Comments in response to "Call for public comments on the Committee's draft agenda"

- *Radhakishan Rawal*[1]

Many thanks for accepting one of the suggestions I had made during the 22nd Session and giving this opportunity to offer inputs for setting agenda for next four years to the observers. I would like to suggest inclusion of the following three items in the agenda.

1. Mechanism to quickly adopt changes to the UN Model in existing tax treaties – UN MLI

The UN Tax Committee is doing excellent work by including new Articles in the UN Model and amending the existing Articles. These would have no practical implications of these changes to the model unless the treaty provisions are amended. Amendment of existing treaties through the normal bilateral negotiation mechanism could take several years and the amendments to the UN Model could be theoretical.

For quick amendments to the existing tax treaties, a Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (referred to as "BEPS MLI" for the purpose of this discussion) was developed as a part of OECD/G20 BEPS Package. BEPS MLI is currently operational and has been signed by more than 90 countries. To implement proposals of Pillar One and Two more MLIs are contemplated.

It is reasonable to state that Multilateral Instruments will play an important role in international taxation in the years to come. To quickly implement such changes in the tax treaties, it is desirable that UN Tax Committee also develops and implements MLI mechanism.

Existing BEPS MLI contains certain provisions related to UN Model as well. Accordingly, the new UN MLI can be created in a manner that there is no overlap between the UN and BEPS MLI. Further, certain difficulties with the BEPS MLI can be addressed in the proposed UN MLI and UN MLI could be an improved version. My Concept Note[2] on UN MLI can be accessed at https://www.southcentre.int/tax-cooperation-policy-brief-15-june-2021/

2. Issues related to indirect transfer

Changes to Article 13 of the UN Model, related to offshore indirect transfer, were approved by the Committee in the twenty second session. The Committee may evaluate need to address some of the issues raised in my earlier submissions reproduced in E/C.18/2020/CRP.36.

https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-10/CRP36%20for%2021st%20session%20-%20Capital%20gains%20on%20OIT%207OCT20.pdf

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[1] Radhakishan Rawal is a Mumbai, India based Chartered Accountant. The comments made in this note are personal comments and not on behalf of any organization.

[2] Certain observations as regards intergovernmental tax committee, contained in the Concept Note can be ignored as those comments were from the perspective of FACTI Panel report and the Concept Note was prepared for presentation at an Ambassador-level close briefing conducted for the Permanent Representatives of the G77 in Geneva organised by South Center and FACTI Panel.

3. Certain structural issues in the UN Model

Interplay between Article 14 and Articles 10, 11, 12 and 12A of the UN Model appear to be resulting in certain inconsistent and unintended results. This could be for the reason that historically there existed difference between Article 14 of the UN Model and OECD Model before deletion of Article 14 from the OECD Model. While Article 14(1) of the UN Model had three sub-clauses (subsequently reduced to two), the OECD Model Article 14 had only one sub-clause dealing with fixed base and provisions of Articles 10, 11 and 12 of the UN Model were drafted only in the context of fixed base.

A note submitted by me, highlighting these issues in October 2016, is reproduced as ***Annexure A***. The Committee may evaluate the need to address the issues raised. The Committee may also want to examine the rationale behind adoption of limited force of attraction rule in Article 7(1) but not in Article 14.

Annexure A

UN Model

Interplay between Article 14 and Article 10,11, 12 & 12A

1. Certain broad principles of the UN Model

1.1 Principle for giving full or limited taxing right to the source country

The various Articles of the UN Model Conventions distribute taxing rights between the source and the resident country. The broad principle followed in such distribution for certain categories of income is that if the presence of the recipient of income (non-resident) in the source country is beyond ***a defined threshold***, then the source country is given unlimited rights to tax such income as per its domestic law.

This principle is adopted in Article10(4), 11(4), 12(4) and 12A(5) [3].

In case the defined threshold is not met then for certain categories of income then the source country gets a limited right to tax the income. Article 10(2), 11(2),12(2) and 12A(2) specify the rate beyond the source country cannot levy tax.

1.2 Principle for deciding place of accrual of certain categories of income

Deductibility of certain categories of payments in the source country is threshold for determining place of accrual of such income. The rationale is very clear if the deduction for the amount is allowed in the source country, then the source country should be able to levy tax on such amount and hence the amount is deemed to be accruing in such state.

This principle is adopted in Article 11(5), 12(5) and 12A(6).

2. Inconsistent application of the principles

The defined threshold is "permanent establishment" in the source country under Article 7 and "fixed base" or "presence over 183 days" in the source country under Article 14. If the defined threshold is met then the source country gets unlimited right to tax such income.

[3] At draft stage the article was referred as Article XX. The original submission in 2016 did not refer to Article 12A. This number is replaced now.

However, the principles narrated in ***para 1.1*** and ***1.2*** are not applied consistently. The inconsistency is as regards one of the defined thresholds i.e. presence over 183 days in the source country.

2.1 Inconsistent application of principle narrated in para 1.1

The inconsistent application of principle narrated in ***para 1.1*** arises as a result absence of reference to 183 days presence in Article10(4), 11(4), 12(4) and 12A(5). These provisions deny application of the provisions of Article 10, 11, 12 and 12A, which give only limited taxing rights to the source country, when the non-resident has a permanent establishment or a fixed base in the source country. The source country gets a full taxing rights in such cases.

Logically, this principle should also be applied when the non-resident's presence exceeds more than 183 days and the provisions of Article 14 are attracted.

2.1 Inconsistent application of principle narrated in para 1.2

The inconsistent application of principle narrated in ***para 1.2*** arises as a result of absence of reference to 183 days presence in Article 11(5), 12(5) and 12A(6). These provisions provide that the income shall be deemed to be accruing in the source country when the deduction for the payment is available to the non-resident payer from taxable income of the permanent establishment or the fixed base. As a result of this the source country gets rights to tax such income.

Logically, this principle should also be applied when the non-resident's presence exceeds more than 183 days and the provisions of Article 14 are attracted. In other words, the income should be deemed to be arising in the source country if deduction for the same is allowed to the non-resident having presence exceeding 183 days (i.e. when Article 14 is triggered in such situation).

These inconsistencies result in undesirable or unintended results. This is explained on the basis of examples in the subsequent paragraphs.

3. Examples explaining result of inconsistent application of the principle narrated in para 1.1

3.1 Example A

Mr. R is a tax resident of Country R and is engaged in providing professional services. During the year Mr. R was present in Country S for 190 days and rendered services to S Limited, a company resident of Country S. Mr. R does not have a fixed base available to him in Country S. As per the contractual arrangement between Mr. R and Company S, Mr. R was required to deposit an amount of USD 1 mn in an escrow account with Bank S in Country S. Company S would be entitled to get this money in case Mr. R fails to fulfil his contractual obligations. On successful fulfilment of the contract, Mr. R will be entitle to take the deposit amount and the interest given by Bank on such deposit in Country S.

As per the domestic law the income earned by Mr. R is subject to tax in Country S @40% on net basis. As per the tax treaty between Country S and Country R, Country S cannot levy tax on the interest arising in Country S at a rate higher than 5%.

In this situation, ideally Country S should be able to levy tax on the entire income earned by Mr. R from Country S @40%. However, in absence of reference to presence of 183 days in Article 11(4) of the tax treaty between Country S and Country R, Country S will not be able to levy tax on the interest income at a rate exceeding 5%. This curtailment on the taxing rights of Country S produces unintended or undesirable results.

3.2 Example B

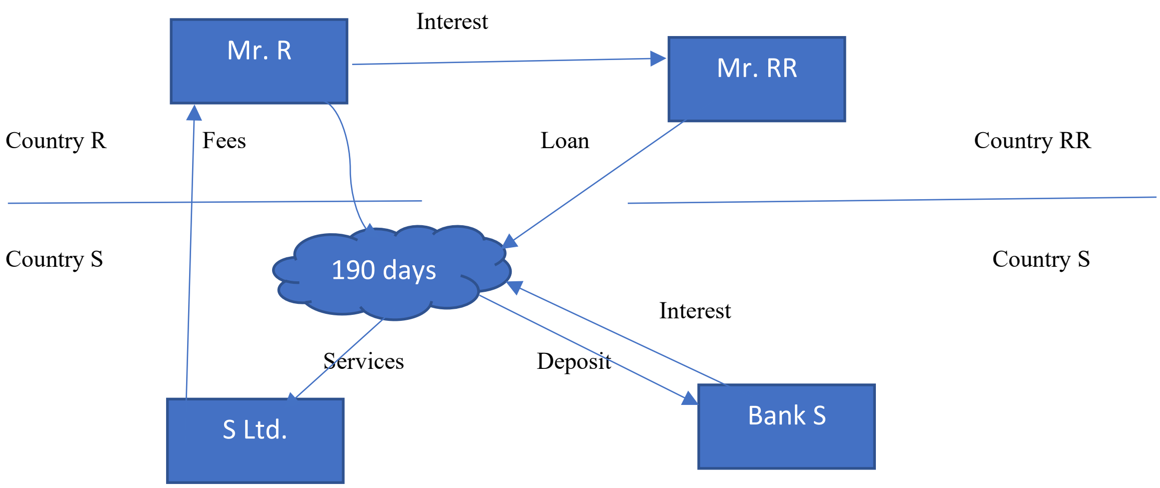
If required, similar examples could be created in the context of royalties and fees for technical services.

4. Examples explaining result of inconsistent application of the principle narrated in para 1.2

4.1 Example X

Mr. R is a tax resident of Country R and is engaged in providing professional services. During the year Mr. R was present in Country S for 190 days and rendered services to S Limited, a company resident of Country S. Mr. R does not have a fixed base available to him in Country S. As per the contractual arrangement between Mr. R and Company S, Mr. R was required to deposit an amount of USD 1 mn in an escrow account with Bank S in Country S. Company S would be entitled to get this money in case Mr. R fails to fulfil his contractual obligations.

Mr. R has borrowed USD 1 mn from Mr. RR who is a tax resident of Country RR. Mr. RR does not have permanent establishment or fixed base in Country S.



Mr. R is taxed in Country S in terms of Article 14 read with domestic law on net basis. Thus Mr. R will be eligible to claim deduction for the interest paid by it to Mr. RR. However, Country S will not be able to levy tax on the interest paid by Mr. R to Mr. RR. This is for the reason that Article 11(5) of the tax treaty between Country S and Country RR does not make any reference to presence for period exceeding 183 days.

This gives unintended or undesirable results. While Mr. R gets deduction for interest paid to Mr. RR (and saves 40% tax liability), Country S is not able to levy tax on such interest income.

4.2 Example Y

If required, similar examples could be created in the context of royalties and fees for technical services.

5. Potential solution

Potential solution could be to make a specific reference to the presence for period exceeding 183 days in the relevant provisions.

If Article 11(4) and 11(5) are to be amended on this basis, the amended text could be as follows:

> *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 or performs such services for a period exceeding 183 days as referred in Article 14(1)(b), and the debt claim in respect of which the interest is paid is effectively connected with (a) such permanent establishment or fixed base or presence exceeding 183 days as referred in Article 14(1)(b), 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 or is present in the Contracting State as referred in Article 14(1)(b) 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 or is deductible while determining income arising as a result of presence exceeding 183 days as contemplated in Article 14(1)(b), then such interest shall be deemed to arise in the State in which the permanent establishment or fixed base is situated or independent personal services as contemplated in Article 14(1)(b) are rendered.*

This is just an initial draft and there could be significant scope for improvement.

6. Way forward

The UN Committee may want to further examine this issue and a sub-committee may be set up for this purpose.

7. General

This note is prepared in the personal capacity of the author. The issues raised, views expressed, suggestions made are not on behalf of any organization.