jurisdiction does not mean that the setting of transfer prices is itself a suspect activity.

Tax planning is only one of a series of considerations that are relevant for MNEs in setting their transfer prices. Overly aggressive tax planning, moreover, may cause an MNE to get enmeshed in a tax fraud investigation that is harmful to its international reputation. Over the past decade, many developed countries have put considerable pressure on MNEs to provide extensive contemporaneous documentation for their transfer prices. This development has reduced some tax planning opportunities and has forced MNEs to do their tax planning before rather than after they have engaged in intra-group transfers. The manipulation of transfer prices is now considerably more sophisticated than it was in the recent past. To protect their source and residence jurisdictions, a developing country must develop in its tax department a similar sophistication. Part of that sophistication is to be able to recognize when an MNE has set its transfer prices in accord with emerging international standards.

A. The arm’s length principle

In computing the taxable income of its members, an MNE group should be required to set transfer prices on intra-group transactions by reference to the prices that would have been applied by unrelated parties in similar transactions under similar conditions in the open market. This general approach to setting transfer prices is known as the “arm’s length” principle. It is currently the

internationally accepted standard for setting transfer prices. Most countries have domestic tax provisions either in general terms or as specific provisions which authorize the tax authorities to adjust transfer prices that deviate from that principle. Specific transfer pricing provisions with an international focus were first introduced during the First World War in the United Kingdom and United States of America. Only in the 1960s, however, did countries develop a systematic approach towards transfer pricing in the international arena.

The verbal formula used in a tax statute to authorize use of an arm's length standard is not very important, for it is the detailed implementation rules that actually give substance to that standard. The various statutory approaches followed by countries fall into the following four categories, namely:

1. Countries which have included a specific reference to the arm's length principle (or to open market prices), and to adjustments in case of deviations, in their tax laws, e.g., Australia refers to considerations less than arm's length considerations (Section 136 AD Income Tax Assessment Act) and the United Kingdom mentions "the price which it might have been expected to fetch if the parties to the transaction had been independent persons dealing at arm's length" (Section 770 Income and Corporation Tax Act 1988 — formerly section 485).

2. Countries which permit prices to be adjusted in case of associated enterprises, without explicit references to the arm's length principle, for example, France (Article 57, General Tax Code "transferred income") and the United States of America (Section 482: the Secretary "may distribute, apportion, or allocate gross income, deductions, or credits, or allowances" between or among related parties to the extent necessary to "prevent evasion of taxes or clearly to reflect the income" of the related parties).

3. Brazil sets rules for the deductibility of the cost of imported goods and rights and the recognition of revenue arising from exports (articles 18-24, Law 9.430 of 27 December 1996).

4. Countries with a broad statutory basis, which has been developed for transfer pricing purposes in case law, e.g., Germany (apart from article 1 of Foreign Relations Tax Act): excessive payments to, or understated receipts from shareholders constitute a constructive dividend which is not deductible (article 8 (3) Corporate Tax Act); and similarly the Netherlands and Switzerland.

In this connection, the OECD Committee on Fiscal Affairs observes:

"When independent enterprises deal with each other, the conditions of their commercial and financial relations (e.g., the price of goods transferred or services provided and the conditions of the transfer or provision) ordinarily are determined by market forces. When associated enterprises deal with each other, their commercial and financial relations may not be directly affected by external market forces in the same way ... [T]he need to make adjustments to approximate arm's length dealings arises irrespective of any contractual obligation undertaken by the parties to pay a particular price or of any intention of the parties to minimize tax. Thus, a tax adjustment under the arm's length principle ... may be appropriate even where there is no

intent to minimize or avoid tax. The consideration of transfer pricing should not be confused with the consideration of problems of tax fraud or tax avoidance, even though transfer pricing policies may be used for such purposes.”⁵⁰

⁵⁰ Ibid., paragraph 1.2.

The Committee cautions that:

“It should not be assumed that the conditions established in the commercial and financial relations between associated enterprises will invariably deviate from what the open market would demand. Associated enterprises in MNEs commonly have a considerable amount of autonomy and often bargain with each other as though they were independent enterprises. Enterprises respond to economic situations arising from market conditions, in their relations with both third parties and associated enterprises. For example, local managers may be interested in establishing good profit records and therefore would not want to establish prices that would reduce the profits of their own companies. Tax administrations should bear in mind that MNEs from a managerial point of view have an incentive to use arm’s length prices to be able to judge the real performance of their different profit centres ... [However,] the relationship between the associated enterprises may influence the outcome of the bargaining. Therefore, evidence of hard bargaining alone is not sufficient to establish that the dealings are at arm’s length.”⁵¹

B. Further consideration of the arm’s length principle

1. Generally

The arm’s length principle is stated, albeit obliquely, in paragraph 1 of article 9 of the United Nations Model Convention which provides that if

“conditions are made or imposed between ... two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.”

According to the OECD Committee on Fiscal Affairs,

“A major reason [for the adoption of the arm’s length principle] is that [it] provides broad parity of tax treatment for MNEs and independent enterprises. Because the arm’s length principle puts associated and independent enterprises on a more equal footing for tax purposes, it avoids the creation of tax advantages or disadvantages that would otherwise distort the relative competitive positions of either type of entity. In so removing these tax considerations from economic decisions, the arm’s length principle promotes the growth of international trade and investment.”⁵²

The application of the arm’s length principle is often difficult, particularly in cases involving transfers of intangible property (e.g., patents, copyrights, know-how, trade marks and trade names)

⁵¹ Ibid., paragraph 1.5.

⁵² Ibid., paragraph 1.7.

and goods produced or marketed with the use of intangible property. Each item of intangible property is, by nature, unique. Patent licenses between unrelated persons may not provide a good indication of an arm's length royalty for a license of a particular patent between associated enterprises because it may not be possible to establish that the usefulness and profit potential of the latter patent is similar to that of the patents licensed between unrelated persons. Sales of goods bearing no trade mark are not comparable to sales made under a trade mark because the prices in the former transactions provide no guide to the contribution of the trade mark to the profitability of the latter sales. Similarly, sales of goods made under one trade mark are not comparable to sales made under another trade mark unless it is established that the values of the two trade marks are similar.

If the owner of intangible property uses the property in transactions with both independent and associated enterprises, the transactions with unrelated persons is usually useful evidence for applying the arm's length principle to the transactions with associated enterprises. For example, if the owner of a patent makes a license of the patent to an unrelated person for use in one market and licenses the patent to an associated enterprise for use in a similar market, the royalty rate for the former license may establish an arm's length royalty for the latter. Similarly, if goods are sold under trade mark to both independent and associated enterprises, the application of the arm's length principle to the latter sales is usually not difficult.

However, owners of valuable intangible property are often reluctant to transfer rights to that property to potential competitors. For example, the owner of an intangible may prefer to license the intangible to an associated enterprise, rather than to an unrelated person, in order to exercise control over the intangible's use, and thereby reduce the risk of the intangible's value being degraded.

Another recurring problem is that information needed for the application of the arm's length principle is sometimes not available to either the taxpayer or the tax administration. For example, if Company A licenses intangible property to a subsidiary corporation in country X, while Company B licenses similar property to an independent company for use in country X, information about the Company B transaction is highly relevant to the application of the arm's length principle to Company A's license to its subsidiary. Neither Company B nor its licensee may be willing to disclose this information, however, to Company A or to the tax administration of country X or of Company A's home country. Also, the ability of a tax department or taxpayer to use available information may be limited by the lack of other information. For example, because an arm's length royalty may depend on various aspects of the licensing arrangement (e.g., the license term, the territory covered by the license and whether the license is exclusive), knowing the royalty rate in the license made by Company B in the above example may not be useful if the other terms and conditions of Company B's license cannot be ascertained.

For these reasons, the OECD Committee on Fiscal Affairs warns that "transfer pricing is not an exact science but does require the exercise of judgment on the part of both the tax administration and taxpayer."⁵³

⁵³ Ibid., paragraph 1.12.

The traditional methods for applying the arm's length principle are the comparable uncontrolled price (CUP) method, the resale price method, and the cost plus method. Under the CUP method, the arm's length price for a transaction among associated enterprise (controlled transaction) is the price charged in comparable transactions among unrelated persons (uncontrolled transactions). Under the resale price method, which is most easily applied where the buyer in the controlled transaction resells the goods, with little or no change, in uncontrolled transactions, the arm's length price for a controlled sale is the price obtained by the buyer in its resale of the goods, less a mark-up equivalent to that obtained by comparable uncontrolled resellers. Under the cost plus method, the arm's length price for the controlled transaction is the seller's cost of producing or otherwise acquiring the goods, plus a mark-up equivalent to the mark-up earned by comparable uncontrolled producers operating under a cost-plus contract.

Some countries have developed other methods for applying the arm's length principle in cases in which neither the taxpayer nor the tax administration is able to obtain the evidence of comparable uncontrolled transactions needed to apply the traditional methods. These methods usually entail some form of profit split, established by reference to the profits of other comparable enterprises that do not engage in controlled transactions.

The various methods for applying the arm's length principle are discussed below, after a discussion of the issue of comparability, which underlies all of the methods.

2. Comparability

The arm's length principle is generally applied by comparing transactions between associated enterprises (controlled transactions) with transactions between unrelated persons. According to the OECD Committee on Fiscal Affairs:

“In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable. To be comparable means that none of the differences (if any) between the situations being compared could materially affect the condition being examined in the methodology (e.g. price or margin), or that reasonably accurate adjustments can be made to eliminate the effect of any such differences ... Independent enterprises, when evaluating the terms of a potential transaction, will compare the transaction to the other options realistically available to them, and they will only enter into the transaction if they see no alternative that is clearly more attractive ... [I]ndependent enterprises would generally take into account any economically relevant differences between the options realistically available to them (such as differences in the level of risk ...) when valuing these options. Therefore, when making the comparisons entailed by application of the arm's length principle, tax administrations should also take these differences into account ...”⁵⁴

⁵⁴ Ibid., paragraph 1.20.

Comparability is affected by various factors, including the characteristics of the property or services, the functions performed by the participants in the transactions, contractual terms, economic circumstances and business circumstances. These factors are discussed below.

(a) Characteristics of property or services

The importance of comparability in the nature of the products or services varies from method to method. This factor is most important under the CUP method because the arm's length price of a good or service is rarely the same as the price of a dissimilar good or service, even if the goods or services are of the same general type. In contrast, the resale price and cost plus methods can often be applied with reference to the mark-ups of uncontrolled producers or resellers of goods that are only of the same type as those involved in the controlled transactions. For example, although the price of a toaster cannot be expected to be comparable to that of a food processor, the mark-ups of producers or resellers of small household appliances may be comparable, even if they do not produce or resell precisely the same items.

(b) Functions performed

The price in a transaction among independent enterprises depends on “the functions that each enterprise performs (taking into account assets used and risks assumed).”⁵⁵ The functions of each enterprise participating in a controlled transaction must therefore be identified and contrasted with those of the participants in the uncontrolled transactions. The relevant functions include “design, manufacturing, assembling, research and development, servicing, purchasing, distribution, marketing, advertising, transportation, financing, and management.”⁵⁶

The nature of the assets used in performing a particular function is also relevant. For example, an enterprise that owns and uses a valuable intangible is not comparable to an enterprise that performs a superficially similar function without the use of intangible property.

Moreover, the risk borne by the various participants in a transaction must be considered because, “[i]n the open market, the assumption of increased risk will also be compensated by an increase in the expected return.”⁵⁷ Some of the relevant risks are “input cost and output price fluctuations; risks of loss associated with the investment in and use of property, plant, and equipment; risks of the success or failure of investment in research and development; financial risks such as those caused by current exchange rate and interest rate variability; [and] credit risks ...”⁵⁸ For example, if a distributor of goods incurs substantial marketing and advertising costs, it should have a higher rate of return if it bears these costs itself than if the producer of the goods has reimbursed the costs. Similarly, an enterprise that manufactures goods for its own account should have a greater return than an enterprise that manufactures similar goods under contract for another enterprise. In controlled transactions, the parties' conduct is usually the best evidence of how they share risks. For example, if a distributing subsidiary nominally bears the risk of fluctuations in exchange rates, but the prices in purchases from the parent corporation are regularly adjusted to reflect changes in exchange rates, currency risks are, in substance, borne by the parent, not the subsidiary.

⁵⁵ Ibid., paragraph 1.21.

⁵⁶ Ibid., paragraph 1.23.

⁵⁷ Ibid., paragraph 1.24.

⁵⁸ Ibid., paragraph 1.24.

(c) Contractual terms

In a transaction between unrelated persons, the risks, responsibilities and benefits are allocated among the parties by their contract. Thus, controlled and uncontrolled transactions are comparable only if, among other things, the contractual terms are comparable. In an arm's length transaction, the parties normally hold each other to the terms of their contracts. Even if contractual terms are comparable, a controlled transaction is thus not comparable to an uncontrolled transaction unless the contract is adhered to in the controlled transaction or circumstances exist that would cause parties dealing at arm's length to waive strict compliance with their contract.

(d) Economic circumstances

Since arm's length prices may differ from market to market, controlled and uncontrolled transactions are comparable only if they take place in the same or comparable markets or reliable adjustments can be made for differences in markets.

(e) Business strategies

Enterprises dealing with others at arm's length sometimes pursue business strategies that involve transactions at prices differing from those that would otherwise prevail. For example, an independent enterprise entering a new market might, in order to establish itself in the market, temporarily sell goods or services at prices below the market prices for comparable items, or it might incur costs for marketing or other start up expenses that are not justified by current levels of sales or profits. A controlled taxpayer may also pursue such a strategy, which may distinguish its transactions from otherwise comparable transactions among unrelated persons.

However, a claim that a business strategy justifies an off-market price or arrangement should be accepted by a tax administration only if all aspects of the parties' conduct is consistent with the strategy. For example, if a manufacturer sells goods to a related distributor at a reduced price as part of a market penetration strategy, this reduction should be reflected either in reduced prices charged by the distributor or in extraordinary expenses incurred by the distributor. Also, the potential benefits of a business strategy should be shared consistently with the costs of pursuing the strategy. For example, if a manufacturer bears the costs of establishing its trade name in a new market, either by selling goods at reduced prices to a related distributor in that market or by directly subsidizing the distributor's marketing costs, the manufacturer's contribution toward the value of the trade name in that market should be recognized in any functional analysis of inter-company prices charged after the name is established.

Tax administrations also should consider whether, when the business strategy was adopted and implemented, an independent enterprise might have found the strategy sufficiently promising to justify pursuing it in the manner that it has been pursued by the associated enterprises. This inquiry should address the costs of the strategy, in relation to the reasonably expected benefits, and the time period over which the strategy was followed.

3. Role of form chosen by associated enterprises

Normally, tax administrations, in testing controlled transactions, should accept the form of those transactions. For example, if a parent corporation makes a sale to a subsidiary of all rights to a patent, and the price for the sale is a lump sum payable at the time of the sale, the sale format should usually be accepted, and a tax administration should not re-characterize the transaction as a license or as a sale in exchange for a series of payments contingent on the revenues generated by the patent or the subsidiary's use of it.

However, if the structure chosen by the associated enterprises differs from the substance of the transactions, that form may be disregarded, and the transactions may be re-characterized consistently with their substance. For example, a transfer from parent corporation to subsidiary, which the parties have characterized as a loan, may be re-characterized as a capital contribution if the substance of the transaction is equity, rather than debt.

The OECD Committee on Fiscal Affairs has also identified a second circumstance justifying disregard of the structure chosen by associated enterprises:

“where, while the form and substance of the transaction are the same, the arrangements made in relation to the transaction, viewed in their totality, differ from those which would have been adopted by independent enterprises behaving in a commercially rational manner and the actual structure practically impedes the tax administration from determining an appropriate transfer price.”⁵⁹

Assume, for example, that Company A has developed a secret process that can be used to manufacture valuable goods at low cost. Company A decides not to patent the process, out of a fear that the disclosure required to obtain the patent would reduce the commercial value of the process. Company A sells the secret process to Company H, an associated entity organized in a low tax country, for a lump sum payment. The tax authorities may disregard the form of this transaction and treat the arrangement between Company A and Company H as a license if it appears, from all the facts and circumstances, that Company A would not have been able to sell the secret process to an unrelated party at its full value. That is, if the facts strongly suggest that Company A, in dealing with unrelated parties, could have maximized its return by entering into a license agreement rather than making a sale, the tax authorities are justified in re-characterizing the “sale” to Company H as a license.

Moreover, even when the tax administration accepts the form in which the controlled transaction has been cast, it may examine uncontrolled transactions structured differently in order to determine whether the controlled transaction is at arm's length. For example, if a parent corporation makes a fixed-price sale of a patent to a subsidiary, the royalty and other terms of uncontrolled

⁵⁹ Ibid., paragraph 1.37.

licenses of comparable intangibles may be evidence relevant to whether the fixed price is an arm's length price.

4. Arm's length ranges

In some situations, several comparable uncontrolled transactions can be identified, and the prices at which those transactions took place differ. Such an arm's length range may occur because various sellers charge different prices in essentially identical transactions due, for example, to their relative skill in bargaining. Indeed, in a market where buyers and sellers have imperfect information about each other, some range of prices is to be expected. A range of prices also can result from the fact that the uncontrolled transactions are not identical, either with the controlled transaction or with themselves. For example, the goods or services may differ in small ways or other terms of the transactions may not be identical.

When faced with an arm's length range, a tax administration might first ask whether the range can be narrowed by refining comparability standards excluding, for example, all uncontrolled transactions other than those most comparable to the controlled transaction and making adjustments to the terms of the uncontrolled transactions to enhance comparability. Once the range has been sufficiently narrowed, the controlled transaction should be accepted as having occurred at arm's length if it falls within the range. If the controlled transaction is outside the range, an adjustment is appropriate to bring it within the range. This might be done, for example, by restating the price in the controlled transaction at the median of the prices in the uncontrolled transactions. If the circumstances suggest that the taxpayer, in setting its prices outside the range, had not acted in good faith, the tax authorities might set the arm's length price at a point within the range that would be least beneficial to the taxpayer.

Comparable transactions between unrelated parties provide only an estimate of the price for goods and services that would be set in an actual marketplace sale between a buyer and a seller acting at arm's length. Prior to an actual negotiation between unrelated parties over the price of goods or services, all that can be predicted with confidence is that any agreed price will be within some range. The bottom of that range will be set by the seller's minimum price requirements, and the top of the range will be set by the buyer's maximum price requirements. Those minimum and maximum prices may themselves be difficult to determine, but in theory at least, they are knowable. The price that goods or services will sell for within that range is theoretically unknowable in advance of the completed sale.⁶⁰ Because of this characteristic of *a priori* market prices, the arm's length price set for intra-group transfers is always going to be a range of prices, although in many cases that range may be so narrow as to be equivalent to having a specific price. An effective transfer pricing system, therefore, must be designed to establish a single price when the comparable transactions have merely established a range of market prices.

5. Use of data from other years

⁶⁰ See Michael J. McIntyre, *The International Income Tax Rules of the United States*, Lexis Publishing (Charlottesville, Virginia, 2000) at § 6/D1.1.

Facts and circumstances from years prior to the taxable year are sometimes relevant to the application of the arm's length principle. For example, it may be relevant whether a loss reported by an associated enterprise for the taxable year is an isolated event or is part of a pattern of losses reported by that enterprise. It may be also relevant whether the goods or services sold by the enterprise are at the beginning, middle or end of a product cycle.

Facts and circumstances from later years might also be relevant. However, tax administrations must be careful not to apply the arm's length principle unfairly by hindsight, basing decisions on facts and circumstances that could not reasonably have been anticipated when the controlled transactions were made. In some cases, nevertheless, hindsight may be used to set prices if it appears from the facts and circumstances that uncontrolled persons would have made use of hindsight in setting the price. Assume, for example, that Company P, a parent corporation, transfers intangible property to Company F, its foreign affiliate, at a time when the value of that property is nearly impossible to determine. It is determined that uncontrolled parties engaged in a comparable transfer would avoid the difficult pricing problem by entering into an arrangement that made the compensation for the intangible property a function of the profits derived from its future use. In that event, a price set by hindsight would be the arm's length price.

C. Traditional methods

The arm's length principle has traditionally been applied using one of three methods: the comparable uncontrolled price (CUP) method, the resale price method, or the cost plus method. In some cases, none of these methods works well because they all depend on the availability of price and other data about comparable uncontrolled transactions. When market data needed to apply the traditional methods are not available, arm's length prices can sometimes be approximated using a profit split method or a transactional net margin method. These various methods are separately described below.

1. CUP method

Under the CUP method, a controlled transaction is considered to be at arm's length if the price and other relevant terms and conditions are the same as those of comparable uncontrolled transactions occurring in comparable circumstances. Under the general standards of comparability described above, controlled and uncontrolled transactions are comparable if (1) they do not differ in any way that could materially affect the price or (2) reasonably accurate adjustments can be made for any material differences.

The principal difficulty in applying the CUP method is obtaining reliable information about uncontrolled transactions that are sufficiently comparable to the controlled transaction. Close similarity in the goods or services sold in the transactions is usually required because small differences in products may have a significant effect on price. For example, if the controlled transactions are sales of unbranded Colombian coffee beans, whereas the uncontrolled transactions are sales of unbranded Brazilian coffee beans, the controlled and uncontrolled sales are not

comparable unless the market makes no material distinction between Colombian and Brazilian coffee beans or reliable adjustments can be made for this difference. Similarity in the functions performed by various participants in the transactions is also important, although reliable adjustments can often be made for functional differences. For example, if the uncontrolled sales are made F.O.B., the factory and the controlled sales are made at a delivered price. This difference can be expected to materially affect the prices, but adjustments can usually be made for the shipping, insurance and other delivery costs that are included in the controlled price, but not the uncontrolled price.

The CUP method is often not useable if the price in the controlled or uncontrolled transactions is materially affected by intangible property used in producing or marketing the goods or services (e.g., a patent or a trade mark). For example, a sale of branded goods is not comparable to a sale of unbranded goods unless the brand has no material value or is owned solely by the purchaser of the goods. Similarly, a sale of goods under one trade name is not usually comparable to sales under other trade names because each trade name is unique.

However, the OECD Committee on Fiscal Affairs states:

“The difficulties that arise in attempting to make reasonably accurate adjustments should not routinely preclude the possible application of the CUP method. Practical considerations dictate a more flexible approach to enable the CUP method to be used and to be supplemented as necessary by other appropriate methods, all of which should be evaluated according to their relative accuracy. Every effort should be made to adjust the data so that it may be used appropriately in a CUP method. As for any method, the relative reliability of the CUP method is affected by the degree of accuracy with which adjustments can be made to achieve comparability.”⁶¹

2. Resale price method

Under the resale price method, the arm’s length price in a controlled sale is the price obtained by the buyer in reselling the goods or services to an unrelated person, less an appropriate mark-up (gross margin) for the buyer/reseller. For example, if a distributing subsidiary purchases goods from its parent corporation and resells them to its customers for 100 each and an appropriate gross margin for the subsidiary is 20 per cent of sales, the arm’s length price for the sale from parent to subsidiary is 80 (100, less 20 per cent thereof) under the resale price method.

The appropriate mark-up under the resale price method is the gross margin obtained in comparable circumstances by a comparable buyer/reseller who both buys from and resells to unrelated persons. For instance, if the distributing subsidiary in the example purchases goods from both its parent and from unrelated suppliers, the gross margin in the subsidiary’s resales of goods purchased from unrelated suppliers may be used in applying the resale method to its resales of goods

⁶¹ OECD Committee on Fiscal Affairs, Organisation for Economic Cooperation and Development, *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* (Paris, 1995), paragraph 2.9.

purchased from the parent if the controlled and uncontrolled sales are comparable. Alternatively, the comparable uncontrolled gross margin may be that of an unrelated buyer/reseller.

Under this method, comparability of functions tends to be more important than product similarity. For example, if the distributing subsidiary purchases toasters from its parent and blenders from unrelated suppliers, the blender transactions might be comparable to the toaster transactions for purposes of the resale price method, but not for purposes of the CUP method, because the gross margins of all small appliance distributors in a particular market might be comparable, even though the prices for various appliances might differ substantially. On the other hand, the controlled and uncontrolled transactions may not be comparable if the subsidiary maintains a substantial inventory of blenders but has no toaster inventory because the parent corporation ships toasters directly to the subsidiary's customers. More generally, comparability is importantly affected for purposes of this method by the assets used, risks assumed, and other material factors relating to the functions performed by the controlled and uncontrolled buyer/resellers.

The resale price method is most appropriate if the purchaser in the controlled transaction resells the goods or services without further manufacture or other transformation. If the functions performed by the purchaser go substantially beyond resale, it is not likely that the taxpayer or the tax administration can identify uncontrolled transactions in which the same or comparable functions are performed. For example, if a parent corporation partially manufactures goods and sells them to a subsidiary, which finishes the goods and sells them to unrelated persons, it is not likely that data can be obtained on a comparable company that performs the same functions as the subsidiary and deals solely with unrelated persons, and without this data, an arm's length mark-up cannot be determined.

Even among buyer/resellers, the functions performed can vary considerably. For example, some buyer/resellers are little more than forwarding agents, while others engage in substantial marketing activities and may, for example, provide guarantees to the ultimate consumers. These functional differences can significantly affect the gross margin that would be realized in arm's length transactions, and they must therefore be examined carefully in determining whether controlled and uncontrolled transactions are comparable for purposes of this method.

3. Cost plus method

Under the cost plus method, the arm's length price in a controlled sale is the sum of the costs incurred by the seller and an appropriate mark-up. For example, if a parent corporation produces goods at a cost of 50 and sells them to its distribution subsidiary and an appropriate mark-up for the parent is 20 per cent of costs, the price under the cost plus method for the sale from parent to subsidiary is 60 (costs of 50 per cent, plus 20 per cent thereof). The cost plus method is most commonly used where the seller in the controlled transaction produces the goods or services. It might provide the most reliable measure of arm's length results if, for example, the buyer in the controlled transaction subjects the goods to further manufacture or processing or the controlled transaction involves services, rather than goods.

The mark-up under the cost plus method should be the mark-up obtained in comparable uncontrolled transactions. The controlled seller's mark-up in comparable sales to unrelated persons is perhaps the best evidence of an arm's length mark-up, but the mark-ups of other comparable producers also may be used. The issue of comparability is essentially the same under this method as under the resale price method, described above, except that the focus is on the producer/seller in the cost plus method and the buyer/seller in the resale price method. For example, if Company A produces toasters, which it sells to a distribution subsidiary, and Company B produces irons, which it sells to independent distributors, the gross margin of Company B might be usable in applying the cost plus method to Company A's sales to its subsidiary if the gross margins of all small appliance manufacturers tends to be about the same.

In applying this method, all functional differences, including differences in assets utilized and risks undertaken, must be accounted for if they materially affect gross margin. For example, if Company B manufactures its irons under long-term contracts obligating its distributors to purchase fixed quantities of irons each month, whereas Company A maintains an inventory of finished goods and is subject to the vagaries of market demand, the companies' operations are not comparable because Company A has assets and risks that Company B does not have. Company B may not be used as an uncontrolled comparable for Company A's transactions unless reliable adjustments can be made for these differences.

The relative efficiencies of the controlled and uncontrolled producers are an important consideration in this context. For example, if Company B is much more efficient in its manufacturing operations than Company A, it should probably enjoy higher gross margins. It is often not possible to make reliable adjustments for differences in efficiency, and when this is so, the cost plus method is usually not the best method to employ. Other differences in costs, such as differences in wage rates paid, also should be considered. For example, if the wages are much lower in the country where Company B does its manufacturing than in the county where Company A does its manufacturing, then the profit margin earned by Company B in its sales to unrelated parties is an unreliable measure of the profits that Company A should earn on its sales to a related distributor, unless the effect of this wage differential on gross margins cannot be quantified accurately.

Comparability in accounting methods is also important, particularly in the classification of costs as production costs or as other costs. However, if adequate data on the uncontrolled transactions is available, adjustments can usually be made for accounting differences. For example, if Company A accounts for shipping costs as production costs, whereas Company B accounts for these costs as selling costs, the gross margins of the two companies are not comparable. If complete records for both companies are available, however, accurate adjustments can be made for this accounting difference.

4. Transactional profit methods

The OECD Committee on Fiscal Affairs identifies two "transactional profit methods" — the "profit split method" and the "transactional net margin method." "[I]n those exceptional cases in which the complexities of real life business put practical difficulties in the way of the application of

the traditional transaction methods,” these methods “may provide [results] consistent with the arm’s length principle.”⁶² The Committee warns that “the transactional profit methods may not be applied automatically simply because there is a difficulty in obtaining data.”

(a) Profit split method

The objective of the profit split method is to divide the aggregate profit of associated enterprises among them in the same proportions that it would have been divided by market prices if the enterprises were independent. The allocation is based on the functions performed by each of the associated enterprises. The contribution of each function is computed, to the extent possible, by reference to data on comparable enterprises dealing only with unrelated persons. Because independent enterprises rarely set their prices in order to achieve any particular split of profits, the profit split method only approximates arm’s length prices and does so indirectly.

An advantage of the profit split method is that it often can be applied when no comparable uncontrolled transactions can be identified. According to the OECD Committee on Fiscal Affairs, “the profit split method offers flexibility by taking into account specific, possibly unique, facts and circumstances of the associated enterprises that are not present in independent enterprises, while still constituting an arm’s length approach to the extent that it reflects what independent enterprises reasonably would have done if faced with the same circumstances.”⁶³ Another advantage of this method is that because all parties to the controlled transactions are examined, the method is not likely to produce extreme, improbable results for any of the parties.

Tax administrations and taxpayers often face several problems in applying the profit split method. Reliable information about the transactions of foreign affiliates may be difficult to obtain, and the combined profits of associated enterprises usually cannot be determined without this information. Even if the information is obtainable, the computation of the combined profit may be impeded by accounting differences among the enterprises and by complex currency translation issues.

Moreover, if the method is applied to split actual profits, rather than projected profits, transfer prices are effectively determined with hindsight, based on the ultimate results of the controlled transactions, whereas prices in uncontrolled transactions are nearly always determined before or as the transactions occur. According to the OECD Committee on Fiscal Affairs, “the application of the profit split method [in this way] could penalize or reward a taxpayer by focussing on circumstances that the taxpayer could not reasonably have foreseen.”⁶⁴ The method, therefore, should be applied “in a context that is similar to what the associated enterprises would have experienced, i.e. on the basis of information known or reasonably foreseeable by the associated enterprises at the time the transactions were entered into ...”⁶⁵

⁶² Ibid., paragraph 3.2.

⁶³ Ibid., paragraph 3.6.

⁶⁴ Ibid., paragraph 3.12.

⁶⁵ Ibid., paragraph 3.14.

(b) Transactional net margin method

Under the transactional net margin method, the net profit of an associated enterprise is evaluated with reference to some base, such as sales, costs or assets. For example, the prices at which a manufacturer sells its goods to a distribution subsidiary might be found to be at arm's length if these prices leave the subsidiary with a profit of, say, 2 per cent of sales, 3 per cent of costs, or 10 per cent of the value of its assets. The percentage used in applying the method is inferred from the profitability of other enterprises that perform similar functions but deal only with unrelated persons. For example, the distribution subsidiary's profits might be computed as 2 per cent of sales if that is within the range of net profit margins of comparable independent distributors.

5. Priority of methods

In some countries, the traditional methods (the CUP, resale price and cost plus methods) are preferred over the transactional profit methods, and the CUP method is preferred to all other methods if one or more comparable uncontrolled transactions can be identified. In other countries, no method is preferred as a general matter, and the preferred method in any situation is the method that provides the most reliable measure of arm's length results in that situation.

The United States of America initially developed the methods that the OECD calls the "profit split method" and the "transactional net margin method" in regulations promulgated in 1994. Under those regulations, there is no formal priority of methods. The selection of methods is made under the so-called best method rule. Under that rule, a controlled taxpayer must use the transfer pricing method that provides the "most reliable measure" of an arm's length result under the taxpayer's particular facts and circumstances. In selecting a method, two important factors must be considered: compatibility and the quality of data and assumptions. Methods relying on uncontrolled transactions with the highest degree of comparability are to be preferred.

The difference in the approach of the United States of America and the approach advocated by the OECD may not be very different in practice. The OECD guidelines provide that the newer methods may be used only as a last resort, whereas the United States of America would apply a newer method whenever it constitutes the best available method. In practice, the newer pricing methods are mostly used in the United States of America in cases involving valuable intangible property. In those cases, the traditional methods are usually difficult or impossible to apply. If the traditional methods cannot be applied, the application of a newer method would be, in the OECD formulation, a "last resort."

III. SUGGESTED ARRANGEMENTS BETWEEN COMPETENT AUTHORITIES REGARDING THE EXCHANGE OF INFORMATION

Concerning treaties for the avoidance of double taxation and tax evasion, the competent authorities might wish to provide for the exchange of such information as is necessary for carrying out the provisions of the treaty or of the domestic laws of the Contracting States concerning taxes covered by the treaty. In this regard, the following are suggested guidelines for arrangements regarding the implementation of appropriate exchanges of information. They are in the form of an inventory of possible arrangements from which the competent authorities under a tax treaty may select the particular arrangements which they decide should be utilized. The inventory is not intended to be exhaustive nor is it to be implied that all matters listed are to be drawn on in every case. Instead, the inventory is a listing of suggestions to be examined by competent authorities in deciding on the matters they wish to cover. For a detailed discussion of the subject, please see the commentary on article 26 at pages 351-379 of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (June 2001).

A. Routine transmittal of information⁶⁶

Some competent authorities have implemented a routine or automatic flow of information from one treaty country to another. The following are various aspects that the competent authorities should focus on in developing a structure for such routine exchange. Some countries not desiring to receive such information in a routine fashion (or unable to receive it routinely because the transmitting countries do not routinely collect such information) may desire to obtain information of this type under a specific request. In these situations, items mentioned in the present section should be considered as available for coverage under the next section, "Transmittal on specific request."

1. Items covered

a) Regular sources of income

The items covered under a routine transmittal or exchange of information may extend to regular sources of income flowing between countries, such as dividends, interest, compensation (including wages, salaries, fees and commissions), royalties, rents and other possible items whose regular flow between the two countries is significant. It should be recognized, however, that at present many countries are not in a position to supply routine information of this type because their tax collection procedures do not provide the needed data. In most respects, information routinely provided is likely to be far more valuable to the receiving country if it is provided in electronic form.

b) Transactions involving taxpayer activity

⁶⁶ In the following, "transmitting country" refers to the country transmitting information and "receiving country" refers to the country receiving information.

A routine exchange of information may cover certain significant transactions involving taxpayer activity.

(i) Transactions relevant to the treaty itself:

- Claims for refund of transmitting country tax made by residents of receiving country;
- Claims for exemption or particular relief from transmitting country tax made by residents of receiving country.

(ii) Transactions relevant to special aspects of the legislation of the transmitting country:

- Items of income derived by residents of the receiving country that receive exemption or partial relief under special provisions of the national law of the transmitting country.

(iii) Transactions relating to activities in the transmitting country of residents of the receiving country:

- Opening and closing by receiving country residents of a branch, office, etc. in the transmitting country;
- Creation or termination by receiving country residents of a corporation in the transmitting country;
- Creation or termination by receiving country residents of a trust in the transmitting country;
- Opening and closing by receiving country residents of bank accounts, money market accounts, brokerage accounts and the like in the transmitting country;
- Property in the transmitting country acquired by residents of the receiving country by inheritance, bequest or gift;
- Ancillary probate proceedings in the transmitting country concerning receiving country residents.

(iv) General information:

- Tax laws, administrative procedures, major relevant tax cases, etc. of the transmitting country;
- Developments affecting the taxation in the transmitting country of regular sources of income flowing between countries, especially as they affect the treaty, including court decisions relating to tax treaties, administrative interpretations of court decisions on treaty provisions, and administrative practices or developments affecting application of the treaty;
- Activities that affect or distort application of the treaty, including new patterns or techniques of evasion or avoidance used by residents of the transmitting or receiving country;

- Activities that have repercussions regarding the tax system of the receiving country, including new patterns or techniques of evasion or avoidance used by residents of either country that significantly affect the receiving country's tax system.

2. General operational aspects to be considered

The competent authorities should consider the following in developing an effective routine exchange programme:

- (a) Countries that are more interested in receiving information on a specific request basis than on a routine basis should, in formulating specific requests, keep in mind the items mentioned in this inventory under the heading of routine information;
- (b) A minimum floor amount may be fixed to exclude the exchange of data of minor importance;
- (c) The routine source of income items may be rotated from year to year, e.g., dividends only in one year, interest in another, etc.;
- (d) The information to be exchanged routinely need not be strictly reciprocal in all items. Country A may be interested in receiving information on some items but not others; the preferences of country B may extend to different items. It is not necessary for either country to receive items in which it is not interested, nor should either country refuse to transmit information on certain items simply because it is not interested in receiving information on those items;
- (e) Although the information to be exchanged on income items may not always be helpful in exposing tax evasion, the routine exchange may provide indications of the degree to which income flows are escaping tax;
- (f) Whether the information as to income items should cover only the payee or also the payer;
- (g) Whether the information should cover only residents of the receiving country or also those domiciled therein or citizens thereof, or be limited to any of these categories;
- (h) The degree of detail involved in the reporting, e.g., name of taxpayer or recipient, profession, address, etc.;
- (i) Whether the information is available in electronic form;
- (j) The form and the language in which the information should be provided.

If the information provided by the transmitting country is available electronically and in a format that permits easy insertion into a database, the receiving country can utilize the information more readily at lower cost, and the problems of information overload from receiving too much information are radically reduced. If the receiving country is accustomed to dealing mostly with electronic data, it may have difficulty making good use of certain information provided in paper form, especially if much of that information is not particularly useful.

3. Factors to be considered by the transmitting country

The transmitting country should consider factors affecting its ability to fulfil the requirements of a routine exchange of information. Such a consideration should lead to a more careful selection of the information to be routinely exchanged, avoiding exchanges of information that will be of little practical use to the receiving country.

Among the factors to be considered is the administrative ability of the transmitting country to obtain the information involved. This ability is a function of the general effectiveness of its administrative procedures, its utilization of withholding taxes, its utilization of information returns from payers or others and the over-all costs of obtaining the information, and the extent to which its reporting agents provide information in electronic form.

4. Factors to be considered by receiving country

The receiving country should consider factors affecting its ability to utilize the information that could be received under a routine exchange of information, such as the administrative ability of the receiving country to use the information on a reasonably current basis and effectively to associate such information with its own taxpayers, either routinely or on a sufficient scale to justify the routine receipt of the information. The ability to link information routinely exchanged with particular taxpayers will depend to a considerable degree on the form (electronic or paper) in which that information is transmitted.

B. Transmittal on specific request

A widely used method of exchange of information is that of a request for specific information made by one treaty country to another. The specific information may relate to a particular taxpayer and certain facets of his situation or to particular types of transactions or activities or to information of a more general character. The following are various aspects that the competent authorities should focus on in developing a structure for such exchanges.

1. Items covered

(a) Particular taxpayers

The information that a receiving country may want from a transmitting country is essentially open-ended and depends on the factors involved in the situation of the taxpayer under the tax system of the receiving country and the relationship of the taxpayer and his activities to the transmitting country. A detailed enumeration of the types of information that may be within the scope of an exchange pursuant to specific request does not seem to be a fruitful or necessary task. The agreement to provide information pursuant to specific request may thus be open-ended as to the range, scope and type of information, subject to the over-all constraints to be discussed herein.

Specifically requested information may consist, for example, of:

- (i) Information needed to complete the determination of a taxpayer's liability in the receiving country when that liability depends on the taxpayer's worldwide income or assets; the nature of the stock ownership in the transmitting country of the receiving country corporation; the amount or type of expense incurred in the transmitting country; or the fiscal domicile of an individual or corporation;
- (ii) Information needed to determine the accuracy of a taxpayer's tax return to the tax administration of the receiving country or the accuracy of the claims or proof asserted by the taxpayer in defence of the tax return when the return is either regarded as suspect or under actual investigation;
- (iii) Information needed to determine the true liability of a taxpayer in the receiving country when it is suspected that his reported liability is wrong.
- (iv) Information needed to determine whether a taxpayer has reported facts regarding a transaction involving both countries in a consistent manner.

(b) Particular types of transactions or activities

The exchange on specific request need not be confined to requests regarding particular taxpayers but may extend to requests for information on particular types of transactions or activities, including:

- (i) Information on price, cost, commission or other such patterns in the transmitting country necessary to enable the tax administration of the receiving country either to determine tax liability in a particular situation or to develop standards for investigation of its taxpayers in situations involving possible under or over invoicing of exported or imported goods, the payment of commissions on international transactions and the like;
- (ii) Information on the typical methods by which particular transactions or activities are customarily conducted in the transmitting country;
- (iii) Information as to whether a particular type of activity is being carried on in the transmitting country that may have effects on taxpayers or tax liabilities in the receiving country.

(c) Economic relationships between the countries

The specific request may extend to requests for information regarding economic relationships between the countries which may be useful to a country as a check on the effectiveness of its tax administration activities, including:

- (i) Volume of exports from the transmitting country to the receiving country;
- (ii) Volume of imports into the transmitting country from the receiving country;
- (iii) Names of banks and other financial institutions dealing in the transmitting country with branches, subsidiaries, etc. of residents of the receiving country.

Since items in this category, such as the volume of exports between the countries, are presumably not regarded as secret to the tax authorities in the transmitting country, they may be disclosed generally in the receiving country, as article 26 provides.

2. Rules applicable to the specific request

The competent authorities should develop rules for the transmission of specific requests by the receiving country and the response by the transmitting country. Although the rules may be general in character in the sense that they set standards or guidelines governing the specific request procedures, the rules should also permit discussion between the competent authorities of special situations that either country believes require special handling.

The rules should specify:

- (a) The amount and nature of detail that the receiving country must include in the request, the form of such request, the years covered by the request, and the language of the request and reply;
- (b) The extent to which the receiving country must pursue or exhaust its own administrative processes and possibilities before making a specific request; (presumably the receiving country should make a bona fide effort to obtain the information for itself before resorting to the specific request procedure, unless it is obvious that the costs of the effort are slight for the transmitting country and substantial for the receiving country);
- (c) The nature and extent of the response by the transmitting country, including the form of the response if the information is intended for possible use in judicial or other proceedings that may require an authentication of any documents provided.

C. Transmittal of information on discretionary initiative of transmitting country

The competent authorities should determine whether, in addition to the routine and specific request methods of exchange of information, they desire a transmittal of information on the discretionary initiative of the transmitting country itself. Such a transmittal could occur when, in the course of its own activities, the tax administration of the transmitting country obtains information that it considers would be of importance to the receiving country. The information may relate to facets of a particular taxpayer's situation and the relationship of that situation to its liability in the receiving country or to the liability of other taxpayers in the receiving country. The information may also relate to a pattern of transactions or conduct by various taxpayers or groups of taxpayers occurring in either country that is likely to affect the tax liabilities or tax administration of the receiving country either in relation to its national laws or to the treaty provisions.

In the standards governing the exchange of information developed pursuant to the treaty, the competent authorities should specify whether it is the duty of a transmitting country affirmatively to develop a procedure and guidelines governing when information has to be transmitted at the initiative of the transmitting country, whether the transmitting country has a duty to at least consider

providing the information but has no obligation to actually provide it, or whether the transmitting state need not even consider providing the information. Even if it is agreed that the transmitting country has a duty to develop a system for such transmittal, presumably it would retain the right to decide when the conditions under that system have been met.

D. Use of information received

The permissible uses of the information received under an exchange of information agreement are largely specified in article 26 of the United Nations Model Convention. Under the article, the extent of the use of information depends primarily on the requirements of national law regarding the disclosure of tax information or on other “security requirements” regarding tax information. Consequently, the extent of the disclosure or the restrictions on disclosure may vary between the two countries. However, such possible variance need not be regarded as inappropriate or as negating exchanges of information that would otherwise occur if the countries involved are satisfied with such a consequence under article 26 as adopted in their convention.

1. Recipients of information received through exchange

The competent authorities should specify, either in detail or by reference to existing comparable rules in the receiving country, who are the qualifying recipients of information in that country. Under article 26, the information can be disclosed, for example:

- (a) To administrators of the taxes covered in the convention;
- (b) To enforcement officials and prosecutors for such taxes;
- (c) To administrative tribunals for such taxes;
- (d) To judicial tribunals for such taxes;
- (e) In public court proceedings or in judicial decisions that may become available to the public;
- (f) To the competent authority of another country (see section E below).

2. Form in which information is provided

The permissible extent of the disclosure may affect the form in which the information should be provided in order to be useful to the receiving country. For example, if the information may be used in judicial tribunals and if, to be so used, it must be of a particular character or form, the competent authorities should consider how to provide for a transmittal that meets this need. (See also the comment on documents under section B.2 above.)

E. Consultation among several competent authorities

Competent authorities may want to consider developing procedures for consultations covering more than the two competent authorities under a particular treaty. Thus, if countries A, B and C are joined in a network of treaties, the competent authorities of A, B and C might desire to hold a joint

consultation. This consultation could be desired whether all three countries are directly intertwined (for example, where there are A-B, A-C and B-C treaties), or whether one country is a link in a chain but not fully joined (for example, where there are A-B and B-C treaties but not an A-C treaty). Countries desiring to have their competent authorities engage in such consultations should provide the legal basis for the consultations by adding the necessary authority in their treaties. Some countries may feel that article 26 permits joint consultation where all three countries are directly linked by bilateral treaties. However, the language of that model provision does not cover joint consultation when a link in the chain is not fully joined, as in the second situation above. In such a case, it is necessary to add a treaty provision allowing the competent authority of country B to provide information received from country A to the competent authority of country C. Such a treaty provision could include a safeguard that the competent authority of country A must consent to the action of the competent authority of country B. Presumably, he would so consent only when he was satisfied as to the provisions regarding protection of secrecy in the B-C treaty.

F. Overall factors

A variety of overall factors affecting the exchanges of information should be considered by the competent authorities, either as to their specific operational handling in the implementation of the exchange of information or as to their effect on the entire exchange process itself. Among such overall factors are:

1. Factors affecting implementation of exchange of information

- (a) The competent authorities should decide on the channels of communication for the different types of exchanges of information. One method of communication that may be provided for is to permit an official of one country to go in person to the other country to receive the information from the competent authority and discuss it so as to expedite the process of exchange of information.
- (b) Some countries may decide that it is useful and appropriate for a country to have representatives of its own tax administration stationed in the other treaty country. Such an arrangement presumably would rest on an authority, treaty or agreement other than that in the article on exchange of information of the double taxation treaty (although, if national laws of both countries permit, this article would be treated as covering this topic) and the arrangement would determine the conditions governing the presence of such representatives and their duties. The process need not be reciprocal, so that country A might have its representatives in country B but not vice versa if country A considered the process to be useful and country B did not. If arrangements exist for such representatives, the competent authorities may want to coordinate with those representatives when such coordination would make the exchange of information process more effective and where such coordination is otherwise appropriate.
- (c) Some countries may decide it is appropriate to have a tax official of one country participate directly with tax officials of the other country in a joint or “team” investigation of a particular taxpayer or activity. For most countries, the authority for such an arrangement probably would be an authority, treaty or agreements other than that in the treaty article on exchange of information, although, if national laws of both countries permit, article 26 could be treated by the countries as authorizing the competent authorities to make this arrangement. In either event, if the arrangement is made, it is appropriate to extend to such an investigation the safeguards and procedures developed for the exchange of information.
- (d) The process of exchange of information should be developed so that it is responsive to the countries’ needs in implementing substantive treaty provisions. Thus, treaty provisions regarding inter-company pricing and the allocation of income and expenses have their own informational requirements for effective implementation. The exchange of information process should reflect those requirements.

- (e) The substantive provisions of the treaty should take account of and be responsive to the exchange of information process. Thus, if the exchange of information process provides an adequate information base to support one country's allowance of deductions for expenses incurred in another country, the treaty should be developed on the basis of the substantive appropriateness of such deduction.
- (f) The competent authorities should determine to what extent the costs of information exchanges should be shared or reimbursed.
- (g) In light of the increasing use of electronic databases by tax administrators, the competent authorities should develop guidelines governing the sharing of information in such databases and the security measures that would be imposed to prevent improper access to those databases.

2. Factors affecting structure of exchange of information process

- (a) The arrangements regarding exchange of information worked out by country A with country B need not parallel those worked out between country A and country C or between country B and country C. The arrangements should be responsive to the needs of the two countries directly involved and need not be fully parallel in every case just for the sake of formal uniformity. However, prevention of international tax evasion and avoidance often requires international cooperation of the tax authorities of several countries. As a consequence, some countries may consider it appropriate to devise procedures and treaty provisions that are sufficiently flexible to enable them to extend their cooperation to multi-country consultation and exchange arrangements.
- (b) The competent authorities should weigh the effects of a domestic legal restriction on obtaining information in a country that requests information from another country not under a similar domestic legal restriction. For example, suppose country A requests information from country B and the tax authorities in country B are able to go to their financial institutions to obtain such information, whereas the tax authorities in country A are generally not able to go to their own financial institutions to obtain such information for tax purposes. How should the matter be regarded in country B? Article 26 permits country B to obtain the information from its financial institutions and transmit it to country A. It thus is a matter of discretion in country B as to whether it should respond, and the matter might be an appropriate subject for negotiations between the competent authorities. Many countries in practice do respond in this situation, and such a course is useful in achieving effective exchange of information to prevent tax avoidance. However, if country A wants to obtain information in such cases from other countries, it should also recognize its responsibility to try to change its domestic laws to strengthen the domestic authority of its own tax administration and to enable it to respond to requests from other countries.

- (c) The competent authorities should also weigh the effects of a possible imbalance growing out of divergences in other aspects of tax administration. For example, if country A cannot respond as fully to requests as country B can because of practical problems of tax administration in country A, should the level of the exchange of information be geared to the position of country A? Or, in general or in particular aspects, should country B be willing to respond to requests of country A even though country A would not be able to respond to similar requests of country B? This matter is similar to that discussed in the preceding paragraph and a similar response is appropriate.
- (d) Article 26 authorizes a transmitting country to utilize its administrative procedures solely to provide information to the requesting country, even when the person about whom information is sought is not involved in a tax proceeding in the transmitting country. Moreover, the transmitting country can, for the purpose of exchange of information, utilize its own administrative authority in the same way as if its own taxation were involved.
- (e) The competent authorities should weigh the effect on the process of exchange of information on one country's belief that the tax system or tax administration of the other country, either in general or in particular situations, is discriminatory or confiscatory. It may be that further exploration of such a belief could lead to substantive provisions in the treaty or in national law that would eliminate the problems perceived by the first country and thereby facilitate the process of exchange of information.
- (f) Article 26 does not permit a transmitting state to refuse to exchange information required to be exchanged under the treaty in order to enhance the competitive position of its taxpayers. For example, assume that country A has a treaty with country B providing for exchange of information, but country C does not have a treaty with country B. Company A, a corporation resident in country A, and Company C, a corporation resident in country C, are competing with each other for business in country B. Country A may feel that if it provides country B with information allowing country B to tax Company A properly and country C does not provide similar information about Company C, then Company A may be put at a competitive disadvantage relative to Company C. Notwithstanding this concern, country A is still required to honour its obligations under Article 26. The competent authorities of country B, nevertheless, should do what they can to reassure their counterparts in country A that the tax department in country B is doing its best to collect the proper tax from taxpayers that compete with country A residents.

3. Periodic consultation and review

The competent authorities should establish efficient and expeditious provisions for consultation to address the inevitable differences that will arise on the interpretation and application of Article 26. The consultation should extend both to particular situations and problems and to

periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.

IV. PROCEDURAL ASPECTS OF TAX TREATY NEGOTIATIONS

The procedural aspects of negotiating a tax treaty include the identification of the need for a treaty, the establishment of contracts with a potential treaty partner, the appointment of a delegation, the preparations for negotiations, the conduct of the negotiations and procedures for bringing the treaty into force.

A. Identification of need for a treaty

In determining whether a need exists for a tax treaty with a particular country, a country should examine the nature and extent of the existing economic relationship between the two countries as well as the potential and desire for growth in that relationship. In particular, there should be an intelligent assessment of the nature of future economic relationship. For example, a country should consider the likelihood of foreign direct or portfolio investment from the country concerned, the possibility of the country's technical or managerial personnel coming for employment, and the likelihood that residents of the other country will set up branches, offices or subsidiaries within its territorial jurisdiction. In addition, the country should examine whether the interrelationships between the tax systems of the two countries are inhibiting economic relationships. These inhibiting effects may, for example, be the results of excessively high levels of tax on international income flows, inadequate statutory relief from double taxation, and conflicting definitions of terms or concepts. Finally, a country should attempt to determine whether, to what extent and for what reasons the tax systems of the two countries result in double taxation on residents of the two countries.

B. Initial contacts

Once a country has identified the need for entering into a treaty with a particular country, it must communicate to that country its desire to open negotiations. As a general rule, such contacts are made initially through diplomatic channels. When a personal relationship exists between tax officials in the two countries, however, it may be helpful to utilize that relationship. In that event, the official diplomatic contacts should be supplemented by informal contacts through these personal channels.

When necessary, this initial contact phase may be the appropriate time to request information or other materials on the tax system and tax treaties of the other country.

C. Appointment of a delegation

A delegation typically consists of three to five individuals, although this number by no means reflects a hard and fast rule.

The leader of the delegation should be a senior official with tax policy responsibility who has the authority to make independent policy decisions, at least on a tentative basis.

The members of the delegation should be individuals who, among them, combine most or all of the following skills:

- (a) Familiarity with the administrative aspects of tax treaties and with the administration of the international aspects of internal law. An individual having such familiarity would represent, in effect, the competent authority function on the delegation;
- (b) A lawyer who is familiar with domestic tax law and able to draft treaty provisions;
- (c) An economist or other individual with an understanding of the economic relationships between the two countries and an ability to assess the economic impact of the decisions being made in the course of the negotiations.

If negotiations are to be held in a country's home capital, the opportunity may be taken to bring other people into the negotiations for training purposes. If this is to be done, however, care should be exercised to keep the delegations from becoming so big as to "overpower" the visiting delegation.

Finally, it is most important that one member of the delegation be assigned responsibility for taking careful notes of the discussions.

D. Preparations for negotiations

Members of the delegation should participate, possibly along with others, in preparing for the negotiations. The preparations typically include the following steps:

- (a) The tax system of the other country and its existing tax treaties must be studied. The other treaties provide an indication of the range of positions acceptable to the other country;
- (b) A draft treaty or working paper should be prepared showing initial positions on the major issues in a tax treaty. This draft may be in general form, to be used for all treaty discussions, or it may be geared to the particular discussions being undertaken. This draft should be transmitted to the other delegation. Though this step is useful for advising the other delegation of positions to be taken in the negotiations, it is also useful for the members of the delegation that prepares it, in requiring them to focus clearly on their own positions;
- (c) If the other delegation has prepared a similar draft or working paper, the two drafts should be compared and positions should be prepared on all points of difference;
- (d) In working out a country's position, the following groups should be consulted to suggest issues from their own experience: (i) the business community in the country; (ii) that

- country's citizens who are in the other country (the country's embassy in the other country can carry out this function); and (iii) other government agencies (e.g., investment agencies, government marketing boards, etc.);
- (e) If the country does not have any of its nationals available who are familiar with the tax laws of the other country, it may wish to engage an outside expert as a consultant;
 - (f) It is most useful if at least one member of the delegation is familiar with the United Nations Model Convention, the OECD Model Convention and any relevant regional model treaties.

E. Arrangements for meetings between negotiating delegations

Experience has shown that negotiations typically require at least two rounds of discussions, sometimes more, which are usually held on an alternating basis in the two capitals.

It is common experience that one week is an optimal length for a round of discussions. By the end of a week, there is usually an accumulation of issues that require careful consideration with principal officials before final decisions can be made. Furthermore, as a purely practical matter, officials frequently find that the amount of work that piles accumulates during the discussions can become intolerable when treaty discussions extend more than a week at a time.

In arranging for the meetings, the host delegation should make certain that: (a) there is a common language for negotiations, or (b) that interpreters will be available who can deal with tax concepts and terminology in both languages.

F. Conduct of the negotiations

1. First round of negotiations

It is helpful, as a first order of business, to make certain that each side understands the tax system of the other, particularly as it relates to the taxation of international income flows. If there are particularly complex aspects of a country's tax law that are relevant for a tax treaty, it is often helpful for that country to prepare a brief explanation in written form for the other delegation.

Once there is a general understanding of the two tax systems, the negotiations themselves can begin with an article-by-article review of the draft or drafts previously prepared. If neither side has its own model or draft, the United Nations Model Convention can be used for this purpose. During this initial article-by-article review, agreement can be reached on relatively easy points, and a clarification and, in some cases, a narrowing of the differences can be achieved on the remaining points.

If time remains after concluding one complete review of the draft, a second article-by-article review can be started. At this point, greater effort should be devoted to reaching agreement.

At the conclusion of the week's discussions, it is useful to prepare an agreed statement of the open issues and, if possible, to schedule the next meeting.

2. Between the first and second rounds of the negotiations

It should be agreed at the conclusion of the first round that one side will prepare a draft showing agreed language and, by use of brackets and alternative language or other suitable symbols, the open issues. This document should be the discussion draft for the second round.

It is important that the notes of the discussions be recorded and distributed to members of the delegations as quickly as possible, while memories are still fresh, particularly if there is more than one treaty under negotiation at the time.

Between the two rounds, the heads of the delegations should correspond in order to exchange drafts, to indicate tentative conclusions on major open issues and to confirm the schedule for the next round of discussions.

3. Second round of negotiations

It is important to maintain both momentum and continuity in treaty negotiations. Thus, the time between rounds should be minimized and, to the extent possible, the composition of the delegations should be retained.

Before resuming the article-by-article or issue-by-issue review of the draft, there should be a brief discussion of changes, if any, in the tax laws of either country between the first and the second rounds.

The review of the common working draft should continue, further narrowing any differences which remained at the beginning of the second round. Although it is generally best not to reverse prior decisions, this possibility should not be ruled out if either side considers it necessary. All decisions at this stage are made subject to policy review.

On occasion, agreements are reached in the course of negotiations that do not readily lend themselves to inclusion in the treaty but that should be made public at some time. There may be, for example, an agreed interpretation of a treaty provision, that is too detailed to go into the treaty text. This interpretation may be spelled out in an exchange of letters to be signed at the same time as the treaty. Such letters of understanding normally would not be subject to ratification, but would form part of the public record.

If full agreement has been reached by the conclusion of the second round, the treaty should be initialled by the heads of delegations. Initialling indicates that the draft reflects the agreement reached at the negotiating level.

If full agreement has not been reached, but nonetheless seems possible, the procedures suggested in the subsections F.2 and F.3 may be repeated. Although it may be possible, at this stage, to conclude an agreement by correspondence, there may be value in scheduling a third, perhaps briefer, meeting so as not to lose momentum. It is sometimes much easier to understand each other's point of view in face-to-face discussions.

G. Preparations for the signature of the treaty

Once agreement has been reached at the delegation level, the draft should be reviewed by senior policy officials. At this stage, to an even greater extent than during the negotiations, frivolous or minor changes should be avoided, but if a strong policy reason for proposing a change in the initialled draft is perceived, this information should be communicated immediately to the other delegation.

Once the draft is fully agreed upon, arrangements should be made for signature at the earliest opportunity under the appropriate procedures in each country. The need to conform texts in two languages can make this stage a time-consuming process. The printing, binding and sealing of agreed texts for signature is normally handled by foreign ministries.

H. Miscellaneous considerations

Countries may find it useful to issue press releases or other public statements that negotiations are about to begin with a particular country. The purpose of such a statement is to solicit comments from interested parties. This procedure may serve two purposes. It may bring to light issues that tax officials had not previously been aware of. Also, those in the private sector appreciate the opportunity to participate in the treaty process.

The negotiations are normally treated as confidential until the treaty is signed. This requirement of confidentiality has at least two positive purposes. It avoids locking negotiators into what may have been intended as tentative negotiating positions. It also avoids subjecting negotiators to pressures from parties who would be affected by these tentative decisions.

Countries may wish to consider a procedure for reviewing the progress of negotiations, during their course, with interested parties in the private sector. This review can most profitably be done after the general pattern of the new treaty has been established but before final decisions are made. It can serve to apprise the negotiators of some issues that may have surfaced after the beginning of the negotiations, or of problems that could result from provisions already tentatively agreed to. In such meetings, however, caution must be exercised to avoid revealing negotiating positions and other confidential information.

It is useful for the negotiators to maintain contact with economic officers in their embassy in the capital of the other country and to keep them advised of the progress of the negotiations. Among other things, this facilitates the role of these officers in exchanging messages and other

communications between formal negotiation sessions. These officers often will sit in on negotiations held in the country where they are assigned.

Finally, experience has shown that social contacts between delegations during the negotiations often are most helpful in maintaining a high level of good will between the delegations. The value of such social contacts is in no way correlated with their elaborateness or cost.

ANNEXES

**MODEL CONVENTIONS AND DRAFT MODEL CONVENTIONS
FOR THE AVOIDANCE OF DOUBLE TAXATION**

ANNEX 1

**MODEL BILATERAL CONVENTION FOR THE PREVENTION OF THE
DOUBLE TAXATION OF INCOME**

(MEXICO DRAFT)

Article 1

1. The present Convention is designed to prevent double taxation in the case of the taxpayers of the contracting States, whether nationals or not, as regards the following taxes:

A. With reference to State A:

1.
2.
3.

B. With reference to State B:

1.
2.
3.

2. It is mutually agreed that the present Convention shall apply also to any other tax, or increase of tax, imposed by either contracting State subsequent to the date of signature of this Convention upon substantially the same bases as the taxes enumerated in the preceding paragraph of this Article.

Article 2

Income from real property shall be taxable only in the State in which the property is situated.

Article 3

1. Income from mortgages on real property shall be taxable only in the State where the property is situated.

2. Income from mortgages on sea and/or air vessels shall be taxable only in the State where such vessels are registered.

Article 4

1. Income from any industrial, commercial or agricultural business and from any other gainful activity shall be taxable only in the State where the business or activity is carried out.

2. If an enterprise or an individual in one of the Contracting States extends its or his activities to the other State, through isolated or occasional transactions, without possessing in that State a permanent establishment, the income derived from such activities shall be taxable only in the first State.

3. If an enterprise has a permanent establishment in each of the Contracting States, each State shall tax that part of the income which is produced in its territory.

4. As regards agricultural and mining raw materials and other natural materials and products, the income which results from prices prevailing between independent persons or conforming to world market quotations shall be regarded as realised in the State in which such materials or products have been produced.

Article 5

Income which an enterprise of one of the Contracting States derives from the operation of ships or aircraft registered in such State is taxable only in that State.

Article 6

1. Directors' percentages, attendance fees and other special remuneration paid to directors, managers and auditors of companies are taxable only in the State where the fiscal domicile of the enterprise is situated.

2. If, however, such remuneration is paid for services rendered in a permanent establishment situated in the other Contracting State, it shall be taxable only in that State.

Article 7

1. Compensation for labour or personal services shall be taxable only in the contracting State in which such services are rendered.

2. A person having his fiscal domicile in one Contracting State shall, however, be exempt from taxation in the other Contracting State in respect of such compensation if he is temporarily present within the latter State for a period or periods not exceeding a total of one hundred and eighty-three days during the calendar year, and shall remain taxable in the first State.

3. If the person remains in the second State more than one hundred and eighty-three days, he shall be taxable therein in respect of compensation he earned during his stay there, but shall not be taxable in respect of such compensation in the first State.

4. Income derived by an accountant, an architect, a doctor, an engineer, a lawyer or other person engaged in the practice of a liberal profession shall be taxable only in the Contracting State in which the person has a permanent establishment at or from which he renders services.

5. If any such person has a permanent establishment in both contracting States, he shall be taxable in each State only on the income received for services rendered therein.

Article 8

1. Salaries, wages and other remuneration paid by one of the Contracting States, or by public bodies, institutions or services depending on it, to its nationals carrying out public functions in the other State shall be taxable only in the first State, provided that these functions are included within the normal field of activity of the State, as this field is defined by international usage.

2. Public pensions shall be taxable only in the State of the debtor entity.

Article 9

Income from movable capital shall be taxable only in the Contracting State where such capital is invested.

Article 10

1. Royalties from immovable property or in respect of the operation of a mine, a quarry or other natural resource shall be taxable only in the Contracting State in which such property, mine, quarry or other natural resource is situated.

2. Royalties and amounts received as a consideration for the right to use a patent, a secret process or formula, a trade mark or other analogous right shall be taxable only in the State where such right is exploited.

3. Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State, in consideration for the right to use a musical, artistic, literary, scientific or other cultural work or publication shall not be taxable in the former State.

Article 11

Private pensions and life annuities shall be taxable only in the State where the debtor has his fiscal domicile.

Article 12

Gains derived from the sale or exchange of real property shall be taxable only in the State in which the property is situated.

Article 13

The State where the taxpayer has his fiscal domicile shall retain the right to tax the entire income of the taxpayer whether derived from its territory or from that of the other Contracting State, but shall deduct from its tax on such entire income the lesser of the two following amounts:

- A. The tax collected by the latter Contracting State on the income which is taxable in its territory according to the preceding Articles;
- B. The amount which represents the same proportion in comparison with the total tax on the income that is taxable in both States as the income taxable in the other State in comparison with the total income.

Article 14

In the case of a taxpayer with a fiscal domicile in both Contracting States, the tax, the collection of which under this Convention depends on fiscal domicile, shall be imposed in each of the Contracting States in proportion to the period of stay during the preceding year or according to a proportion to be agreed by the competent administrations.

Article 15

A taxpayer having his fiscal domicile in one of the Contracting States shall not be subject in the other Contracting State, in respect of income he derives from that State, to higher or other taxes than the taxes applicable in respect of the same income to a taxpayer having his fiscal domicile in the latter State, or having the nationality of that State.

Article 16

1. When a taxpayer shows proof that the action of the tax administration of one of the Contracting States has resulted in double taxation, he shall be entitled to lodge a claim with the tax administration of the State in which he has his fiscal domicile or of which he is a national.
2. Should the claim be admitted, the competent tax administration of that State shall consult directly with the competent authority of the other State, with a view to reaching an agreement for an equitable avoidance of double taxation.

Article 17

As regards any special provisions which may be necessary for the application of the present Convention, more particularly in cases not expressly provided for, the competent authorities of the two Contracting States may confer together and take the measures required in accordance with the spirit of this Convention.

Article 18

1. This Convention and the accompanying Protocol, which shall be considered to be an integral part of the Convention, shall be ratified and the instruments of ratification shall be exchanged at . . . as soon as possible.

2. This Convention and Protocol shall become effective on the first day of January 19... They shall continue effective for a period of three years from that date and indefinitely after that period. They may, however, be terminated by either of the Contracting States at the end of the three-year period or at any time thereafter, provided that at least six months prior notice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period.

Done in duplicate, at . . . this . . . day of . . . 19....

ANNEX 2

**MODEL BILATERAL CONVENTION FOR THE PREVENTION
OF THE DOUBLE TAXATION OF INCOME AND PROPERTY
(LONDON DRAFT)**

Article 1

1. The present Convention is designed to prevent double taxation in the case of the taxpayers of the contracting States, whether nationals or not, as regards the following taxes:

A. With reference to State A:

- 1.
- 2.
- 3.

B. With reference to State B:

- 1.
- 2.
- 3.

2. It is mutually agreed that the present Convention shall apply also to any other tax, or increase of tax, imposed by either Contracting State subsequent to the date of signature of this Convention upon substantially the same bases as the taxes enumerated in the preceding paragraph of this Article.

Article 2

Income from real property shall be taxable in the State in which the property is situated.

Article 3

1. Income from mortgages on real property shall be taxable in the State where the property is situated.

2. Income from mortgages on sea and/or air vessels shall be taxable in the State where such vessels are registered.

Article 4

1. Income derived from any industrial, commercial or agricultural enterprise and from any other gainful occupation shall be taxable in the State where the taxpayer has a permanent establishment.
2. If an enterprise in one State extends its activities to the other State without possessing a permanent establishment therein, the income derived from such activities shall be taxable only in the first State.
3. If any enterprise has a permanent establishment in each of the Contracting States, each State shall tax only that part of the income which is produced in its territory.

Article 5

Income which an enterprise in one of the Contracting States derives from the operation of ships or aircraft engaged in international transport is taxable only in the State in which the enterprise has its fiscal domicile.

Article 6

1. Remuneration for labour or personal services shall be taxable in the contracting State in which such services are rendered.
2. A person having his fiscal domicile in one Contracting State shall, however, be exempt from taxation in the other Contracting State in respect of such remuneration if he is temporarily present within the latter State for a period or periods not exceeding a total of one hundred and eighty-three days during the taxable year, and shall remain taxable in the first State.
3. If a person remains in the second State more than one hundred and eighty-three days, he shall be taxable therein in respect of the remuneration he earned during his stay there, but shall not be taxable in respect of such remuneration in the first State.
4. Income derived by an accountant, an architect, an engineer, a lawyer, a physician or other person engaged on his own account in the practice of a profession shall be taxable in the Contracting State in which the person has a permanent establishment at, or from, which he renders services.
5. If any person described in the preceding paragraph has a permanent establishment in both Contracting States, he shall be taxable in each State only on the income for services rendered therein.

Article 7

Salaries, wages, pensions and other remuneration paid by the Government, political subdivisions and governmental agencies of one of the Contracting States to nationals of such State in

respect of the performance of diplomatic, consular or other governmental functions in the other State, shall be taxable only in the first State, provided that these functions are included within the normal field of governmental functions and are not connected with the carrying on of a trade or business on behalf of the State, its subdivisions and its agencies.

Article 8

1. Dividends and other income from shares in a company and shares of profits accruing to limited liability partners in a limited liability partnership shall be taxable only in the Contracting State where the company or limited liability partnership has its fiscal domicile.

2. Notwithstanding the provisions of paragraph 1, dividends paid by a company which has its fiscal domicile in one Contracting State to a company which has its fiscal domicile in the other Contracting State and has a dominant participation in the management or capital of the company paying the dividends shall be exempt from tax in the former State.

3. Dividends paid by, or undistributed profits of, a company which has its fiscal domicile in one Contracting State shall not be subjected to any tax by the other contracting State by reason of the fact that the dividends or undistributed profits represent, in whole or in part, income derived from the territory of that other State.

Article 9

1. Interest on bonds, securities, notes, debentures or on any other form of indebtedness shall be taxable only in the State where the creditor has his fiscal domicile.

2. The State of the debtor is, however, entitled to tax such interest by means of deduction or withholding at source.

3. The tax withheld at source under paragraph 2 of this Article shall in no case exceed.....per cent of the taxed interest.

Article 10

1. Royalties from immovable property or in respect of the operation of a mine, a quarry or other natural resource shall be taxable only in the Contracting State in which such property, mine, quarry or other natural resource is situated.

2. Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other Contracting State in consideration for the right to use a patent, a secret process or formula, a trade-mark or other analogous right shall not be taxable in the former State.

3. If, however, royalties are paid by an enterprise of one Contracting State to another enterprise of the other Contracting State which has a dominant participation in its management or capital, or vice versa, or when both enterprises are owned or controlled by the same interests, the

royalties shall be subject to taxation in the State where the right in consideration of which they are paid is exploited, subject to deduction from the gross amount of such royalties of all expenses and charges, including depreciation, relative to such rights and royalties.

4. Royalties derived from one of the Contracting States by an individual, corporation or other entity of the other contracting State, in consideration for the right to use an artistic, scientific or other cultural work or publication shall not be taxable in the former State.

Article 11

Private pensions and life annuities shall be taxable only in the State where the recipient has his fiscal domicile.

Article 12

1. Gains derived from the sale or exchange of real property shall be taxable only in the country in which the property is situated.

2. Gains derived from the sale or exchange of assets other than real property, appertaining to an industrial, commercial or agricultural enterprise or to any other independent occupation, shall be taxable according to the provisions of Articles IV and V.

3. Gains derived from the sale or exchange of any capital assets other than those mentioned in the preceding paragraphs of the present Article shall be taxable only in the State where the recipient has his fiscal domicile.

Article 13

The State where the taxpayer has his fiscal domicile shall retain the right to tax the entire income of the taxpayer whether derived from its territory or from that of the other Contracting State, but shall deduct from its tax on such entire income the lesser of the following amounts:

- A. The tax collected by the other Contracting State on the income which is taxable in its territory according to the preceding Articles;
- B. The amount which represents the same proportion of the tax of the State of fiscal domicile on the entire net income of the taxpayer as the net income taxable in the other State bears to the entire net income.

Article 14

In the case of a taxpayer with a fiscal domicile in both Contracting States, the tax, the collection of which under this Convention depends on fiscal domicile, shall be imposed in each of the Contracting States in proportion to the period of stay during the taxable year or according to a proportion to be agreed by the competent administrations.

Article 15

The provisions of the preceding Articles shall be applicable, *mutatis mutandis*, to taxes on property, capital or increment of wealth whether such taxes are permanent or are levied once only.

Article 16

A taxpayer having his fiscal domicile in one of the Contracting States shall not be subject in the other Contracting State, in respect of income he derives from that State, to higher or other taxes than the taxes applicable in respect of the same income to a taxpayer having his fiscal domicile in the latter State, or having the nationality of that State.

Article 17

1. When a taxpayer shows proof that the action of the tax administration of one of the Contracting States has resulted in double taxation, he shall be entitled to lodge a claim with the tax administration of the State in which he has his fiscal domicile or of which he is a national.

2. Should the claim be admitted, the competent tax administration of that State shall consult directly with the competent authority of the other State, with a view to reaching an agreement for an equitable avoidance of double taxation.

Article 18

The provisions of the present Convention shall not be construed to restrict in any manner any exemption, deduction, credit, allowance, advantage and right of administrative or judicial appeal accorded to a taxpayer by the laws of either of the Contracting States.

Article 19

As regards any special provisions which may be necessary for the application of the present Convention, more particularly in cases not expressly provided for, and in the event of substantial changes in the tax laws of either of the Contracting States, the competent authorities of the two Contracting States shall confer together and take the measures required in accordance with the spirit of the present Convention.

Article 20

1. This Convention and the accompanying Protocol, which shall be considered to be an integral part of the Convention, shall be ratified and the instruments of ratification shall be exchanged at.....as soon as possible.

2. This Convention and Protocol shall become effective on the first day of January 19... They shall continue effective for a period of three years from that date and indefinitely after that

period. They may, however, be terminated by either of the Contracting States at the end of the three-year period or at any time there after, provided that at least six months prior notice of termination has been given, the termination to become effective on the first day of January following the expiration of the six-month period.

DONE in duplicate, at this . . . day of 19...

ANNEX 3

MODEL CONVENTION FOR THE AVOIDANCE OF DOUBLE TAXATION BETWEEN MEMBER COUNTRIES AND OTHER COUNTRIES OUTSIDE THE ANDEAN SUBREGION (ANDEAN MODEL)

CHAPTER I SCOPE OF THE CONVENTION AND GENERAL DEFINITIONS

Article 1 *SCOPE OF THE CONVENTION*

The taxes subject to this Convention are:

In the case of (State A):

In the case of (State B):

This Convention shall also apply to any future amendments of the above-mentioned taxes, and to any taxes established by each Contracting State after the signing of this Convention, which, by virtue of its tax base or its taxable matter, are substantially and economically similar to any of the above-cited taxes.

Article 2 *GENERAL DEFINITIONS*

For the purposes of this Convention, and unless otherwise defined:

(a) The terms “one of the Contracting States” and “the other Contracting State” mean (State A) or (State B), as the context requires.

(b) The expressions “territory of one of the Contracting States” and “territory of the other Contracting State” mean the territory of (State A) or the territory of (State B), as the context requires.

(c) The word “person” means:

1. An individual
2. A juridical person.

(d) An individual shall be deemed to be a resident of the Contracting State in which said individual has his or her habitual abode.

A business enterprise shall be deemed to be a resident of the State specified in its articles of constitution. In the absence of articles of constitution, or if no State of residence is specified

therein, the business enterprise shall be deemed to be a resident of the State wherein its actual managerial control is established.

Where the determination of the State of residence under these rules is not possible, the competent authorities of the Contracting States shall decide the issue by mutual agreement.

(e) The word “source” means the activity, right or property that generates, or may generate, the income.

(f) The term “business activities” means activities undertaken by business enterprises.

(g) The word “enterprise” means an organization constituted by one or more persons that undertakes a profit-making activity.

(h) The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean an enterprise that is a resident of one of the Contracting States.

(i) The word “royalty” means any benefit, thing of value or sum of money paid for the use, or for the privilege of using, copyrights, patents, industrial drawings or models, exclusive processes or formulas, trade marks or other intangible property of a similar nature.

(j) The term “capital gains” means the profit obtained by a person in the alienation of property not habitually acquired, produced or transferred in his ordinary line of business activity.

(k) The word “pension” means a periodic payment made in consideration of services rendered or injuries sustained; and the word “annuity” means a certain sum of money payable periodically during the life of the beneficiary, or during a certain period of time, gratuitously or in consideration of payments made in money.

(l) The term “competent authority” means, in the case of (State A), theand in the case of (State B), the.....

Article 3

MEANING OF UNDEFINED TERMS

Any word or term not defined in this Convention shall have the meaning assigned thereto by the legislation in force of each Contracting State.

CHAPTER II

TAX ON INCOME

Article 4

TAX JURISDICTION

Irrespective of the nationality or State of residence of a person, income of whatever nature received by such person shall be taxable only by the Contracting State wherein the source of such income is situated, except for the cases specified in this Convention.

Article 5
INCOME FROM REAL PROPERTY

Income of whatever kind from real property shall be taxable only by the Contracting State wherein such real property is situated.

Article 6
INCOME FROM RIGHTS TO EXPLOIT NATURAL RESOURCES

Any benefit received from leasing or subleasing, or from transferring or granting, any right to exploit or use in any manner whatsoever the natural resources of one of the Contracting States, shall be taxable only by such Contracting State.

Article 7
BUSINESS PROFITS

Profits resulting from business activities shall be taxable only by the Contracting State wherein such business activities have been undertaken.

It is understood that a business enterprise carries out activities in the territory of a Contracting State when it has in such Contracting State any of, but not limited to, the following:

- (a) An office or place of business management;
- (b) A factory, plant, industrial workshop or assembly shop;
- (c) A construction project in progress;
- (d) A place or facility wherein natural resources are extracted or exploited, such as a mine, well, quarry, plantation or fishing boat;
- (e) An agency or premises for the sale of goods;
- (f) An agency or premises for the purchase of goods;
- (g) A depository, storage facility, warehouse or any similar establishment used for receiving, storing or delivering goods;
- (h) Any other premises, office or facilities, the purpose of which is preparatory or auxiliary to the business activities of the enterprise;
- (i) An agent or representative.

Where a business enterprise undertakes activities in both Contracting States, each one of them may tax income from sources within its territory. If the activities are undertaken through representatives, or through the use of facilities, such as the ones indicated in the preceding paragraph, the profits earned shall be attributed to such persons or facilities, provided that said persons or facilities are totally independent from the business enterprise.

Article 8
PROFITS OF TRANSPORTATION ENTERPRISES

The profits earned by a transportation enterprise from its air, land, sea, lake or river operations, shall be liable to taxation only by the Contracting State of which such enterprise is a resident.

Article 8
ALTERNATIVE

The profits earned by a transportation enterprise from its air, land, sea, lake or river operations in any of the Contracting States shall be taxable only by such Contracting State.

Article 9
ROYALTIES FROM THE USE OF PATENTS, TRADE MARKS AND TECHNOLOGY

Royalties derived from the use of patents, trade marks, non-patented technical knowledge or other similar intangible property within the territory of one of the Contracting States shall be taxable only by such Contracting State.

Article 10
INTEREST

Interest derived from loans shall be taxable only by the Contracting State in the territory of which the loan has been used.

Subject to rebuttal, it is presumed that the loan has been used in the Contracting State from which the interest payment has been made.

Article 11
DIVIDENDS AND SHARES OF PROFIT

Dividends and shares of profit shall be taxable only by the Contracting State of which the business enterprise paying them is a resident.

Article 12
CAPITAL GAINS

Capital gains shall be taxable only by the Contracting State wherein the property is situated at the time of the sale, except for capital gains derived from the alienation of:

(a) Ships, aircraft, buses and other transportation vehicles, which shall be taxable only by the Contracting State wherein such vehicles are registered at the time of the alienation thereof, and

(b) Negotiable instruments, shares of stock and other securities, which shall be taxable only by the Contracting State in which territory they have been issued.

Article 13

INCOME FROM THE RENDERING OF PERSONAL SERVICES

Remunerations, fees, wages, salaries, benefits and similar compensation received as payments for services rendered by employees, professionals or technicians, or for personal services in general, shall be taxable only in the territory wherein such services have been rendered, except for wages, salaries, remunerations and similar compensation, received by:

- (a) Persons rendering services to a Contracting State in the discharge of official duties duly accredited, which shall be taxable only by such Contracting State, even if the services have been rendered within the territory of the other Contracting State.
- (b) The crews of ships, aircraft, buses and other transportation vehicles engaged in international traffic, which shall be taxable only by the Contracting State of which the employer is a resident.

Article 14

PROFESSIONAL SERVICE AND TECHNICAL ASSISTANCE BUSINESS ENTERPRISES

Income received by business enterprises engaged in rendering professional services or technical assistance, shall be taxable only by the Contracting State wherein such services or assistance are rendered.

Article 15

PENSIONS AND ANNUITIES

Pensions, annuities and other periodic income of a similar character shall be taxable only by the Contracting State wherein the source of such income is situated.

The source is considered to be situated in the territory of the State where the contract providing for such periodic income is executed and, if there is no contract, in the State from which the payment of such income is made.

Article 16

PUBLIC ENTERTAINMENT ACTIVITIES

Income derived from artistic or public entertainment activities shall be taxable only by the Contracting State wherein such activities have been carried out, without regard to the time that the persons performing said activities stay in the territory of such Contracting State.

**CHAPTER III
TAXES ON NET WEALTH**

Article 17
TAXES ON NET WEALTH

Net wealth situated within the territory of one of the Contracting States shall be taxable only by such Contracting State.

Article 18
STATUS OF TRANSPORTATION VEHICLES, LOANS, AND SECURITIES

For the purposes of the preceding Article, it is understood that:

(a) Aircraft, ships, buses and other transportation vehicles, as well as the personal property used in the operation thereof, are situated in the Contracting State wherein their respective ownership is registered.

(b) Loans, shares of stock and other securities are situated in the Contracting State of which the debtor, or the issuing enterprise, is a resident.

**CHAPTER IV
GENERAL PROVISIONS**

Article 19
CONSULTATIONS AND INFORMATION

The competent authorities of the Contracting States shall hold consultations between themselves and exchange the information necessary for deciding by mutual agreement any difficulty or doubt which may arise out of the application of this Convention, and for establishing the administrative controls required for the avoidance of fraud and tax evasion.

The information exchanged pursuant to the provisions of the preceding paragraph shall be considered as confidential, and shall not be transmitted to any person other than the authorities responsible for the administration of the taxes which are subject to this Convention.

For the purposes of this Article, the competent authorities of the Contracting States may communicate directly between themselves.

Article 20
RATIFICATION

This Convention shall be ratified by the governments of the Contracting States in accordance with their respective constitutional and legal requirements.

The instruments of ratification shall be exchanged at.....as soon as possible.

Upon the exchange of the instruments of ratification, this Convention shall have effect and apply:

(a) With respect to income of individuals, to income received on and after the first day of January of the calendar year following the year of the ratification.

(b) With respect to business profits, to profits received during the first fiscal year starting after the ratification of this Convention.

(c) With respect to other taxes, to those in which the assessment thereof corresponds to the calendar year following the year of the ratification.

Article 21
EFFECTIVENESS AND TERMINATION

This Convention shall remain in force and effect indefinitely, but either of the Contracting States, from the first day of January to the 30th day of June of any calendar year, may denounce the Convention by giving notice thereof in writing to the other Contracting States and, in such event, the Convention shall cease to have effect:

(a) With respect to income of individuals, as of the first day of January of the calendar year immediately following the year in which such notice is given.

(b) With respect to income of juridical persons after the closing of the fiscal year, the beginning of which would have occurred during the calendar year in which notice of termination of this Convention is given.

(c) With respect to the other taxes, as of the first day of January of the calendar year following the year in which such notice is given.

IN TESTIMONY WHEREOF, the respective plenipotentiaries have hereunto set their hands and seals.

MADE at . . . on the . . . day of . . . in . . . copies in the . . . language, and . . . copies in the . . . language, with the . . . copies being equally valid and authentic.

ANNEX 4

**MODEL DOUBLE TAXATION CONVENTION
ON INCOME AND ON CAPITAL 2000⁶⁷
(OECD)**

TITLE OF THE CONVENTION

**Convention between (State A) and (State B)
with respect to taxes on income and on capital⁶⁸**

PREAMBLE TO THE CONVENTION⁶⁹

**CHAPTER I
SCOPE OF THE CONVENTION**

***Article 1*
PERSONS COVERED**

This convention shall apply to persons who are residents of one or both of the Contracting States.

***Article 2*
TAXES COVERED**

1. This Convention shall apply to taxes on income and on capital imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.
2. There shall be regarded as taxes on income and on capital all taxes imposed on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.
3. The existing taxes to which the Convention shall apply are in particular:
 - a) (in State A):
 - b) (in State B):

⁶⁷ The OECD Model Convention continues to evolve over time and it would be desirable to refer to the updated version.

⁶⁸ States wishing to do so may follow the widespread practice of including in the title a reference to either the avoidance of double taxation or to both the avoidance of double taxation and the prevention of fiscal evasion.

⁶⁹ The Preamble of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

4. The Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any significant changes that have been made in their taxation laws.

CHAPTER II DEFINITIONS

Article 3 GENERAL DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:
 - a) The term “person” includes an individual, a company and any other body of persons;
 - b) The term “company” means any body corporate or any entity that is treated as a body corporate for tax purposes;
 - c) The term “enterprise” applies to the carrying on of any business;
 - d) The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;
 - e) The term “international traffic” means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;
 - f) The term “competent authority” means:
 - (i) (in State A):
 - (ii) (in State B):
 - g) The term “national” means:
 - (i) any individual possessing the nationality of a Contracting State;
 - (ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State;
 - h) The term “business” includes the performance of professional services and of other activities of an independent character.

2. As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

Article 4 RESIDENT

1. For the purposes of this Convention, the term “resident of a Contracting State” means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature, and also includes that State and any

political subdivision or local authority thereof. This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein.

2. Where by reason of the provisions of paragraph 1 an individual is a resident of both Contracting States, then his status shall be determined as follows:

- (a) He shall be deemed to be a resident only of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident only of the State with which his personal and economic relations are closer (centre of vital interests);
- (b) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident only of the State in which he has an habitual abode;
- (c) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident only of the State of which he is a national;
- (d) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident only of the State in which its place of effective management is situated.

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term “permanent establishment” means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term “permanent establishment” includes especially:

- (a) A place of management;
- (b) A branch;
- (c) An office;
- (d) A factory;
- (e) A workshop, and
- (f) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. A building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months.

4. Notwithstanding the preceding provisions of this Article, the term “permanent establishment” shall be deemed not to include:

- (a) The use of facilities solely for the purpose of storage, display or delivery of goods or merchandise belonging to the enterprise;

- (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery;
- (c) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;
- (d) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information for the enterprise;
- (e) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character;
- (f) The maintenance of a fixed place of business solely for any combination of activities mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 6 applies — is acting on behalf of an enterprise and has, and habitually exercises, in a Contracting State an authority to conclude contracts in the name of the enterprise, that enterprise shall be deemed to have a permanent establishment in that State in respect of any activities which that person undertakes for the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph.

6. An enterprise shall not be deemed to have a permanent establishment in a Contracting State merely because it carries on business in that State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business.

7. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise), shall not of itself constitute either company a permanent establishment of the other.

CHAPTER III TAXATION OF INCOME

Article 6 *INCOME FROM IMMOVABLE PROPERTY*

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term “immovable property” shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture

and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall apply to income derived from the direct use, letting, or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise.

Article 7 ***BUSINESS PROFITS***

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State, but only so much of them as is attributable to that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In determining the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere.

4. Insofar as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this Article.

3. No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

4. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

7. Where profits include items of income which are dealt with separately in other Articles of this Convention, then the provisions of those Articles shall not be affected by the provisions of this Article.

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.

4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 9

ASSOCIATED ENTERPRISES

1. Where

- a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or
- b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State — and taxes accordingly — profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such

adjustment, due regard shall be had to the other provisions of this Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

Article 10 ***DIVIDENDS***

1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.

2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:

a) 5 per cent of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25 per cent of the capital of the company paying the dividends;

b) 15 per cent of the gross amount of the dividends in all other cases.

The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of these limitations. This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid.

3. The term “dividends” as used in this Article means income from shares, “jouissance” shares or “jouissance” rights, mining shares, founders’ shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident through a permanent establishment situated therein and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except insofar as such dividends are paid to a resident of that other State or insofar as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment situated in that other State, nor subject the company’s undistributed profits to a tax on the company’s undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Article 11
INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.
2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if the beneficial owner of the interest is a resident of the other Contracting State, the tax so charged shall not exceed 10 per cent of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.
3. The term “interest” as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor’s profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article.
4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the interest, being a resident of a Contracting State, carries on business in the other Contracting State in which the interest arises through a permanent establishment situated therein and the debt-claim in respect of which the interest is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.
5. Interest shall be deemed to arise in a Contracting State when the payer is a resident of that State. Where, however, the person paying the interest, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment in connection with which the indebtedness on which the interest is paid was incurred, and such interest is borne by such permanent establishment, then such interest shall be deemed to arise in the State in which the permanent establishment is situated.
6. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest, having regard to the debt-claim for which it is paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 12
ROYALTIES

1. Royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State shall be taxable only in that other State.

2. The term “royalties” as used in this Article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematograph films, any patent, trade mark, design or model, plan, secret formula or process, or for information concerning industrial, commercial or scientific experience.

3. The provisions of paragraph 1 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise through a permanent establishment situated therein and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

4. Where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties, having regard to the use, right or information for which they are paid, exceeds the amount which would have been agreed upon by the payer and the beneficial owner in the absence of such relationship, the provisions of this Article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

Article 13 ***CAPITAL GAINS***

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in Article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise), may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3 shall be taxable only in the Contracting State of which the alienator is a resident.

[*Article 14* - INDEPENDENT PERSONAL SERVICES]
[Deleted]

Article 15
INCOME FROM EMPLOYMENT

1. Subject to the provisions of Articles 16, 18 and 19, salaries, wages and other similar remuneration derived by a resident of a Contracting State in respect of an employment shall be taxable only in that State unless the employment is exercised in the other Contracting State. If the employment is so exercised, such remuneration as is derived therefrom may be taxed in that other State.

2. Notwithstanding the provisions of paragraph 1, remuneration derived by a resident of a Contracting State in respect of an employment exercised in the other Contracting State shall be taxable in the first-mentioned State only if:

- a) the recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned, and
- b) the remuneration is paid by, or on behalf of, an employer who is not a resident of the other State, and
- c) the remuneration is not borne by a permanent establishment which the employer has in the other State.

3. Notwithstanding the preceding provisions of this Article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Article 16
DIRECTORS' FEES

Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the board of directors of a company which is a resident of the other Contracting State may be taxed in that other State.

Article 17
ARTISTES AND SPORTSMEN

1. Notwithstanding the provisions of Articles 7 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as a sportsman, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or a sportsman in his capacity as such accrues not to the entertainer or sportsman himself but to another person, that income may, notwithstanding the provisions of Articles 7 and 15, be taxed in the Contracting State in which the activities of the entertainer or sportsman are exercised.

Article 18
PENSIONS

Subject to the provisions of paragraph 2 of Article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

Article 19
GOVERNMENT SERVICE

1. a) Salaries, wages and other similar remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

b) However, such salaries, wages and other similar remuneration shall be taxable in the other Contracting State only if the services are rendered in that State and the individual is a resident of that State who:

(i) is a national of that State; or

(ii) did not become a resident of that State solely for the purpose of rendering the services.

2. a) Any pension paid by or out of funds created by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

b) However, such pension shall be taxable in the other Contracting State only if the individual is a resident of and a national of that State.

3. The provisions of Articles 15, 16, 17 and 18 shall apply to salaries, wages and other similar remuneration, and to pensions in respect of services rendered in connection with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Article 20
STUDENTS

Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

Article 21
OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing Articles of this Convention shall be taxable only in that State.
2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of Article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein and the right or property in respect of which the income is paid is effectively connected with such permanent establishment. In such case the provisions of Article 7 shall apply.

CHAPTER IV
TAXATION OF CAPITAL

Article 22
CAPITAL

1. Capital represented by immovable property referred to in Article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.
2. Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State may be taxed in that other State.
3. Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.
4. All other elements of capital of a resident of a Contracting State shall be taxable only in that State.

CHAPTER V
METHODS FOR ELIMINATION OF DOUBLE TAXATION

Article 23 A
EXEMPTION METHOD

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income or capital from tax.

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of Articles 10 and 11, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

3. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

4. The provisions of paragraph 1 shall not apply to income derived or capital owned by a resident of a Contracting State where the other Contracting State applies the provisions of this Convention to exempt such income or capital from tax or applies the provisions of paragraph 2 of Article 10 or 11 to such income.

Article 23 B ***CREDIT METHOD***

1. Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow:

- a) as a deduction from the tax on the income of that resident, an amount equal to the income tax paid in that other State;
- b) as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State.

Such deduction in either case shall not, however, exceed that part of the income tax or capital tax, as computed before the deduction is given, which is attributable, as the case may be, to the income or the capital which may be taxed in that other State.

2. Where in accordance with any provision of the Convention income derived or capital owned by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income or capital of such resident, take into account the exempted income or capital.

CHAPTER VI
SPECIAL PROVISIONS

Article 24
NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances, in particular with respect to residence, are or may be subjected. This provision shall, notwithstanding the provisions of Article 1, also apply to persons who are not residents of one or both of the Contracting States.
2. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith, which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances, in particular with respect to residence, are or may be subjected.
3. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, relief and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.
4. Except where the provisions of paragraph 1 of Article 9, paragraph 6 of Article 11 or paragraph 4 of Article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.
5. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.
6. The provisions of this Article shall, notwithstanding the provisions of Article 2, apply to taxes of every kind and description.

Article 25
MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of Article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with the Convention. Any agreement reached shall be implemented notwithstanding any time limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly, including through a joint commission consisting of themselves or their representatives, for the purpose of reaching an agreement in the sense of the preceding paragraphs.

Article 26
EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws concerning taxes of every kind and description imposed on behalf of the Contracting States, or of their political subdivisions or local authorities, insofar as the taxation there under is not contrary to the Convention. The exchange of information is not restricted by Articles 1 and 2. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State and shall be disclosed only to persons or authorities (including courts and administrative bodies) concerned with the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to the taxes referred to in the first sentence. Such persons or authorities shall use the information only for such purposes. They may disclose the information in public court proceedings or in judicial decisions.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

- a) to carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

- b) to supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;
- c) to supply information which would disclose any trade, business, industrial, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (*ordre public*).

Article 27

MEMBERS OF DIPLOMATIC MISSIONS AND CONSULAR POSTS

Nothing in this Convention shall affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements.

Article 28

TERRITORIAL EXTENSION⁷⁰

1. This Convention may be extended, either in its entirety or with any necessary modifications [to any part of the territory of (State A) or of (State B) which is specifically excluded from the application of the Convention or], to any State or territory for whose international relations (State A) or (State B) is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. Any such extension shall take effect from such date and subject to such modifications and conditions, including conditions as to termination, as may be specified and agreed between the Contracting States in notes to be exchanged through diplomatic channels or in any other manner in accordance with their constitutional procedures.

2. Unless otherwise agreed by both Contracting States, the termination of the Convention by one of them under Article 30 shall also terminate, in the manner provided for in that Article, the application of the Convention [to any part of the territory of (State A) or of (State B) or] to any State or territory to which it has been extended under this Article.

CHAPTER VII FINAL PROVISIONS

Article 29

ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at as soon as possible.

2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:

⁷⁰ The words between brackets are of relevance when, by special provision, a part of the territory of a Contracting State is excluded from the application of the Convention.

- (a) (in State A):
- (b) (in State B):

Article 30
TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year In such event, the Convention shall cease to have effect:

- (a) (in State A):
- (b) (in State B):

TERMINAL CLAUSE⁷¹

⁷¹ The terminal clause concerning the signing shall be drafted in accordance with the constitutional procedure of both Contracting States.

ANNEX 5

A CONVENTION NEGOTIATED BY THE MEMBER STATES OF THE COUNCIL OF EUROPE AND THE ORGANIZATION FOR ECONOMIC COOPERATION AND DEVELOPMENT (OECD) ON MUTUAL ADMINISTRATIVE ASSISTANCE IN TAX MATTERS (1988)

CHAPTER I SCOPE OF THE CONVENTION

Article 1 OBJECT OF THE CONVENTION AND PERSONS COVERED

1. The Parties shall, subject to the provisions of Chapter IV, provide administrative assistance to each other in tax matters. Such assistance may involve, where appropriate, measures taken by judicial bodies.
2. Such administrative assistance shall comprise:
 - (a) Exchange of information, including simultaneous tax examinations and participation in tax examinations abroad;
 - (b) Assistance in recovery, including measures of conservancy; and
 - (c) Service of documents.
3. A Party shall provide administrative assistance whether the person affected is a resident or national of a Party or of any other State.

Article 2 TAXES COVERED

1. This Convention shall apply:
 - (a) To the following taxes:
 - (i) Taxes on income or profits;
 - (ii) Taxes on capital gains which are imposed separately from the tax on income or profits;
 - (iii) Taxes on net wealth, imposed on behalf of a Party; and
 - (b) To the following taxes:
 - (i) Taxes on income, profits, capital gains or net wealth which are imposed on behalf of political subdivisions or local authorities of a Party;
 - (ii) Compulsory social security contributions payable to general government or to social security institutions established under public law; and
 - (iii) Taxes in other categories, except customs duties, imposed on behalf of a Party, namely:

- A. Estate, inheritance or gift taxes;
- B. Taxes on immovable property;
- C. General consumption taxes, such as value-added or sales taxes;
- D. Specific taxes on goods and services such as excise taxes;
- E. Taxes on the use or ownership of motor vehicles;
- F. Taxes on the use or ownership of movable property other than motor vehicles;
- G. Any other taxes;

(iv) Taxes in categories referred to in sub-paragraph (iii) above which are imposed on behalf of political subdivisions or local authorities of a Party.

2. The existing taxes to which the Convention shall apply are listed in Annex A in the categories referred to in paragraph 1.

3. The Parties shall notify the Secretary General of the Council of Europe or the Secretary general of OECD (hereinafter referred to as the “Depositaries”) of any change to be made to Annex A as a result of a modification of the list mentioned in paragraph 2. Such change shall take effect on the first day of the month following the expiration of a period of three months after the date of receipt of such notification by the Depositary.

4. The Convention shall also apply, as from their adoption, to any identical or substantially similar taxes which are imposed in a Contracting State after the entry into force of the Convention in respect of that Party in addition to or in place of the existing taxes listed in Annex A and, in that event, the Party concerned shall notify one of the Depositaries of the adoption of the tax in question.

CHAPTER II GENERAL DEFINITIONS

Article 3 DEFINITIONS

1. For the purposes of this Convention, unless the context otherwise requires:

- (a) The terms “applicant State” and “requested State” mean respectively any Party applying for administrative assistance in tax matters and any Party requested to provide such assistance;
- (b) The term “tax” means any tax or social security contribution to which the Convention applies pursuant to Article 2;
- (c) The term “tax claim” means any amount of tax, as well as interest thereon, related administrative fines and costs incidental to recovery, which are owed and not yet paid;
- (d) The term “competent authority” means the persons and authorities listed in Annex B;
- (e) The term “national”, in relation to a Party, means:
 - (i) All individuals possessing the nationality of that Party, and

- (ii) All legal persons, partnerships, associations and other entities deriving their status as such from the laws in force in that Party.

For each Party that has made a declaration for that purpose, the terms used above will be understood as defined in Annex C.

2. As regards the application of the Convention by a Party, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that Party concerning the taxes covered by the Convention.

3. The Parties shall notify one of the Depositaries of any change to be made to Annexes B and C. Such change shall take effect on the first day of the month following the expiration of a period of three months after the date of receipt of such notification by the Depositary in question.

CHAPTER III FORMS OF ASSISTANCE

Section I Exchange of Information

Article 4 GENERAL PROVISION

1. The Parties shall exchange any information, in particular as provided in this Section, that is foreseeably relevant to:

- 1) The assessment and collection of tax, and the recovery and enforcement of tax claims, and
- 2) The prosecution before an administrative authority or the initiation of prosecution before a judicial body. Information which is unlikely to be relevant to these purposes shall not be exchanged under this Convention.

2. A Party may use information obtained under this Convention as evidence before a criminal court only if prior authorization has been given by the Party which has supplied the information. However, any two or more Parties may mutually agree to waive the condition of prior authorization.

3. Any Party may, by a declaration addressed to one of the Depositaries, indicate that, according to its internal legislation, its authorities may inform its resident or national before transmitting information concerning him, in conformity with Articles 5 and 7.

Article 5 EXCHANGE OF INFORMATION ON REQUEST

1. At the request of the applicant State, the requested State shall provide the applicant State with any information referred to in Article 4 which concerns particular persons or transactions.
2. If the information available in the tax files of the requested State is not sufficient to enable it to comply with the request for information, that State shall take all relevant measures to provide the applicant State with the information requested.

Article 6
AUTOMATIC EXCHANGE OF INFORMATION

With respect to categories of cases and in accordance with procedures which they shall determine by mutual agreement, two or more Parties shall automatically exchange the information referred to in Article 4.

Article 7
SPONTANEOUS EXCHANGE OF INFORMATION

1. A Party shall, without prior request, forward to another Party information of which it has knowledge in the following circumstances:
 - (a) The first-mentioned Party has grounds for supposing that there may be a loss of tax in the other Party;
 - (b) A person liable to tax obtains a reduction in or an exemption from tax in the first-mentioned Party which would give rise to an increase in tax or to liability to tax in the other Party;
 - (c) Business dealings between a person liable to tax in a Party and a person liable to tax in another Party are conducted through one or more countries in such a way that a saving in tax may result in one or the other Party or in both;
 - (d) A Party has grounds for supposing that a saving of tax may result from artificial transfers of profits within groups of enterprises;
 - (e) Information forwarded to the first-mentioned Party by the other Party has enabled information to be obtained which may be relevant in assessing liability to tax in the latter Party.
2. Each Party shall take such measures and implement such procedures as are necessary to ensure that information described in paragraph 1 will be made available for transmission to another Party.

Article 8
SIMULTANEOUS TAX EXAMINATIONS

1. At the request of one of them, two or more Parties, shall consult together for the purposes of determining cases and procedures for simultaneous tax examinations. Each Party involved shall decide whether or not it wishes to participate in a particular simultaneous tax examination.
2. For the purposes of this Convention, a simultaneous tax examination means an arrangement between two or more Parties to examine simultaneously, each in its own territory, the tax affairs of a person or persons in which they have a common or related interest, with a view to exchanging any relevant information which they so obtain.

Article 9
TAX EXAMINATION ABROAD

1. At the request of the competent authority of the applicant State, the competent authority of the requested State may allow representatives of the competent authority of the applicant State to be present at the appropriate part of a tax examination in the requested State.
2. If the request is acceded to, the competent authority of the requested State shall, as soon as possible, notify the competent authority of the applicant State about the time and place of the examination, the authority or official designated to carry out the examination and the procedures and conditions required by the requested State for the conduct of the examination. All decisions with respect to the conduct of the tax examination shall be made by the requested State.
3. A Party may inform one of the Depositories of its intention not to accept, as a general rule, such requests as are referred to in paragraph 1. Such a declaration may be made or withdrawn at any time.

Article 10
CONFLICTING INFORMATION

If a Party receives from another Party information about a person's tax affairs which appears to it to conflict with information in its possession, it shall so advise the Party which has provided the information.

Section II
Assistance in Recovery

Article 11
RECOVERY OF TAX CLAIMS

1. At the request of the applicant State, the requested State shall, subject to the provisions of Articles 14 and 15, take the necessary steps to recover tax claims of the first-mentioned State as if they were its own tax claims.

3. The provision of paragraph 1 shall apply only to tax claims which form the subject of an instrument permitting their enforcement in the applicant State and unless otherwise agreed between the Parties concerned, which are not contested. However, where the claim is against a person who is not a resident of the applicant State, paragraph 1 shall only apply, unless otherwise agreed between the Parties concerned, where the claim may no longer be contested.

4. The obligation to provide assistance in the recovery of tax claims concerning a deceased person or his estate is limited to the value of the estate or of the property acquired by each beneficiary of the estate, according to whether the claim is to be recovered from the estate or from the beneficiaries thereof.

Article 12
MEASURES OF CONSERVANCY

At the request of the applicant State, the requested State shall, with a view to the recovery of an amount of tax, take measures of conservancy even if the claim is contested or is not yet the subject of an instrument permitting enforcement.

Article 13
DOCUMENTS ACCOMPANYING THE REQUEST

1. The request for administrative assistance under this Section shall be accompanied by:
 - (a) A declaration that the tax claim concerns a tax covered by the Convention and, in the case of recovery, that, subject to paragraph 2 of Article 11, the tax claim is not or may not be contested;
 - (b) An official copy of the instrument permitting enforcement in the applicant State;
and
 - (c) Any other document required for recovery or measures of conservancy.

2. The instrument permitting enforcement in the applicant State shall, where appropriate and in accordance with the provisions in force in the requested State, be accepted, recognized, supplemented or replaced as soon as possible after the date of the receipt of the request for assistance, by an instrument permitting enforcement in the latter State.

Article 14
TIME LIMITS

1. Questions concerning any period beyond which a tax claim cannot be enforced shall be governed by the law of the applicant State. The request for assistance shall give particulars concerning that period.
2. Acts of recovery carried out by the requested State in pursuance of a request for assistance, which, according to the laws of that State, would have the effect of suspending or interrupting the period mentioned in paragraph 1, shall also have this effect under the laws of the applicant State. The requested State shall inform the applicant State about such acts.
3. In any case, the requested State is not obliged to comply with a request for assistance which is submitted after a period of 15 years from the date of the original instrument permitting enforcement.

Article 15
PRIORITY

The tax claim in the recovery of which assistance is provided shall not have in the requested State any priority specially accorded to the tax claims of that State even if the recovery procedure used is the one applicable to its own tax claims.

Article 16
DEFERRAL OF PAYMENT

The requested State may allow deferral of payment or payment by installments if its laws or administrative practice permit it to do so in similar circumstances, but shall first inform the applicant State.

Section III
Service of Documents

Article 17
SERVICE OF DOCUMENTS

1. At the request of the applicant State, the requested State shall serve upon the addressee documents, including those relating to judicial decisions, which emanate from the applicant State and which relate to a tax covered by this Convention.
2. The requested State shall effect service of documents:
 - (a) By a method prescribed by its domestic laws for the service of documents of a substantially similar nature;

- (b) To the extent possible, by a particular method requested by the applicant State or the closest to such method available under its own laws.
- 3. A Party may effect service of documents directly through the post on a person within the territory of another Party.
- 4. Nothing in the Convention shall be construed as invalidating any service of documents by a Party in accordance with its laws.
- 5. When a document is served in accordance with this Article, it need not be accompanied by a translation. However, where it is satisfied that the addressee cannot understand the language of the document, the requested State shall arrange to have it translated into or a summary drafted in its or one of its official languages. Alternatively, it may ask the applicant State to have the document either translated into or accompanied by a summary in one of the official languages of the requested State, the Council of Europe or the OECD.

CHAPTER IV
PROVISIONS RELATING TO ALL FORMS OF ASSISTANCE

Article 18
INFORMATION TO BE PROVIDED BY THE APPLICANT STATE

- 1. A request for assistance shall indicate where appropriate:
 - (a) The authority or agency which initiated the request made by the competent authority;
 - (b) The name, address and any other particulars assisting in the identification of the person in respect of whom the request is made;
 - (c) In the case of a request for information, the form in which the applicant State wishes the information to be supplied in order to meet its needs;
 - (d) In the case of a request for assistance in recovery or measures of conservancy, the nature of the tax claim, the components of the tax claim and the assets from which the tax claim may be recovered;
 - (e) In the case of a request for service of documents, the nature and the subject of the document to be served;
 - (f) Whether it is in conformity with the law and administrative practice of the applicant State and whether it is justified in the light of the requirements of Article 19.
- 2. As soon as any other information relevant to the request for assistance comes to its knowledge, the applicant State shall forward it to the requested State.

Article 19
POSSIBILITY OF DECLINING A REQUEST

The requested State shall not be obliged to accede to a request if the applicant State has not pursued all means available in its own territory, except where recourse to such means would give rise to disproportionate difficulty.

Article 20
RESPONSE TO THE REQUEST FOR ASSISTANCE

1. If the request for assistance is complied with, the requested State shall inform the applicant State of the action taken and of the result of the assistance as soon as possible.
2. If the request is declined, the requested State shall inform the applicant State of that decision and the reason for it as soon as possible.
3. If, with respect to a request for information, the applicant State has specified the form in which it wishes the information to be supplied and the requested State is in a position to do so, the requested State shall supply it in the form requested.

Article 21
PROTECTION OF PERSONS AND LIMITS TO THE OBLIGATION
TO PROVIDE ASSISTANCE

1. Nothing in this Convention shall affect the rights and safeguards secured to persons by the laws or administrative practice of the requested State.
2. Except in the case of Article 14, the provisions of this Convention shall not be construed so as to impose on the requested State the obligation:
 - (a) To carry out measures at variance with its own laws or administrative practice or the laws or administrative practice of the applicant State;
 - (b) To carry out measures which it considers contrary to public policy (*ordre public*) or to its essential interests;
 - (c) To supply information which is not obtainable under its own laws or its administrative practice or under the laws of the applicant State or its administrative practice;
 - (d) To supply information which would disclose any trade, business, industrial, commercial or professional secret, or trade process, or information the disclosure of which would be contrary to public policy (*ordre public*) or to its essential interests;
 - (e) To provide administrative assistance if and insofar as it considers the taxation in the applicant State to be contrary to generally accepted taxation principles or to the provisions of a convention for the avoidance of double taxation, or of any other convention which the requested State has concluded with the applicant State;

- (f) To provide assistance if the application of this Convention would lead to discrimination between a national of the requested State and nationals of the applicant State in the same circumstances.

Article 22
SECRECY

1. Any information obtained by a Party under this Convention shall be treated as secret in the same manner as information obtained under the domestic laws of that Party, or under the conditions of secrecy applying in the supplying Party if such conditions are more restrictive.
2. Such information shall in any case be disclosed only to persons or authorities (including courts and administrative or supervisory bodies) involved in the assessment, collection or recovery of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes of that Party. Only the persons or authorities mentioned above may use the information and then only for such purposes. They may, notwithstanding the provisions of paragraph 1, disclose it in public court proceedings or in judicial decisions relating to such taxes, subject to prior authorization by the competent authority of the supplying Party. However, any two or more Parties may mutually agree to waive the condition of prior authorization.
3. If a Party has made a reservation provided for in sub-paragraph a of paragraph 1 of article 30, any other Party obtaining information from that Party shall not use it for the purpose of a tax in a category subject to the reservation. Similarly, the Party making such a reservation shall not use information obtained under this Convention for the purpose of a tax in a category subject to the reservation.
4. Notwithstanding the provisions of paragraphs 1, 2 and 3, information received by a Party may be used for other purposes when such information may be used for such other purposes under the laws of the supplying Party and the competent authority of that Party authorizes such use. Information provided by a Party to another Party may be transmitted by the latter to a third Party, subject to prior authorization by the competent authority of the first mentioned Party.

Article 23
PROCEEDINGS

1. Proceedings relating to measures taken under this Convention by the requested State will be brought only before the appropriate body of that State.
2. Proceedings relating to measures taken under this Convention by the applicant State, in particular those which, in the field of recovery, concern the existence or the amount of the tax claim or the instrument permitting its enforcement, shall be brought only before the appropriate body of that State. If such proceedings are brought, the applicant State shall inform the requested State, which shall suspend the procedure pending the decision of the body in question. However, the requested State shall, if asked by the applicant State, take measures of conservancy to safeguard recovery. The requested State can also be informed of such proceedings by any interested person.

Upon receipt of such information, the requested State shall consult on the matter, if necessary, with the applicant State.

3. As soon as a final decision in the proceedings has been given, the requested State or the applicant State, as the case may be, shall notify the other State of the decision and the implications which it has for the request for assistance.

CHAPTER V SPECIAL PROVISIONS

Article 24 IMPLEMENTATION OF THE CONVENTION

1. The Parties shall communicate with each other for the implementation of this Convention through their respective competent authorities. The competent authorities may communicate directly for this purpose and may authorize subordinate authorities to act on their behalf. The competent authorities of two or more Parties may mutually agree on the mode of application of the Convention among themselves.

2. Where the requested State considers that the application of this Convention in a particular case would have serious and undesirable consequences, the competent authorities of the requested and of the applicant State shall consult each other and endeavor to resolve the situation by mutual agreement.

3. A coordinating body composed of representatives of the competent authorities of the Parties shall monitor the implementation and development of this Convention, under the aegis of the OECD. To that end, the coordinating body shall recommend any action likely to further the general aims of the Convention. In particular, it shall act as a forum for the study of new methods and procedures to increase international cooperation in tax matters and, where appropriate, it may recommend revisions or amendments to the Convention. States which have signed but not yet ratified, accepted or approved the Convention are entitled to be represented at the meetings of the coordinating body as observers.

4. A Party may ask the coordinating body to furnish opinions on the interpretation of the provisions of the Convention.

5. Where difficulties or doubts arise between two or more Parties regarding the implementation of the Convention, the competent authorities of those Parties shall endeavour to resolve the matter by mutual agreement. The agreement shall be communicated to the coordinating body.

6. The Secretary General of OECD shall inform the Parties and the Signatory States which have not yet ratified, accepted or approved the Convention, of opinions furnished by the coordinating body according to the provisions of paragraph 4 above and of mutual agreements reached under paragraph 5 above.

Article 25
LANGUAGE

Requests for assistance and answers thereto shall be drawn up in one of the official languages of the OECD and of the Council of Europe or in any other language agreed bilaterally between the Contracting States concerned.

Article 26
COSTS

Unless otherwise agreed bilaterally by the Parties concerned:

- (a) Ordinary costs incurred in providing assistance shall be borne by the requested State;
- (b) Extraordinary costs incurred in providing assistance shall be borne by the applicant State.

CHAPTER VI
FINAL PROVISIONS

Article 27
OTHER INTERNATIONAL AGREEMENTS OR ARRANGEMENTS

1. The possibilities of assistance provided by this Convention do not limit, nor are they limited by, those contained in existing or future international agreements or other arrangements between the Parties concerned or other instruments which relate to cooperation in tax matters.
2. Notwithstanding the rules of the present Convention, those Parties which are members of the European Economic Community shall apply in their mutual relations the common rules in force in that Community.

Article 28
SIGNATURE AND ENTRY INTO FORCE OF THE CONVENTION

1. This Convention shall be open for signature by the member States of the Council of Europe and the Member countries of OECD. It is subject to ratification, acceptance or approval. Instruments of ratification, acceptance or approval shall be deposited with one of the Depositaries.
2. This Convention shall enter into force on the first day of the month following the expiration of a period of three months after the date on which five States have expressed their consent to be bound by the Convention in accordance with the provisions of paragraph 1.
3. In respect of any member State of the Council of Europe or any Member country of OECD which subsequently expresses its consent to be bound by it, the Convention shall enter into force on

the first day of the month following the expiration of a period of three months after the date of the deposit of the instrument of ratification, acceptance or approval.

Article 29

TERRITORIAL APPLICATION OF THE CONVENTION

1. Each State may, at the time of signature, or when depositing its instrument of ratification, acceptance or approval, specify the territory or territories to which this Convention shall apply.
2. Any State may, at any later date, by a declaration addressed to one of the Depositories, extend the application of this Convention to any other territory specified in the declaration. In respect of such territory, the Convention shall enter into force on the first day of the month following the expiration of a period of three months after the date of receipt of such declaration by the Depository.
3. Any declaration made under either of the two preceding paragraphs may, in respect of any territory specified in such declaration, be withdrawn by a notification addressed to one of the Depositories. The withdrawal shall become effective on the first day of the month following the expiration of a period of three months after the date of receipt of such notification by the Depository.

Article 30

RESERVATIONS

1. Any State may, at the time of signature or when depositing its instrument of ratification, acceptance or approval or at any later date, declare that it reserves the right:
 - (a) Not to provide any form of assistance in relation to the taxes of other Parties in any of the categories listed in sub-paragraph (b) of paragraph 1 of Article 2, provided that it has not included any domestic tax in that category under Annex A of the Convention;
 - (b) Not to provide assistance in the recovery of any tax claim, or in the recovery of an administrative fine, for all taxes or only for taxes in one or more of the categories listed in paragraph 1 of Article 2;
 - (c) Not to provide assistance in respect of any tax claim which is in existence at the date of entry into force of the Convention in respect of that State or, where a reservation has previously been made under sub-paragraph (a) or (b) above, at the date of withdrawal of such a reservation in relation to taxes in the category in question;
 - (d) Not to provide assistance in the service of documents for all taxes or only for taxes in one or more of the categories listed in paragraph 1 of Article 2;
 - (e) Not to permit the service of documents through the post as provided for in paragraph 3 of Article 17.
2. No other reservation may be made.
3. After the entry into force of the Convention in respect of a Party, that Party may make one or more of the reservations listed in paragraph 1 which it did not make at the time of ratification,

acceptance or approval. Such reservations shall enter into force on the first day of the month following the expiration of a period of three months after the date of receipt of the reservation by one of the Depositaries.

4. Any Party which has made a reservation under paragraphs 1 and 3 may wholly or partly withdraw it by means of a notification addressed to one of the Depositaries. The withdrawal shall take effect on the date of receipt of such notification by the Depositary in question.

5. A Party which has made a reservation in respect of a provision of this Convention may not require the application of that provision by any other Party; it may, however, if its reservation is partial, require the application of that provision insofar as it has itself accepted it.

Article 31 DENUNCIATION

1. Any Party may, at any time, denounce this Convention by means of a notification addressed to one of the Depositaries.

2. Such denunciation shall become effective on the first day of the month following the expiration of a period of three months after the date of receipt of the notification by the Depositary.

3. Any Party which denounces the Convention shall remain bound by the provisions of Article 22 for as long as it retains in its possession any documents or information obtained under the Convention.

Article 32 DEPOSITARIES AND THEIR FUNCTIONS

1. The Depositary with whom an act, notification or communication has been accomplished, shall notify the member States of the Council of Europe and the Member countries of OECD of:

- (a) Any signature;
- (b) The deposit of any instrument of ratification, acceptance or approval;
- (c) Any date of entry into force of this Convention in accordance with the provisions of Articles 28 and 29;
- (d) Any declaration made in pursuance of the provisions of paragraph 3 of Article 4 or paragraph 3 of Article 9 and the withdrawal of any such declaration;
- (e) Any reservation made in pursuance of the provisions of Article 30 and the withdrawal of any reservation effected in pursuance of the provisions of paragraph 4 of Article 30;
- (f) Any notification received in pursuance of the provisions of paragraph 3 or 4 of Article 2, paragraph 3 of Article 3, Article 29 or paragraph 1 of Article 31;
- (g) Any other act, notification or communication relating to this Convention.

2. The Depositary receiving a communication or making a notification in pursuance of the provisions of paragraph 1 shall inform immediately the other Depositary thereof.

IN WITNESS WHEREOF the undersigned, being duly authorized thereto, have signed this Convention.

DONE at Strasbourg, the 25th day of January 1988, in English and French, both texts being equally authentic, in two copies, of which one shall be deposited in the archives of the Council of Europe and the other in the archives of OECD. The Secretaries General of the Council of Europe and of OECD shall transmit certified copies to each member State of the Council of Europe and Member country of OECD.

Certified a true copy of the original, in English and in French, deposited in the archives of the Council of Europe and the OECD.

Paris, this 12th day of September 1989

(Signed)

The Legal Counsel
Head of the Legal Directorate of the OECD

ANNEX 6

THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES IN PRACTICE

I. Introduction

The aim of this paper is to assess the impact of the United Nations Model Double Taxation Convention between Developed and Developing Countries on current tax treaty practice. It is based on an extensive research project in which 811 concluded treaties were scrutinized in order to ascertain whether they adopt the distinctive provisions of the United Nations Model. These provisions were determined by comparing the United Nations Model Convention with the OECD Model Tax Convention on Income and Capital of 1977. The changes made to the OECD Model Convention in 1992 and subsequently were not taken into account.

The research project was carried out using the International Bureau of Fiscal Documentation (IBFD) Tax Treaty Database. It covered all comprehensive tax treaties concluded from 1 January 1980, the year in which the United Nations Model Convention was published, to 1 April 1997, the date of the most recent version of the Tax Treaty Database. The treaties concluded by the former USSR and the former Republic of Yugoslavia that continue to be applied by a number of new states in that region of the world were counted only once.

For the purposes of this research project a distinction had to be drawn between developed and developing countries. Such a distinction inevitably carries an element of subjectivity, and so this invidious task was considerably simplified by reference to membership of the OECD when the United Nations Model Convention was published. The 24 countries that were members of the OECD in 1980 were regarded as developed countries and all other countries were regarded as developing countries, regardless of their actual stage of development. This meant, for example, that Mexico and Hungary, which joined the OECD only recently, were counted as developing countries.

In the first instance, the research focused on the tax treaties concluded by developing countries with either a developed or another developing country. This group, referred to as Group A in this paper, comprised 697 treaties. The project also looked at the tax treaties concluded between OECD countries. That group comprised 114 treaties, and is referred to as Group B.

The following provisions that are specific to the United Nations Model Convention were scrutinized:

Article 5 (3) (a)	Construction activities
Article 5 (3) (b)	Furnishing of services
Articles 5 (4) (a) and (b)	Delivery of goods
Article 5 (4) (f) OECD	Combination of activities
Article 5 (5)	Stock agents
Article 5 (6)	Insurance activities
Article 5 (7)	Agents with one principal

Article 7 (1)	Limited force of attraction
Article 7 (3)	Management fees, interest and royalty payments
Article 7 (5)	OECD Purchase of goods
Article 8B	Shipping profits
Article 12 (3)	Radio and television broadcasting
Article 13 (4)	Real property shares
Article 13 (5)	Other shares
Article 14 (1)	Additional criteria
Article 16 (2)	Top-level managerial officials
Article 18B (1) and (2)	Pensions
Articles 18A (2) and 18B (3)	Social security payments
Article 20 (2)	Equal treatment of students
Article 21 (3)	Source State taxation of other income
Article 25 (4)	Implementation clauses
Article 26 (1)	Prevention of tax fraud/evasion, secret information and implementation

The provisions relating to the withholding taxes on dividends, interest and royalties were not examined as the United Nations Model Convention, unlike the OECD Model Convention, does not recommend a particular percentage for these categories of income. In this respect any withholding rate, including the rates recommended by the OECD Model Convention, is consistent with the United Nations Model Convention. A more fundamental aspect that was not examined is the omission from the United Nations Model Convention of the second sentence of article 4 (1) of the OECD model, which limits the treaty concept of residence. The inclusion or omission of this provision is so intertwined with the rest of the treaty and the domestic law of the treaty partners that it would have been impossible to consider it without extending the project to Herculean proportions.

Even the most cursory glance at a number of concluded treaties is sufficient to reveal the tremendous variety that can be achieved within the confines of a seemingly simple and rigid framework. The authors of this paper had no choice but to select the most important and commonly occurring variations for comment. Nevertheless, where it was felt appropriate, some provisions of particular interest are mentioned even though they are found in only a very limited number of treaties.

II. Article 5 (3) (a): Construction activities

A. The United Nations Model Convention

Article 5 (3) (a) of the United Nations Model Convention reads as follows:

(3) *The term “permanent establishment” likewise encompasses:*

(a) *A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only where such site, project or activities continue for a period of more than six months;*

(b)(...).

The relevant differences between the construction clause of the OECD and the United Nations Model Convention refer to:

- (a) The inclusion of supervisory activities, and
- (b) The minimum period of six months.

B. Tax treaties

1. Supervisory activities

According to the OECD Commentary, supervisory activities are explicitly subsumed under the construction clause, provided the work is performed by the main contractor himself. However, supervisory activities performed by a subcontractor who is not engaged in the physical work do not constitute a permanent establishment. In this respect the United Nations Model Convention departs from the OECD Model Convention. According to the United Nations Model Convention, supervisory activities may constitute a permanent establishment irrespective of whether they are performed by the main contractor or a subcontractor and irrespective of whether the contractor is physically involved in the work.

There are 449 treaties in which supervisory activities are included as one of the elements that may constitute a permanent establishment. Of these treaties 410 have been concluded by developing countries, with either a developed or another developing country (group A), and 39 have been concluded between developed countries (group B).

2. Minimum period

There are 513 treaties that prescribe a minimum period shorter than the 12 months recommended by the OECD Model Convention. Of these treaties 484 have been concluded by developing countries, with either a developed or another developing country (group A), and 29 have been concluded between developed countries (group B). Of the 29 treaties in group B, five prescribe a 9-month period and 24 prescribe a six-month period. The following periods shorter than 12 months are found in the treaties:

Number of treaties	Period	
	Days	Months
50	–	9
2	275	–
2	–	8
1	–	7
355	–	6
58	183	–
1	–	5
5	120	–
29	–	3
3	90	–
7	0*	0*

*No minimum period is included.

There are 298 treaties that prescribe a minimum period of 12 months or longer. Of these treaties 215 have been concluded by developing countries, with either a developed or another developing country (group A), and 83 have been concluded between developed countries (group B). All treaties in group B prescribe a 12-month period.

The following periods of 12 months or longer are found in the treaties:

Number of treaties	Period	
	days	months
2	–	36
4	–	24
3	–	18
289	–	12

For the sake of completeness it should be mentioned that a few treaties contain different limits for the various types of construction activity.

III. Article 5 (3) (b): Furnishing of services

A. The United Nations Model Convention

Article 5 (3) (b) of the United Nations Model Convention reads as follows:

(3) *The term “permanent establishment” likewise encompasses:*

(a)(...);

(b) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

This provision is not specifically included in the OECD Model Convention.

B. Tax treaties

There are 221 tax treaties with a specific provision for the furnishing of services. Of these treaties, 219 have been concluded by developing countries, with either a developed or another developing country (group A), and two have been concluded between developed countries (group B).

The following periods are found in the treaties:

Number of treaties	Period	
	Days	Months
1	–	18
19	–	12
9	–	9
2	275	–
1	–	8
111	–	6
34	183	–
3	–	4
6	120	–
23	–	–

2	91	–
5	90	–
5	0*	0*

*No minimum period is adopted.

In 10 treaties concluded by developing countries (group A) a distinction is made between services performed for unrelated enterprises and services performed for related enterprises. In these treaties a minimum period applies to services performed for unrelated enterprises and no minimum period or a shorter minimum period applies to services performed for related enterprises. Seven treaties prescribe no minimum period in situations involving related parties and three treaties prescribe a shorter period than for situations involving unrelated parties (i.e., 30 days instead of 90 days).

The two treaties between developed countries (group B) prescribe the six-month period recommended by the United Nations Model Convention.

IV. Article 5 (4) (a) and (b): Delivery of goods

A. The United Nations Model Convention

Article 5 (4) (a) and (b) read as follows:

- (4) Notwithstanding the preceding provisions of this article, the term “permanent establishment” shall be deemed not to include:
- (a) The use of facilities solely for the purpose of storage *or* display [] of goods or merchandise belonging to the enterprise;
 - (b) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage *or* display []; (...).

In this paragraph the term “delivery” as provided in the corresponding provisions of the OECD Model Convention is omitted.

B. Tax treaties

There are 167 tax treaties that do not list “delivery” as one of the activities that do not constitute a permanent establishment. All these treaties are concluded by developing countries, with either a developed or another developing country (group A).

V. Article 5 (4) (f) OECD: Combination of activities

A. The United Nations Model Convention

The United Nations Model Convention does not include the provision contained in article 5 (4) (f) of the OECD Model Convention, which is formulated as follows:

“...the maintenance of a fixed place of business solely for any combination of activities, mentioned in subparagraphs a) to e), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.”

B. Tax treaties

In line with the United Nations Model Convention, no provision for the combination of activities is adopted in 264 treaties. Of these treaties 233 have been concluded by developing countries, with either a developed or another developing country (group A), and 31 have been concluded between developed countries (group B).

VI. Article 5 (5) (b): Stock agents

A. The United Nations Model Convention

Article 5 (5) (b) of the United Nations Model Convention reads as follows:

(5) Notwithstanding the provisions of paragraphs 1 and 2, where a person — other than an agent of an independent status to whom paragraph 7 applies — is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such person:

(a) Has and habitually exercises in that State an authority to conclude contracts;

or

(b) *Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.*

This subparagraph b extends the concept of an “agent”.

B. Tax treaties

There are 243 treaties with a specific provision for stock agents. Of these treaties, 234 have been concluded by developing countries, with either a developed or another developing country (group A), and nine have been concluded between developed countries (group B).

These provisions differ in wording, albeit not in content. Thus, in 62 of these treaties reference is made to the fulfilment of orders or to the supply of goods rather than to the delivery of goods.

In addition to the provision for stock agents, 56 of these treaties include a specific provision for agents who habitually secure orders for the sale of goods or merchandise. Further, 30 of these treaties include a specific provision for agents who manufacture or process goods. An example of the first type of provision is:

- (c) *He habitually secures orders for the sale of goods or merchandise in the first-mentioned State, wholly or almost wholly on behalf of the enterprise itself, or on behalf of the enterprise and other enterprises controlled by it or which have a controlling interest in it.*

An example of a provision for agents who manufacture goods is:

- (c) *he manufactures, assembles, processes, packs or distributes in the first-mentioned State for the enterprise goods or merchandise belonging to the enterprise.*

Finally, in two treaties the specific provision for stock agents applies only in the case of abuse. This provision reads as follows:

- (b) *(stock agent)... The foregoing provision of this subparagraph shall apply only if it is proved that in order to avoid taxation in the first-mentioned State, such person undertakes not only the regular delivery of the goods or merchandise, but also undertakes virtually all the activities connected with the sale of goods or merchandise except for the actual conclusion of the sales contract itself.*

VII. Article 5 (6): Insurance activities

A. The United Nations Model Convention

Article 5 (6) of the United Nations Model Convention reads as follows:

- (6) *Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.*

This provision is not included in the OECD Model Convention. The provision broadens the definition of permanent establishment by including the following activities carried on by insurance enterprises:

- (a) The collection of premiums;
- (b) The insurance of risks.

These activities qualify as a permanent establishment only if they are not performed through an agent of an independent status.

B. Tax treaties

There are 210 tax treaties with a specific provision for insurance activities. Of these treaties, 184 have been concluded by developing countries, with either a developed or another developing country (group A), and 26 have been concluded between developed countries (group B).

It should be noted, however, that only in 137 treaties (five of which belong to group B) insurance activities are deemed to constitute a permanent establishment as provided by the United Nations Model Convention. In the remaining 73 treaties (21 of which belong to group B), the same result is achieved by adopting in article 7 or in the protocol to article 7 a provision stating that the provisions of article 7 do not affect the application of domestic law regarding the taxation of profits from insurance business.

In seven treaties in group A the right of the source State to tax profits from insurance activities is limited to 2.5% of the gross amount of the premiums. In one of these treaties this limitation applies only to profits from re-insurance activities, while the right to tax profits from insurance activities remains unlimited.

VIII. Article 5 (7): Agents with one principal

A. The United Nations Model Convention

Article 5 (7) of the United Nations Model Convention reads as follows:

- (7) An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent, or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. *However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph.*

The second sentence of this provision extends the scope of the permanent establishment concept by treating an agent who acts wholly or almost wholly for one principal as a dependent agent.

B. Tax treaties

There are 243 tax treaties with a specific provision for agents with only one principal. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

In 54 of these treaties the scope of this provision is limited to cases in which the transactions between the agent and the enterprise are not on an arm's length basis. An example of such an additional clause is: "*(...) if the transactions between the agent and the enterprise were made under conditions which differ from those which would be made between independent enterprises.*" In five of these treaties the taxpayer is given the possibility of demonstrating that the transactions were concluded in arm's length conditions.

In 22 of these treaties this specific provision not only covers activities performed by the agent on behalf of the enterprise itself, but also activities on behalf of associated enterprises. In that case the provision may be formulated as follows: "However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise *itself or on behalf of that enterprise and other enterprises controlling, controlled by, or subject to the same common control, as that enterprise*, he will not be considered an agent of an independent status within the meaning of this paragraph."

IX. Article 7 (1): Limited force of attraction

A. The United Nations Model Convention

Article 7 (1) contains a force of attraction which is limited as follows:

- (1) The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State, but only so much of them as is attributable to (a) that permanent establishment; (b) *sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.*

Clauses (b) and (c) strengthen the position of the source State by extending its right to tax to profits from business activities that are not carried out by an enterprise through its permanent establishment. The source State may attribute such non-permanent establishment profits to a permanent establishment of the enterprise if they are derived from the sale of goods or merchandise or any other business activity in the source State, provided that these transactions are similar to those concluded through the permanent establishment.

B. Tax treaties

There are 162 treaties with a limited force of attraction rule. Of these treaties 153 have been concluded by developing countries, with either a developed or another developing country (group A), and nine have been concluded between developed countries (group B).

In 38 of these treaties (one of which belongs to group B) the enterprise may prove that the transactions or activities were genuinely carried out otherwise than through the permanent establishment. The wording of this provision differs in the various treaties. Two frequently recurring examples are:

“However, the profits derived from the sales described in subparagraph (b) or other business activities described in subparagraph (c) shall not be taxable in the other State if the enterprise demonstrates that such sales or business activities have been carried out for reasons other than obtaining a benefit under this convention.”

“The provisions of subparagraph (b) and (c) shall not apply if the enterprise shows that such sales or activities could not reasonably have been undertaken by that permanent establishment.”

In 19 of these treaties (five of which belong to group B) the limited force of attraction rule applies only in cases of tax avoidance or abuse. In this case, the burden of proof is on the tax authorities. An example of such a provision is:

“The provisions of subparagraph (b) and (c) shall only apply provided that it is proved that the transaction concerned has been resorted to in order to avoid taxation in the Contracting State where the permanent establishment is situated.”

In 12 treaties (three of which belong to group B) the limited force of attraction rule applies only if there is some connection with the permanent establishment. An example of such a provision is:

“The provisions of subparagraph (b) and (c) shall only apply provided that the permanent establishment has contributed in any manner in those sales or activities.”

In six treaties in group A the scope of the limited force of attraction rule is restricted; the rule applies only to sales of goods or merchandise and business activities of the *same* kind as those sold or effected through the permanent establishment, not to *similar* sales and activities.

One treaty in group A refers only to sales, not to other business activities.

X. Article 7 (3): Management fees, interest and royalty payments

A. The United Nations Model Convention

Article 7 (3) of the United Nations Model Convention reads as follows:

- (3) *In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment, including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management or, except in the case of a banking enterprise, by way of interest on moneys lent to the head office of the enterprise or any of its other offices.*

In the above paragraph the principles laid down in the first sentence are defined and clarified in the second and third sentences.

B. Tax treaties

There are 201 treaties that include a clarification with respect to the determination of the profits of a permanent establishment. Of these treaties, 195 have been concluded by developing countries, with either a developed or another developing country (group A), and six have been concluded between developed countries (group B).

XI. Article 7 (5) OECD: Purchase of goods

A. The United Nations Model Convention

The United Nations Model Convention does not include the provision contained in article 7 (5) of the OECD Model Convention, which is formulated as follows:

No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise.

B. Tax treaties

In line with the United Nations Model Convention, the above-mentioned provision is omitted from 45 treaties. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

XII. Article 8 B: Shipping profits

A. The United Nations Model Convention

Article 8 B (2) of the United Nations Model Convention reads as follows:

Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the overall net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by ... per cent. (The percentage is to be established through bilateral negotiations.) (...)

This provision attributes to the source State a limited right to tax shipping profits, if the shipping activities in the source State are more than casual.

B. Tax treaties

There are 108 treaties providing for source State taxation with respect to shipping profits. Of these treaties, 105 have been concluded by developing countries, with either a developed or another developing country (group A), and three have been concluded between developed countries (group B).

C. Deviations from the United Nations Model Convention

A number of treaties contain provisions similar to, but deviating from, the United Nations Model Convention. The most relevant deviating provisions can be summarized as follows:

- (a) In four treaties in group A the taxing right of the source State is unlimited;
- (b) In 101 treaties in group A and three in group B the right of the source State to tax is not dependent on the activities being “more than casual”. Consequently, under these treaties it is irrelevant whether there is a scheduled or planned visit of a ship to a particular country to pick up freight or passengers;
- (c) In 14 treaties in group A the scope of the provision is extended to air transport profits;

- (d) Five treaties in group A provide for a limited taxing right during the first 10 fiscal years after the entry into force of the treaty. After that period the source State loses its right to tax profits of shipping enterprises of its treaty partner.

In three treaties in group A the taxing right of the source State is limited to profits from the operation of ships between ports of the source State and ports of third States. Profits from operations between ports of the source State and ports of the treaty partner State are therefore not subject to tax in the source State.

D. Limitations to the taxing right of the source State

There are various types of limitation in the 104 treaties that provide for a limited right to tax in the source State. These limitations can be summarized as follows:

- (a) Fifty-nine treaties in group A and three in group B provide for a reduction of the tax imposed by the source State by 50%;
- (b) One treaty in group A provides for a reduction of the tax imposed by the source State by 2/3;
- (c) Five treaties in group A provide for a reduction of the tax imposed by the source State of 50% during the first five years after the entry into force of the treaty and of 25% during the subsequent five years;
- (d) Eight treaties in group A allow a withholding tax to be levied on the gross amount of the receipts derived in the source State. The withholding percentages vary from 1% to 3%;
- (e) Five treaties in group A provide for a maximum taxation in the source State equal to the lesser of 50% of the tax imposed by domestic law and a certain percentage of the gross receipts derived in that State. The percentage varies from 2% to 4%;
- (f) Thirteen treaties provide that the tax charged by the source State “*shall not exceed the lesser of: (a) 1.5% of the gross revenue derived from sources in that State; and (b) the lowest rate of (name of one Contracting State) tax that may be imposed on profits of the same kind derived under similar circumstances by a resident of a third State*”. In one of these treaties, the percentage in (a) is 1% rather than 1.5%;
- (g) Ten treaties provide that (a) the tax imposed by the source State is to be reduced by 50% and (b) the taxable profits are to be deemed not to exceed a certain percentage of the gross receipts. The percentage varies from 5% to 7.5%.

XIII. Article 12 (3): Radio or television broadcasting

A. The United Nations Model Convention

The royalty definition of article 12 (3) of the United Nations Model Convention reads as follows:

- (3) The term “royalties” as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, *or films or tapes used for radio or television broadcasting*, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

The OECD Model Convention does not include in the definition of the term “royalties” payments made as a consideration for the use of, or the right to use, films or tapes used for radio or television broadcasting.

B. Tax treaties

There are 712 treaties that mention films or tapes used for radio or television broadcasting in the royalty definition. Of these treaties, 610 have been concluded by developing countries, with either a developed or another developing country (group A), and 102 have been concluded between developed countries (group B).

It should be mentioned, however, that radio broadcasting is not mentioned in 39 treaties in group A and six treaties in group B. Further, six treaties in group A and five in group B include a generic reference to sound and video recording or to all means of reproduction of sound and image, while television and radio broadcasting are not expressly mentioned.

XIV. Article 13 (4): Real property shares

A. The United Nations Model Convention

Article 13 (4) of the United Nations Model Convention reads as follows:

- (4) *Gains from the alienation of shares of the capital stock of a company, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State, may be taxed in that State.*

This provision is not specifically included in the OECD Model Convention.

B. Tax treaties

There are 374 treaties with a specific provision for real property shares. Of these treaties, 308 have been concluded by developing countries, with either a developed or another developing country (group A), and 66 have been concluded between developed countries (group B). In a number of these treaties, real property shares are not dealt with in a separate paragraph, but together with gains on the alienation of real property in the first paragraph of the capital gains article.

In many treaties real property shares quoted on an approved stock exchange are excluded from this special regime. On the other hand quite a number of treaties specifically include interests in real property partnerships and/or trusts.

In nine treaties the special regime for real property shares applies only if the participation exceeds a certain limit.

XV. Article 13 (5): Other shares

A. The United Nations Model Convention

Article 13 (5) of the United Nations Model Convention reads as follows:

(5) *Gains from the alienation of shares other than those mentioned in paragraph 4 representing a participation of...per cent (the percentage is to be established through bilateral negotiations) in a company which is a resident of a Contracting State may be taxed in that State.*

Under the OECD Model Convention the right to tax capital gains on the alienation of shares is attributed to the State of which the alienator is resident, whereas under the United Nations Model Convention this right is attributed to the State of which the company is resident (the source State).

B. Tax treaties

There are 384 treaties which more or less follow the recommendation of the United Nations Model Convention. Of these treaties, 322 have been concluded by developing countries, with either a developed or another developing country (group A), and 62 have been concluded between developed countries (group B).

In all these treaties, the taxing right on capital gains on shares is explicitly attributed to the source State. It should be mentioned, however, that the same result may be achieved without such an explicit attribution. This is the case if, for example, the capital gains article does not contain a sweeping clause and there is no other income article, or there is an other income article that is in conformity with article 21 (3) of the United Nations Model Convention. Such situations in which the source State can apply its domestic legislation are not included in the above-mentioned figures.

Further, it should be mentioned that the structure and wording of the regime for capital gains on shares in many treaties deviate considerably from the recommendation of the United Nations Model Convention set out above. The complexity of this regime in many treaties makes it difficult to consider its elements in isolation rather than in their entire context. Nevertheless, a few general remarks can be made.

In many treaties the taxation right attributed to the source State is limited:

- (a) In 82 treaties in group A and 25 treaties in group B, the source State has only the right to tax capital gains on shares derived by individuals who emigrated to the treaty partner state. In most of these treaties this taxation right is limited to a certain period after emigration;
- (b) In 13 treaties in group A the tax that the source State may levy on capital gains on shares is explicitly limited to a certain percentage varying from 10 to 25%;
- (c) In seven treaties in group A and one in group B the taxation right of the source State is limited by the exclusion of capital gains realized in the course of a corporate organization, reorganization, amalgamation, division or similar transaction;
- (d) In two treaties in group A and three in group B the taxation right of the source State is limited to cases in which the shares are sold to a resident of the source State.

In 228 treaties in group A and 50 treaties in group B no minimum participation requirement is adopted. Of the remaining 106 treaties 44 have a participation requirement based on the shares sold and 62 have one based on the shares owned by the seller.

XVI. Article 14 (1): Additional criteria

A. The United Nations Model Convention

Article 14 (1) of the United Nations Model Convention reads as follows:

- (1) Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State *except in the following circumstances, when such income may also be taxed in the other contracting State:*
 - (a) If he has [] a fixed base *regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or*
 - (b) *If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in the fiscal year concerned; in*

that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State; or

- (c) *If the remuneration for his activities in the other Contracting State is paid by a resident of that Contracting State or is borne by a permanent establishment or a fixed base situated in that Contracting State and exceeds in the fiscal year... (the amount is to be established through bilateral negotiations).*

The principal differences between the independent personal services provisions of the OECD and the United Nations Models are to be found in the criteria based on:

- a) A length of stay of 183 days, and
- b) An amount of remuneration.

B. Tax treaties

1. The length of stay

In comparison with the OECD Model Convention the source State’s right to tax is extended by a provision that it may tax if a professional is present in that State for at least 183 days in a fiscal year, even if there is no fixed base.

There are 284 tax treaties with a length of stay criterion. Of these treaties, 264 have been concluded by developing countries, with either a developed or another developing country (group A), and 20 have been concluded between developed countries (group B).

The following periods are found in the treaties:

Number of treaties	Length of stay	
	Days	Months
225	183 days	
1	182 days	
2	180 days	
1		6 months
17	120 days	
2	91 days	
36	90 days	

There are no treaties between developed countries that prescribe a period shorter than 183 days.

The length of stay must be computed over the fiscal year, a period of 12 months or the calendar year. One treaty, however, provides for a length of stay (183 days) to be computed over two consecutive years.

No fixed base criterion has been adopted in 46 of these treaties, two of which have been concluded between developed countries. In one treaty in group A neither a fixed base nor a 183 days' presence in the source State is per se sufficient to attribute a taxing right to the source State, but both criteria must be met at the same time.

In two treaties in group A the right to tax is attributed to the source State if a fixed base is maintained in that State for at least 183 days. In this case, the existence of the fixed base is irrelevant if it is not maintained for a period of at least 183 days. On the other hand, the fact that a professional stays in the source State for more than 183 days is also not relevant in the absence of a fixed base maintained for the said period.

2. The amount of remuneration

In the United Nations Model Convention the source State's right to tax is extended by a provision that the source State may tax any remuneration for independent personal services that exceeds a certain amount.

There are 45 tax treaties that include a criterion based on the amount of remuneration. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

No fixed base criterion has been adopted in 14 of these treaties; two of them also include no length of stay criterion.

XVII. Article 16 (2): Top-level managerial officials

A. The United Nations Model Convention

Article 16 (2) of the United Nations Model Convention reads as follows:

- (2) *Salaries, wages and other similar remuneration derived by a resident of a Contracting State in his capacity as an official in a top-level managerial position of a company which is a resident of the other Contracting State may be taxed in that other State.*

In this provision the principle applicable to the taxation of directors' fees is extended to the taxation of the remuneration paid to top-level managerial officials.

B. Tax treaties

There are 68 treaties dealing with remuneration paid to top-level managerial officials. Of these treaties 62 have been concluded by developing countries, with either a developed or another developing country (group A), and six have been concluded between developed countries (group B).

In 11 of these treaties (five of which belong to group B) a definition is adopted of the term “top-level managerial function”. According to this definition the term applies only to functions similar to those carried out by the members of the board of directors referred to in article 16 (1) of the OECD and the United Nations Models.

In seven of these treaties (three of which belong to group B), remuneration for the discharge of day-to-day functions is excluded from the scope of article 16. In these treaties such remuneration is covered by article 15 (Dependent personal services).

XVIII. Article 18A (2) and 18B (3): Social security payments

A. The United Nations Model Convention

The provision recommended by the United Nations Model Convention in Article 18A (2) and 18B (3) on social security payments reads as follows:

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

This provision is not specifically included in the OECD Model Convention. It attributes an exclusive taxation right to the source State.

B. Tax treaties

There are 254 treaties with a separate provision for social security payments attributing the right to tax to the source State. Of these treaties, 206 have been concluded by developing countries, with either a developed or another developing country (group A), and 48 have been concluded between developed countries (group B).

Most of these treaties prescribe an exclusive taxation right. Only in 31 treaties in group A and 20 treaties in group B is a non-exclusive taxation right attributed to the source State.

In 15 treaties in group A and five in group B the taxation right attributed to the source State is limited by the exclusion of social security payments made to an individual who is both a resident and a national of the treaty partner State. In one treaty in group A and one treaty in group B the taxation right of the source State is limited to social security payments made to nationals of the

source State. Finally, in one treaty in group B the taxation right of the source State is limited by a maximum rate of 17.5%.

XIX. Article 18B (1) and (2): Pensions

A. The United Nations Model Convention

The provisions recommended by the United Nations Model Convention in Article 18B (1) and (2) on pensions read as follows:

- (1) Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration to past employment *may be taxed* in that State.
- (2) *However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.*

The OECD Model Convention does not attribute any right to tax to the source State. The United Nations Model Convention attributes a non-exclusive taxation right to the source State.

B. Tax treaties

There are 295 treaties attributing to the source State a right to tax pensions. Of these treaties, 259 have been concluded by developing countries, with either a developed or another developing country (group A), and 36 have been concluded between developed countries (group B).

Most of these treaties prescribe a non-exclusive taxation right. Only in 41 treaties in group A and 4 treaties in group B is an exclusive taxation right attributed to the source State. In one treaty in group B the exclusive taxation right of the source State applies only to the State's own nationals.

In 149 treaties in group A and 28 in group B the taxation right of the source State applies to annuities. It should be noted, however, that in six of those treaties in group A the source State taxation applies only to annuities and not to pension payments which are taxable exclusively in the residence State.

In 16 treaties in group A and 8 treaties in group B the taxation right of the source State is limited to lump sum payments, while all other pension payments are taxable only in the residence State of the recipient.

In a number of treaties the right of the source State to tax pensions is not specifically dealt with by a separate treaty provision. In 14 treaties in group A and three treaties in group B this taxation right is based on an "other income" article that is in line with the United Nations Model Convention. In six treaties there is no "other income" article, which means that the source State can apply its domestic law.

In 34 treaties in group A and six in group B the taxation right of the source State is limited to a percentage that varies from 5% to 20%. Furthermore, two treaties in group B provide for a reduction of 50% of the ordinary tax rate in the source State. In most of these treaties the limited flat rate does not apply in all cases. In some treaties the limited taxation right applies only to periodic payments, while lump sum payments are subject to ordinary taxation. In other treaties pensions are subject to a limited taxation right or, if lower, the tax which would be due by a resident of the source State on the pension payment and/or annuity. Further, there are treaties providing for different percentages for pension payments and annuities.

In six treaties in group A and one in group B the taxation right of the source State is limited to payments that exceed a certain amount per year. In six other treaties in group A the allocation of the taxation right to the source State is subject to the condition that the pension and/or annuity is borne, paid or deducted by an enterprise or a permanent establishment situated in that State.

In nine treaties in group A and two in group B the taxation right of the source State is limited to pensions and/or annuities that are paid to a former resident of the source State.

In a number of treaties the taxation right of the source State depends in various configurations on the nationality of the receiver of the pension payment or annuity. A few other treaties contain a number of other additional conditions.

XX. Article 20 (2): Equal treatment of students

A. The United Nations Model Convention

Article 20 (2) of the United Nations Model Convention reads as follows:

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

This provision is not specifically included in the OECD Model Convention.

B. Tax treaties

There are 53 treaties with a specific equal treatment provision for students. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

It should be mentioned, however, that there are many treaties prescribing a greater exemption, relief or reduction than that recommended by the United Nations Model Convention.

XXI. Article 21 (3): Source State taxation of other income

A. The United Nations Model Convention

Article 21 (3) of the United Nations Model Convention reads as follows:

- (3) *Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.*

This provision deviates from the OECD Model Convention in that the source State may tax “other income” that arises in the source State.

B. Tax treaties

There are 343 treaties providing for source State taxation on “other income” arising in the source State. Of these treaties, 308 have been concluded by developing countries, with either a developed or another developing country (group A), and 36 have been concluded between developed countries (group B).

It should be mentioned that there is no “other income” article in 38 treaties. Such situations in which the source State can apply its domestic legislation are not included in the above-mentioned figures.

Three of these treaties in group A provide for a withholding tax to be applied on the gross amount of “other income”. The withholding rates are 10, 15 and 17.5%. Three other treaties in group A attribute an exclusive taxing right to the source State rather than the non-exclusive taxing right prescribed by the United Nations Model Convention.

XXII. Article 25 (4): Implementation clauses

A. The United Nations Model Convention

Article 25 (4) of the United Nations Model Convention contains the following bilateral (second sentence) and unilateral (third sentence) implementation clauses:

- (4) *(...). The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.*

This provision is not specifically included in the OECD Model Convention.

B. Tax treaties

There are 39 treaties that cover the implementation of the mutual agreement procedure. In 27 treaties, only the bilateral implementation clause of the second sentence is adopted, and in one treaty, only the unilateral implementation clause of the third sentence is adopted. The remaining 11 treaties include both implementation clauses.

All these treaties have been concluded by developing countries, with either a developed or another developing country (group A). None of them has been concluded between developed countries.

XXIII. Article 26 (1): Prevention of tax fraud/evasion, secret information and implementation

A. The United Nations Model Convention

Article 26 (1) of the United Nations Model Convention reads as follows:

- (1) The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, insofar as the taxation thereunder is not contrary to the Convention, *in particular for the prevention of fraud or evasion of such taxes*. The exchange of information is not restricted by article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. *However, if the information is originally regarded as secret in the transmitting State it shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention*. Such persons or authorities shall use the information only for such purposes *but may disclose the information in public court proceedings or in judicial decisions*. *The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.*

B. Tax treaties

1. Prevention of tax fraud/evasion (first sentence)

There are 154 treaties that explicitly refer to the prevention of tax fraud or evasion. Of these treaties 146 have been concluded by developing countries, with either a developed or another developing country (group A), and 8 have been concluded between developed countries (group B).

There are only a few treaties the wording of which deviates from the recommendations of the United Nations Model Convention.

2. Secret information (fourth sentence)

There are 50 treaties explicitly dealing with information that is secret in the transmitting State. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

3. Implementation clause (last sentence)

There are 65 treaties that cover the implementation of the exchange of information. All these treaties have been concluded by developing countries, with either a developed or another developing country (group A).

A few of these treaties do not contain any reference to tax avoidance.

XXIV. Summary

United Nations Model Convention	Tax treaties	
	Group A	Group B
Article 5 (3) (a): supervisory activities	410	39
period < 12 months	484	29
Article 5 (3) (b)	219	2
Article 5 (4) (a) and (b)	167	–
Article 5 (4) (f) OECD	233	31
Article 5 (5)	234	9
Article 5 (6)	184	26
Article 5 (7)	243	–
Article 7 (1)	153	9

Article 7 (3)	195	6
Article 7 (5) OECD	45	–
Article 8 B	105	3
Article 12 (3)	610	102
Article 13 (4)	308	66
Article 13 (5)	322	62
Article 14 (1) (b)	264	20
Article 14 (1) (c)	45	–
Article 16 (2)	62	6
Article 18A (2) and B (3)	206	48
Article B (1) (2)	259	36
Article 20 (2)	53	–
Article 21 (3)	308	36
Article 25 (4): Implementation clauses	39	–
Article 26 (1): Prevention of fraud/evasion	146	8
Secret information	50	–
Implementation clause	65	–
Tax treaties 1980/1997	697	114