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Revision of the Manual for the Negotiation of Bilateral Tax Treaties

Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties

Summary

This note comprises a part of the draft revision of the Manual for Negotiation of

BASIC APPROACHES TO TAX TREATY NEGOTIATION

Introduction

Income tax treaties (technically "conventions") begin with the recitation that they are entered into between countries for the purposes of avoiding double taxation of international income flows and the prevention of fiscal evasion with respect to taxes on income and capital gains. The problem of potential international double taxation arises each time an enterprise enters into an inter-country transaction or an individual steps across an international boundary. Taxing conflicts arise in these situations when the countries involved each lay claim to an income tax on resulting income or profits. Historically, the initial measures invoked to alleviate international double taxation were unilateral in nature. Some countries employ a foreign tax credit or offset mechanism. Other countries use an exemption mechanism whereby foreign source income earned by their residents is exempted from domestic taxation. Additional countries use either the tax credit or exemption methods in different tax contexts. Both of the foregoing unilateral tax relief measures recognize the primacy of other countries source taxation structures.

Nevertheless, many countries have found it necessary to supplement unilateral measures by entering into a network of bilateral tax treaties their principal commercial partners and other countries with which their taxpayers are involved in trade or investment. A principal goal of tax treaties is agreement on common definitions of income source, residency and a sufficient nexus (permanent establishment) to subject commercial and industrial profits to source country taxation. Other important goals include reduction of source country withholding rates on passive income such as interest, dividends and royalties, elimination of double taxation, prevention of fiscal evasion with respect to taxes on income and capital gains, tax administration cooperation, and a mechanism for resolving tax disputes between the treaty partners. Tax treaties between developed and developing countries frequently take into account differing levels of economic development, fiscal administration resources and tax structure complexities.

Any tax treaty negotiator must be aware that two major model treaties are used by most countries as a starting point for tax treaty negotiations. The model treaties (which are included in the Appendix) are:

1. OECD Model Convention on Income and on Capital

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

The United States employs its own U. S. Treasury Model Convention as a treaty negotiation starting point in particular with developing countries. Other countries have formally or informally published "Model" treaties setting forth the basic positions their treaty negotiators will take in an opening round of treaty discussions. The following discussion highlights the considerations involved in tax treaty negotiations and the differences in approach between the most recent drafts of the OECD and UN model treaties.

In this portion of the Manual we will state the UN Model as it presently exists and follow it with a discussion of each Article. Where we discuss another treaty or the OECD

EXAMPLE: United States treaties contain a "savings clause" which provides that the United States in determining its taxes of U.S. citizens, residents or corporations may, regardless of other treaty provisions, include all items of income taxable under U.S. revenue laws on the basis upon which the United States imposes taxes. Thus, U.S. citizens, residents and corporations may expect to benefit from a tax treaty only to the extent the foreign treaty partner makes concessions with respect to its own taxes not otherwise creditable for foreign tax credit purposes.

UN MODEL

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

DISCUSSION

Article 2

TAXES COVERED

The model treaties each contain 4 paragraphs, the first two of which broadly define what taxes, both income and capital, are covered by the treaty. However, most actually negotiated treaties dispense with inclusion of the first two paragraphs and move immediately to include the third paragraph of the model treaties. The third paragraph specifies exactly which taxes of each treaty partner are to be applicable to the treaty. (See the treaties in the Appendix)

EXAMPLE: New Zealand-South Africa

1. The existing taxes to which this Agreement shall apply are:

    (a) in New Zealand

    the income tax

    (hereinafter referred to as "New Zealand tax")

    (b) in South Africa

        (i) the normal tax

        (ii) the secondary tax on companies; and

        (iii) the withholding tax on royalties

Many treaties also contain a provision similar to paragraph 4 of the model treaties which provides that the treaty will also apply to any identical or similar taxes which are imposed after the treaty is in force. The paragraph requires the competent authorities of the Contracting States to notify each other within a reasonable time of any significant changes that have been made in their tax laws.

SIGNIFICANCE: The definition of taxes covered relates directly to which taxes are to be accorded unilateral tax relief via the credit or exemptions mechanisms pursuant to Article 23 of the model treaties, titled Methods for the Elimination of Double Taxation. Specificity in defining the taxes to be covered by the treaty is therefore critical as taxes of either country not included in the definition of taxes covered by the treaty will not qualify for foreign tax credit purposes. This is especially important where a tax is not a pure income tax, e.g. a trade tax or net worth tax.

UN MODEL

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.

DISCUSSION

Article 3

GENERAL DEFINITIONS

The model treaties use Article 3 to group a number of general definitions required for interpretation of the terms used in a treaty. They are “person”, “company”, “enterprise of a Contracting State”, “international traffic” and “national”. Actually negotiated treaties with countries which use place of incorporation to define corporate residence (e.g. United States, Mexico) may contain the term “resident” instead of “place of effective management” in the definition of “international traffic”

Space is also left for the designation of the “competent authority” of each Contracting State which is important for the settlement of treaty disputes under the mutual agreement procedure set forth in Article 25 of the model treaties. 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, Article 6 and dividends, Article 10) is clarified in the articles concerned. Treaty negotiators are free to agree bilaterally on definitions of the terms “a Contracting State” and “the other Contracting State”. Negotiators may alssilalalalalalalhhhla(75wi275wi

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tax treaties may be overridden by subsequent domestic legislation, or that domestic law and treaties are of equal status. As a consequence, in the case of conflict the latter in time prevails. Yet, domestic law treaty overrides are rare.

UN MODEL

Article 4

DISCUSSION

Article 4

RESIDENT

The treaty term “resident of a Contracting State” as defined in Article 4 of the UN model treaty (which varies slightly from the OECD model) 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. However, the term 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. Moreover, it should again be emphasized that under Article 3 of the model treaties the term “person” includes not only individuals, but also a company or any other body of persons.

Most actually negotiated treaties follow the model treaties by looking first to the internal law definition of residence of each State. However, where there is a conflict in those definitions Article 4 of the model treaties lists in decreasing order of relevance a number of subsidiary criteria to be applied when an individual is a resident of both countries under their internal laws to determine which State the individual is considered to be a resident for purposes of the treaty. If none of these criteria (See Article 4(2))is determinative of the individual’s residence status determination of residence is settled by the competent authorities of the Contracting States.

EXAMPLE: Assume X maintains permanent homes in both Australia and Mexico. However, X, a Mexican citizen, keeps his bank accounts and investments in Mexico. Under the Australia-Mexico Treaty, Article 4(b) X is deemed to have closer ties to Mexico (his centre of vital interests) and would be deemed a resident of Mexico for purposes of the treaty.

Note: Some treaties such as the China-United States Treaty dispense with the use of any subsidiary criteria in the event of a residence conflict and instead immediately invoke the competent authority procedure to determine residency.

SIGNIFICANCE:

UN MODEL

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;

(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* *those hich o l h ve een e et een in e en ent enter rises he ill not e*

Article 5(6) of the UN Model does not have a counterpart in the OECD Model. It provides that the collection of premiums or insurance of risks, except re-insurance transactions, in the other State by an insurance company of a Contracting State will be deemed to the an agency permanent establishment unless the activities are performed through an independent agent.

OECD Model Art 5(7) and UN Model Article 6(8) both provide that the existence of a subsidiary company in a treaty country does not of itself constitute that subsidiary a permanent establishment of its parent company. However, it should be noted that a subsidiary company may constitute a permanent establishment of its parent if the subsidiary satisfies the dependent agent requirements under Art 5(5).

UN MODEL

Article

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Article 6(1) of the model treaties recognizes that there is always a very close economic connection between an immovable property (real estate) income source and the country of such source. Thus, the source country is accorded the primary right to tax income from immovable property located therein. Negotiated treaties frequently allow the owner of immovable property located in another treaty country to be taxed on net income basis by the source country. The UN Model commentary notes that the objective should not be to preclude the use of a withholding tax on rents from real property based upon gross income; in such cases the withholding rate should take into account the fact that expenses have been incurred. The UN Model commentary takes the further position that Article 6 is not intended to preclude a country which taxes income from agriculture or other

regular market. The Commentary to the OECD model indicates that the profits so attributable are normally the profits shown on the books of the establishment. The tax authorities of the country in which the permanent establishment is located are, however, permitted to use the provisions of its own internal laws to rectify the accounts of the enterprise so as to properly reflect income which the establishment would have earned if it were an independent enterprise dealing with its head office at arm's length. Moreover, Article 7(4) of both model treaties provides that in so far as it has been customary for a treaty country in which a permanent establishment is located to determine profits to be attributed to the permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing contained in Article 7(2) shall preclude the use of such apportionment method if it accords with the Article 7 principles. However, the profits attributed to a permanent establishment must be determined by using the same method year by year unless there is a good and sufficient reason to the contrary. (UN model Article 7(5), OECD model Article 7(6)).

The model treaties differ substantially regarding the difficult and complex problems of the deductions allowed to the permanent establishment. Both model treaties in Article 7(3) provide that in determining the profits of a permanent establishment, allowance shall be made for expenses, wherever incurred, for purposes of the business of the permanent establishment, including executive and general administrative expenses. However, the UN model recognizes that there are some classes of expenditures that give rise to special problems. These include interest and royalties, etc., paid by the permanent establishment to its head office in return for money loaned or patent rights licensed by the head office to the permanent establishment. Also included are 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 permanent establishment. In

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.

DISCUSSION

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Article 8 of both model treaties limits taxation of profits from the operation of aircraft to the treaty partner country in which the effective place of management of the enterprise is situated. The OECD model applies the same approach to the taxation of profits from the operation of ships, the rationale being that shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend, potentially subjecting the enterprise to taxation on amounts exceeding its total income. This approach, used in treaties between developed countries as well as some treaties between developed and developing countries, creates a major exception to the taxation of business profits on the basis of the permanent establishment principle set forth in Article 7. However, some developing countries have entered into tax treaties that adopt the principle of source taxation and of sharing the revenue at an agreed percentage. This latter approach is consistent with the UN model, Article 8 (2) Alternative B. The UN model article allows taxation of shipping profits by a treaty partner in the case where( )-2(A)1(I)1(R(e)-l *n ~~enter rise of~~ Contr ctin St te rtici tes irectl or in irectl in the* charging prevailing market prices to each other (see related discussion under Article 7). Although such profits might at first be assumed to be those shown on the books of the establishments, Article 9 of the model treaties permits a treaty partner tax authority to rectify the accounts of the enterprise when necessary.

> **EXAMPLE:** Subsidiary (S) located in Mexico sells automobile mufflers to its parent company (P) located in Germany for $40 per muffler. S also sells exactly the same muffler to an independent third party (I) for $50 per muffler. Under Article 9 of their tax treaty Mexican tax authorities may make an adjustment to S's profit from sales to P to reflect the same profit margin earned by S on its sales to I.

An allocation of additional profit to S by Mexico may give rise to economic double taxation if P has already reported and been taxed upon such profit in Germany. Article 9(2) of the model treaties provides that in these circumstances, Germany shall make an appropriate adjustment so as to relieve the double taxation. However, an adjustment is not automatically to be made by Germany simply because the profits in Mexico have been increased. The adjustment is due only if Germany considers that the figure of adjusted profits correctly reflects what the profits would have been had the transactions been at arm's length. Consequently, transfer pricing is an issue of primary importance, both to developed and developing countries, in connection with the proper international treatment of multinational corporations and their complex network of subsidiaries and branches. Thus, it is important to consider Article 9 in conjunction with Article 25 on mutual agreement procedures intended to resolve double taxation conflicts and Article 26 on exchange of information.

In 1999 the UN model inserted a new Article 9(3). It provides that Article 9(2) shall not apply where judicial administrative or other legal proceedings have resulted in a final ruling that, by 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 willful default. A taxpayer may be subject to both tax and non-tax penalties under the article.

UN MODEL

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DISCUSSION

Article 10

DIVIDENDS

All countries impose a tax on the business profits generated within their boundaries by a corporation. In addition, profits distributed by a domestic corporation as dividends are generally subject to tax in the hands of a shareholder, either by way of a flat rate withholding tax at the time the dividends are paid or when the shareholder's total tax liability is determined, or both. As foreign shareholders are normally beyond the reach of a country, the dividends they receive are subject in most countries to a withholding tax regardless of whether resident shareholders are subject to such a form of taxation.

When the foreign shareholder is a parent corporation, owning a significant portion of the stock of the dividend-paying subsidiary corporation, the combination of the corporation tax on the subsidiary and the dividend source withholding tax may exceed the tax payable the withholding tax paid in the source treaty partner country from the amount of tax the resident country charges on the dividend. (See Articles 23A and 23B of the model treaties)

Article 11

NTEREST

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DISCUSSION

Article 11

INTEREST

On a national level interest income is not liable to double taxation, as it is taxed only at the level of the lender; or, if the payer is obliged to withhold a certain portion of the interest as a tax, the recipient can, under provisions of the national law, deduct the amount withheld 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. Internationally, double taxation of interest may arise from the fact that the interest income is taxed in the State in which it arises and also in the State of the residence of the beneficial recipient. Such international double taxation may considerably reduce the amount of interest income received by the beneficiary, or if the payer has agreed to bear the cost of the interest source withholding tax, will increase the financial burden on the payer.

Article 11(3) of both model treaties define the term “interest” for Article 11 purposes to mean 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 are not interest.

In practice, differences exist between the kinds of capital on which interest is payable. It may be payable on investments such as bonds or on loans granted by savers, thereby representing net income for the recipient. Interest may also be paid to financial institutions which may borrow money on capital markets and pay interest as remuneration for the capital obtained. Consequently, both model treaties adopt a split jurisdiction approach to taxation of interest income in Article 11(1) allowing both source country and residence country taxation. In Art 11(2) the OECD model provides that if the beneficial owner of the interest is a resident of the other contracting state source country taxation shall not exceed 10 per cent of the gross amount of the interest. By contrast, the UN model leaves the percentage of source country withholding on interest income to be established by bilateral negotiations. Article 11(4) of both model treaties excludes from Art 11(1) and (2) interest income received by beneficial owners in which the interest arises, through a permanent establishment situated in the source country or performance of independent personal services from a fixed base therein to which the interest paid is effectively connected. In such cases the provisions of Article 7 (business profits) or Article 14 (independent personal services) are applicable. Under a modified force of attraction rule the UN model also makes Article 11(1) and (2) inapplicable is a debt claim is effectively connected with the permanent establishment or fixed base or business in the source country of the same or similar kind as those effected through the permanent establishment Finally, Article 11(6) restricts application of Article 11 in the case of related parties to the amount of interest that would have been paid had the parties been operating at arm's length.

The rationale for the UN model bilateral negotiation approach is that withholding rates

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DISCUSSION

Article 12

ROYALTIES

For tax treaty negotiators the topic of royalties requires careful consideration especially with regard to (1) source country taxation and (2) the definition of what constitutes a royalty. For instance, the OECD model in Article 12 (1) precludes source country royalty taxation and allows only for the exclusive taxation of royalties in the State of the beneficial owner's residence. Yet, more than 50% of all actually negotiated tax treaties allow for some royalty taxation in the source country. Also, no fewer than thirteen OECD member states have entered a reservation against the zero source withholding rate provided in Article 12(1) of the OECD model. Hence, in practice, the split jurisdiction concept contained in the UN model seems to be a more realistic approach to international royalty taxation. Articles 12(1) and (2) of the UN model allow both residency country taxation and source country taxation by withholding at a rate not exceeding a percentage to be established by bilateral negotiations. Unlike the OECD model, the UN model does not contain the term beneficial owner in Article 12(1) which deals with royalty taxation by a residency state. Instead, it is incorporated in Article 12(2) which allows source country taxation of royalty income.

Both models exclude Article 12 coverage in the case of royalties received by beneficial owners in which the royalties arise, though a permanent establishment situated in the source country or the performance of 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 the permanent establishment or base. The UN model broadens the exclusion to also include business activities referred to in paragraph 1 of Article 7 of the UN model. In such cases the provisions of Article 7 or 14, as the case may be, shall apply. Also, both models restrict the application of Article 12 in the case of related parties to the amount of royalties that would have been paid had the parties been operating at arm's length. Finally, the UN model contains Article 12(5) an innovation not found in Article 12 of the OECD model. The paragraph provides that royalties are considered income from sources in the residence country of the payer of the royalties. Where, however, the right or property for which the royalty was paid was used in a state having a place of use rule, the royalty would be deemed to arise in that state.

Article 12(3) of the UN model defines the term "royalties" to mean payments of any kind received as consideration for the use of, or the right to use, any copyright or literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, 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 Article 12(2) is almost equivalent, but eliminates from the definition of royalty: equipment rental, i.e. films or tapes used for radio or television broadcasting, and the right to use industrial, commercial or scientific equipment. No fewer than 13 of the OECD member states have entered reservations concerning OECD Article 12(2) definition of royalty. Most of the reservations reflect an adherence to the scope of inclusion under the UN model Article 12(3). Many recent actual treaties show a great degree of divergence from the OECD model. For instance, practically all treaties include remuneration for the use of, or the right to use equipment. Treaties with developing countries tend to soften the concept of royalties in relation to consulting activities or similar services, such as by including commercial or technical assistance in the enumeration of subjects capable of being licensed. Treaty negotiators continue to struggle with the concept of know-how which can be pure royalties for the use of intangible property under Article 12, pure technical assistance which generally falls under Articles 7 or 14, or a mixed contract which may need to be apportioned.

UN MODEL

Article 1

CAP TA A NS

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DISCUSSION

Article 13

CAPITAL GAINS

Domestically, taxation of capital gains varies considerably from country to country based upon factors such as whether capital gains are taxed at all; the rate at which capital gains are taxed (i.e., as ordinary income or at a lower rate); the method of calculating capital gains (e.g. is basis adjusted for inflation) and the capital gains treatment of differing types of property (e.g. business versus investment). Thus, tax treaties leave the decision of whether capital gains should be taxed and, if they are taxable how they are to be taxed to the domestic law of each treaty partner. Except as provided otherwise in Article 13, the model treaties state that as a general rule gains from the alienation of property are taxable partnership, trust or estate. A substantial number of actually negotiated tax treaties contain a provision that reflects, but may broaden or narrow, the substance of Article 13(4) of the UN model. Recently, the OECD inserted a new Article 13(4) in its model. It provides that gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that State.

UN MODEL

Article 1

NDEPENDENT PERSONA SERV CES

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DISCUSSION

Article 14

INDEPENDENT PERSONAL SERVICES

Under Article 14 of the UN model income derived by a resident of a Contracting State from professional services and other activities of an independent character may be taxed exclusively by the residence State unless a split jurisdiction approach with the source State applies because: (1) he has a fixed base regularly available to him in the source State for the purpose of performing his activities or (2) his stay in the source State exceeds 183 days in any 12 month period during the fiscal year concerned. Then such income may be taxed in the source State as far as it is attributable to the fixed base or the year of presence in the source State. If he has no fixed base or does not meet the source State presence requirement he will enjoy exemption from source State taxation. A substantial number of actually negotiated treaties contain an Article 14 type provision essentially adopting the UN position that there may be some uncertainty that the criteria for establishing a fixed based as opposed to a permanent establishment ought to be identical or whether a fixed base might be comparable to a permanent establishment yet consist of some lesser activity in certain cases.

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DISCUSSION

Article 15

DEPENDENT PERSONAL SERVICES (UN Model)

INCOME FROM EMPLOYMENT (OECD Model)

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DISCUSSION

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS (UN Model)

DIRECTORS' FEES (OECD Model)

Article 16 of both model treaties overrides the jurisdictional principles contained in Articles 15 (both models) and Art 14 (UN model) in the following cases. Directors' fees and other similar payments (including payments in kind and fringe benefits such as health insurance and club memberships) are not limited to taxation in the State of residence of the director or in the State where the services are performed and may be taxed in the State where the company is resident. The State of residency will grant relief from international double taxation under Article 23. The director may be an individual or a legal person, and the fees need not necessarily be paid by the company but can be paid by a third party.

Article 16(2) of the UN model includes an additional paragraph not found in the OECD model. It subjects remuneration paid to top-level managerial officials to the same principle as directors' fees. Under the UN model 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 resident in the other Contracting State may be taxed in that other State. The term "top-level position" refers to a limited group of positions that involve primary responsibility for the general direction of the affairs of the company, apart from the activities of the directors. However, the term covers a person acting as both a director and a top-level manager. A significant number of actually negotiated treaties, especially treaties between developing countries, contain a provision dealing with remuneration paid to top-level managers.

UN MODEL

Article 1

ART STES AND SPORTS PERSONS

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DISCUSSION

Article 17

ARTISTES AND SPORTSPERSONS (UN Model)

ARTISTES AND SPORTSMEN (OECD Model)

Article 17(1) of the model treaties provides that income derived by an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or a sportsperson may be taxed in the State where their personal activities are exercised. Where Article 17(1) applies, Articles 7, 14 (UN model) and 15 are overridden. Hence, the taxpayer is not exempted from tax in the State where his personal activities are exercised with regard to the fact that he has no permanent establishment. (the UN model adds the phrase “or fixed base”) in that State or that he is present there for a period not exceeding 183 during any 12 month period. Article 17(2) provides that where income in respect of personal activities exercised by the entertainer or sportsperson in his capacity as such accrues not to the entertainer or sportsperson himself, but to another person, that income may notwithstanding the provisions of Articles 7, 14 (UN model) and 15 be taxed where the activities are exercised. This provision is aimed in part at a particular from of tax avoidance where a performer contracts with another person that the other person will have the right to the performer’s services, (sometimes referred to as loan out companies).

UN MODEL

Article 1

PENS ONS AND SOC A SEC R T PA ENTS

Article 1 ltern tive A

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Article 1 ltern tive

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DISCUSSION

Article 18

PENSIONS AND SOCIAL SECURITY PAYMENTS (UN Model)
PENSIONS (OECD Model)

Article 18 of the OECD model requires that, subject to Article 19(2), private pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only by his country of residence regardless of the country in which the pension rights may have accrued. Yet, even the OECD commentary notes the reluctance of some OECD States to adopt an exclusive residence country taxation approach to pension benefits and suggests the possibility of a split jurisdiction

jurisdiction tax approach by providing that pensions and other similar payments 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 State where a permanent establishment is situated may thereby indirectly recoup the prior tax benefit it extended to the permanent establishment by allowing deductions for contributions to its pension plans.

UN MODEL

Article 1

OVERN ENT SERV CE

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The rovisions of rticles 1 1 n 1 sh ll l to s l ries es n other si il r re ner tion n to ensions in res ect of services ren ere in connection ith siness c rrie on Contr ctin St te or olitic l s ivision or loc l thorit thereof

DISCUSSION

Article 19

GOVERNMENT SERVICE

The provisions of Article 19 regarding taxation of government service are virtually which they are studying provided the sources for payments arise from sources outside that State. Some actually negotiated treaties add a provision dealing with visiting academics.

UN MODEL

Article 1

OT ER NCO E

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DISCUSSION

Article 21

OTHER INCOME

Art. 21(1) of the models sets forth the residual and exclusive right (with the exceptions subsequently detailed) of the State of residence to tax any items of income, wherever arising, not dealt with in the other taxing jurisdiction allocation rules of the found in the treaty. The income concerned is not only the income of a class not expressly dealt with, but also income from sources not expressly mentioned. The Article especially applies to income having its source in a third State and paid to a resident of one contracting State, or income having its source in one Contracting State and paid to a resident of the same State.

Art. 21(2) of both models provides for an exception to the foregoing general rule where the other income is effectively connected with the activity of a permanent establishment (or fixed base UN model) which a resident of one of the Contracting

States has in the other Contracting State. In such event the provisions of Art.7 (or Art. 14 UN model), as the case may be shall apply. Art. 21(2) does not apply to immovable property, as defined in Art.6(2). The OECD Commentary states that immovable property situated in a Contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient thereof is a resident.

Art. 21(3) of the UN model is an addition not found in the OECD model. It states that notwithstanding the provisions of paragraphs 1 and 2 of Art. 21, items of income of a resident of a Contracting State not otherwise dealt with in the other treaty articles and arising in the other Contracting State may also be taxed in that other State. It is intended to permit the country in which the income arises to tax such income if its law so provides while the provision of Art. 21(1) would permit taxation only in the country of residence. The concurrent application of Arts.21(1) and 21(3) may generate international double taxation subject to elimination under Art. 23.

Finally, the UN Group of Experts noted that there are very artificial devices entered into by persons seeking to take advantage of Art. 21, especially if Art. 21(3) is omitted. The issue may specifically be addressed by adding the following clause:

“The provisions of this article shall not apply if it was the main purpose or one of the main purposes of any individual concerned with the creation or assignments of the rights in respect of which income is paid to take advantage of this article by means of that creation or assignment”

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DISCUSSION

Article 22

CAPITAL

Art. 22 applies to taxes on the possession or ownership of capital, not the income or gains from capital. (e.g. net wealth taxes) as well as the exclusion of taxes on estates and inheritances and on gifts and of transfer duties. The first three paragraphs of Art.22 are identical in structure to the first three paragraphs of Art. 13. Therefore, capital is taxable exclusively in the State of residence, subject to the same three exceptions found in Art. 13. They are:

(1) A resident of a Contracting State who owns immovable property referred to in Art. 6 which is 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 by that other State. The UN model Art. 22(2) also extends such treatment to 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.

(3) In the case of capital represented by 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, such capital may only be taxed in the

DISCUSSION

UN MODEL

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

DISCUSSION

Article 24

NON-DISCRIMINATION

Article 24 is identical in both model treaties. Non-discrimination clauses, such as Article 24, have historically formed the backbone of tax treaties. Under Article 24(1) each treaty country must not discriminate against nationals of the other Contracting State resident in its territory by taxing them more severely than its own nationals. Designed to assure equal tax treatment in each treaty country for its own citizens and the citizens of its treaty partner, the non-discrimination clause offers protection for the nationals of both countries from differential tax treatment by supplementing internal laws against discrimination.

contains two additional sentences allowing the competent authorities to develop both unilateral and bilateral measures to implement the mutual agreement procedure. They are also to consult together for the elimination of double taxation in cases not provided for in the treaty. The UN model commentary, as well as some actually negotiated treaties, specifically authorize the competent authorities to endeavor to agree in the area of allocation of income and expenses between related enterprises or units of the same business enterprise operating in both Contracting States. (E.g. U.S.- France treaty, Art. 25(2))

As advantageous as the current competent authority structure is, in practice its use may be limited. For instance, the competent authority to which a claim is made has to determine the request merits consideration. A negative determination affords the taxpayer no further recourse for the avoidance of double taxation. Also, no remedy exists of the competent authorities do not happen to agree. The UN Commentary suggests the possibility of adding an arbitration clause in such cases. A large number of recent actual negotiated treaties have inserted optional or mandatory arbitration clauses in their mutual agreement procedure articles.

UN MODEL

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

(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).*

DISCUSSION

Article 26

EXCHANGE OF INFORMATION

In order to serve the goal of preventing international double taxation without creating enhanced opportunities for tax evasion and avoidance, tax treaties include a provision to ensure the cooperation between the Contracting States, through an exchange by the competent authorities, of the supply of information necessary t-1(s)-1(ai)-1(c-60(aContr)fc)-1(a288(w)-2902

(e)

Also of significance is the historic multilateral Convention on Assistance in Tax Matters entered into by the Nordic countries. A more recent multilateral Convention is the Mutual Administrative Assistance in Tax Matters Convention which was prepared by the OECD and went into force in 1995. It has been ratified by a number of countries.

OECD MODEL

Article 29 (OECD Model ONLY)

TERRITORIAL EXTENSION

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.

DISCUSSION

This Article, present in only the OECD model, allows State A to extend the Convention in its entirety or with modifications to any State or territory for whose international relations State A is responsible, which imposes taxes substantially similar in character to those to which the Convention applies. The Article is of value to States that have territories overseas or are responsible for the international relations of other States or territories. S(h)v -1(n) Tf14.94l0(m)8(a)-1(y)-20(be)-1(n)ffectuated by the exchange of diplomatic notes in any other manner in accordance with the constituti
Artiii3(U)250(the)-346(O)-106 -1O OtheL(the))-29()1(D)1(11(he)4( )250((r)-e Ar)UN MODEL)-5(e)-1(l 1

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): ....

DISCUSSION

ENTRY INTO FORCE

Under the terms of this Article it is up to Contracting States to agree that a Convention shall enter into force when a specified period has elapsed after the exchange of the instruments of ratification or after the confirmation that each State has completed the procedures required for entry into force.

UN MODEL

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): ....

DISCUSSION

Article 29 (UN Model)
Article 31 (OECD Model)

TERMINATION

As it is desirable that a tax treaty should remain in force at least for a certain period, this Article provides that termination can only be given after a certain year to be fixed by bilateral agreement. It is up to the Contracting States to decide upon the earliest year such notice can be given or even to agree not to fix any such year.