E/C.18/2024/CRP.30

Distr.: General
27 September 2024

Original: English

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

Geneva, 15-18 October 2024

Item 3(c) of the provisional agenda

Issues related to the United Nations Model Double Taxation Convention between Developed and Developing Countries

Co-Coordinators' Report: Technical issues arising under Article 6

Summary

This note is provided to the Committee for ***first discussion*** at its Twenty-ninth Session.

At its Twenty-fourth Session, the Committee approved the Subcommittee's work program, which included technical issues arising under Article 6. The Subcommittee has now drafted proposed changes to the text of Article 6 of the UN Model and to its Commentary to address technical issues relating to the definition of immovable property and the effect on residence State taxation of the allocation rule of Article 6.

The Committee is invited to have a ***first discussion*** of the changes described in paragraphs 9, 10 and 12.

I. Introduction

1. At its Twenty-third Session, the Committee of Experts identified a number of issues that it considered to be priorities for the work of the Subcommittee on the Update of the UN Model. The treatment of immovable property was not included on that list. However, the Committee was also aware that the Subcommittee might look at technical issues regarding the operation or interpretation of the UN Model.

2. At the first meeting of the Subcommittee in January 2022, participants raised issues with respect to both the definition of immovable property and with the allocation rule found in Article 6. These were included in the Subcommittee's proposed work plan in paragraph 13 of the Co-Coordinators' Report, E/C.18/2022/CRP.2, as follows:

> …Several participants raised concerns with respect to Article 6. One is a technical issue regarding the definition of immovable property. The current approach of the article allows the situs country to define the scope of the provision unilaterally through changes to domestic law. Disputes may arise when the scope covers properties which are commonly regarded as movable assets. The Subcommittee has been urged to consider language that would limit that unilateral power and enhance certainty. Another participant raised the issue of capital flight from developing countries to investment in immovable property in developed countries. The Subcommittee was not able to discuss this issue at its January meeting but plans to have a first discussion at a future meeting.

The Subcommittee's proposed work plan as described in the Co-Coordinators' report was approved at the Twenty-fourth Session of the Committee.

3. Section II of this note describes a technical issue regarding the definition of immovable property in Article 6 and a proposed change to the text of the Article and its Commentary. Section III describes a small change to the Commentary on Article 6 to explain the operation of the article's allocation rule. The Annex provides the complete Commentary on Article 6 to show how the proposed revisions would fit into the existing text as well as setting out some minor conforming changes.

II. Issues regarding the definition of "immovable property"

4. The definition of immovable property in paragraph 2 of Article 6 is somewhat unusual in that it begins with a reference to the situs State's domestic law, but then includes a list of types of property that will "in any case" constitute immovable property. The Commentary explains that the reference to the domestic law of the situs state is intended to alleviate difficulties of interpretation with regard to whether an asset or a right is to be regarded as immovable property. The positive and negative lists in the second sentence provide some uniformity across countries. Issues have arisen with respect to both parts of the definition.

5. The reference to domestic law may give rise to unintended results. For instance, where the law of a Contracting State has a wide range of items defined or deemed as immovable property, including properties which are normally recognized as movable properties, the income derived from such properties would fall under paragraph 1 of Article 6, and that from the alienation of shares which derived more than 50 per cent of their value from such properties would fall under paragraph 4 of Article 13. In both situations, the income or gains from properties which are normally recognized as movable properties would be taxed, which may not have been intended by the negotiators.

6. A possible reason for such an outcome may be that the definition of immovable property in the domestic law of the Contracting State is not designed for income tax purposes. For example, some property

tax regimes provide special rules or rates for real property used in farming. Such concessions may apply to not only the real property itself, but also property that is erected on the land (such as buildings) or affixed to the land (such as milking equipment and seed cleaning equipment).[1] Such exemptions may also apply to tangible personal property related to farming while the same property may be subject to the *ad valorem* tax when used for some other purpose, such as processing of agricultural products.

7. A similar problem arises when one Contracting State has modified its domestic law, after a treaty has come into force, to include in the definition of "immovable property" ownership interests in entities that own immovable property located in that State. The intention may be to allow that State to exercise taxing rights under Article 13(4). However, does that change in domestic law also create taxing rights under Article 13(1) even in the absence of Article 13(4)?

8. Article 3(2) of the UN Model includes a reference to a Contracting State's domestic law, but also imposes some limits on that Contracting State's application of its domestic law. It reads:

> 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.

9. Article 3(2) does not apply to Article 6(2) because the term "immovable property" is not an undefined term. However, participants in the Subcommittee found the approach of Article 3(2) instructive. Accordingly, the Subcommittee proposes a small change to Article 6(2) to adopt a similar approach. The revised Article 6(2) would read:

> 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 ***unless the context otherwise requires***. 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 and aircraft shall not be regarded as immovable property.

10. The Commentary to the paragraph would also be modified. The Subcommittee proposes the following changes:

> 6. This paragraph, which gives the term "immovable property" the meaning that it has under the law of the Contracting State in which the property is situated, is intended to alleviate difficulties of interpretation with regard to whether an asset or a right is to be regarded as immovable property ***by deferring to the law of that State. However, the situs State's definition of immovable property must be consistent with the context in which a bilateral treaty was negotiated and is interpreted. That is, the relevant definition is one used for income tax purposes, such as any definition applicable to rules regarding taxation of non-residents on the gain from the sale of immovable property, not for property tax or other purposes. Moreover, the definition should not include property that generally is viewed as "movable property", unless such movable property is permanently***

[1] OAR 150-307-0010 Real Property (U.S. State of Oregon exemption from *ad valorem* taxation).

attached to immovable property (sometimes known as a "fixture"), as in the case of built-in bookshelves or a central heating and air conditioning system.

[7.] The paragraph additionally lists a number of assets and rights which are in any case to be regarded as covered by the term. On the other hand, the paragraph provides that ships and aircraft shall not be regarded as immovable property. Interest from debt secured by immovable property is not covered by Article 6 but is instead dealt with under Article 11 relating to interest.

III. The allocation of taxing rights under paragraph 1

11. Paragraph 1 of Article 6 provides:

> 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.

Unlike some other articles, it does not say anything about taxation in the residence State. However, changes were made in 2021 to paragraph 15 of the Introduction to the UN Model with the intention of making it clear that the use of the term "may be taxed" does not prevent taxation in the residence State. This paragraph reads, in part:

> …More specifically, tax treaties establish which Contracting State shall have jurisdiction to tax a given item of income or capital and under what conditions and subject to which limitations it may do so. For that purpose, both the United Nations Model Tax Convention and the OECD Model Tax Convention identify various categories of income and indicate in which of the Contracting States such income "shall be taxable only" or "may be taxed". In this respect, it is important to note, as is done in paragraph 25.1 of the Introduction of the 2017 version of the OECD Model Tax Convention, that
>
> > … throughout the Convention, the words "may be taxed in" a Contracting State mean that that State is granted the right to tax the income to which the relevant provision applies and that these words do not affect the right to tax of the other Contracting State, except through the application of Article 23 A or 23 B when that other State is the State of residence.

12. Several participants in the Subcommittee have suggested that it would be helpful to developing countries to make this point explicit in the Commentary on Article 6, as there has been confusion in at least one reported case over this issue. The Subcommittee therefore proposes the following change to the Commentary on Article 6:

> 5. This paragraph ***provides that*** ~~grants the right to tax~~ income from immovable property (including income from agriculture or forestry) ***may be taxed in*** ~~to the State of source, that is,~~ the State where the property in question is situated. ***It does not, however, provide that income from immovable property may be taxed exclusively in that State and therefore leaves the possibility of taxation by the State of residence of the recipient of the income from such immovable property. Double taxation is eliminated or reduced through exemption or tax credit in the residence country.***
>
> [6.] Paragraph 1 of the Commentary on Article 6 of the 2017 OECD Model Tax Convention explains that this provision is based on "the fact that there is always a very close economic connection between the source of this income and the State of source" and provides the

following additional explanations, which the Committee considers to be applicable to paragraph 1 of Article 6 of the United Nations Model Tax Convention:

> […] Although income from agriculture or forestry is included in Article 6, Contracting States are free to agree in their bilateral conventions to treat such income under Article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such income.

IV. Issues for the Committee

13. The Committee is invited to have a ***first discussion*** of the changes described in paragraphs 9, 10 and 12 above.

ANNEX

Complete Commentary on Article 6
(with proposed changes)

Article 6

INCOME FROM IMMOVABLE PROPERTY

A. General considerations

1. Article 6 of the ~~United Nations~~ Model ~~Tax Convention~~ reproduces Article 6 of the OECD Model Tax Convention with the exception of the phrase "and to income from immovable property used for the performance of independent personal services" which appears at the end of paragraph 4 of ***Article 6 of*** the ~~United Nations~~ Model ~~Tax Convention~~. This phrase is included in the ~~United Nations~~ Model ~~Tax Convention~~ as a result of the retention of Article 14 dealing with Independent Personal Services.

2. In taxing income from immovable property, the object should be the taxation of profits rather than of gross income; the expenses incurred in earning income from immovable [real] property or from agriculture or forestry should therefore be taken into account. This objective should not, however, preclude the use of a withholding tax on rents from immovable [real] property, based on gross income; in such cases the rate should take into account the fact that expenses have been incurred. On the other hand, if a withholding tax on gross rents is used, it will be just as satisfactory if the owner of the immovable [real] property can elect to have the income from the property taxed on a net basis under the regular income tax. Article 6 is not intended to prevent a country which taxes income from agriculture or other immovable property on an estimated or similar basis from continuing to use that method.

3. Some members of the former Group of Experts were of the view that the distribution of dividends by a company referred to in paragraph 4 of Article 13 should be treated as income from immovable property and, therefore, as covered by Article 6. However, this view was not shared by most other members.

4. It was noted that in some countries, a person may receive income (typically rental income) from immovable property in circumstances where that person instead of directly owning the immovable property owns shares of a company owning that property and that the ownership of those shares entitles that person to the use or enjoyment of the property. Contracting States are free to expand the scope of the Article to cover the deemed income from that use or enjoyment. They may also expand the scope of Article 22 to allow source taxation of shares of such companies.

B. Commentary on the paragraphs of Article 6

Paragraph 1

5. This paragraph ***provides that*** ~~grants the right to tax~~ income from immovable property (including income from agriculture or forestry) ***may be taxed in*** ~~to the State of source, that is,~~ the State where the property in question is situated. ***It does not, however, provide that income from immovable property may be taxed exclusively in that State and therefore leaves the possibility of taxation by the State of residence of the recipient of the income from such immovable property. Double taxation is eliminated or reduced through exemption or tax credit in the residence country.***

6. Paragraph 1 of the Commentary on Article 6 of the 2017 OECD Model Tax Convention explains that this provision is based on "the fact that there is always a very close economic connection between the source

of this income and the State of source" and provides the following additional explanations, which the Committee considers to be applicable to paragraph 1 of Article 6 of ~~the United Nations~~ ***this*** Model ~~Tax Convention~~:

> […] Although income from agriculture or forestry is included in Article 6, Contracting States are free to agree in their bilateral conventions to treat such income under Article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting State. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such income.

Paragraph 2

7~~6~~. This paragraph, which gives the term "immovable property" the meaning that it has under the law of the Contracting State in which the property is situated, is intended to alleviate difficulties of interpretation with regard to whether an asset or a right is to be regarded as immovable property ***by deferring to the law of that State. However, the situs State's definition of immovable property must be consistent with the context in which a bilateral treaty was negotiated and is interpreted. That is, the relevant definition is one used for income tax purposes, such as any definition applicable to rules regarding taxation of non-residents on the gain from the sale of immovable property, not for property tax or other purposes. Moreover, the definition should not include property that generally is viewed as "movable property", unless such movable property is permanently attached to immovable property (sometimes known as a "fixture"), as in the case of built-in bookshelves or a central heating and air conditioning system.***

8. The paragraph additionally lists a number of assets and rights which are in any case to be regarded as covered by the term. On the other hand, the paragraph provides that ships and aircraft shall not be regarded as immovable property. Interest from debt secured by immovable property is not covered by Article 6 but is instead dealt with under Article 11 relating to interest.

Paragraph 3

9~~7~~. This paragraph provides that the general rule set forth in paragraph 1 shall apply regardless of the way in which immovable property is used.

Paragraph 4

10~~8~~. This paragraph stipulates that the provisions of paragraphs 1 and 3 apply also to income from immovable property of industrial, commercial and other enterprises and to income from immovable property used for the performance of independent personal services. The Committee considers that the following explanations found in the Commentary on Article 6 of the 2017 OECD Model Tax Convention are applicable to paragraph 4 of ***this***~~the United Nations~~ Model ~~Tax Convention~~ but that they apply equally in the case of income from immovable property used for the performance of independent personal services by reason of the inclusion of such income in paragraph 4:

> 4. *[…]* the right to tax of the State of source has priority over the right to tax of the other State and applies also where in the case of an enterprise income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment *[or fixed base]*, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment *[or fixed base]* situated in that State. It should further be noted that the provisions of the Article do not prejudge the

application of domestic law as regards the manner in which income from immovable property is to be taxed.