Economic & Social Affairs

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

United Nations

ST/ESA/PAD/SER.E/37

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

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

United Nations New York, 2003

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 r Tc-0.06he

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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 treaty[1] 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 r

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

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

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

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 witht0.625m taxable613s worldwid its worldbilhvor-1.7(p)04(o)15 TTw[(co

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
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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 erformit m9TDpdiff27(e)-0.3(s to a d-0.tcing asIf a Seibli)-

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

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

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.

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

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 abro

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 ordinar

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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, where the source State grants special tax concessions to a foreign investor resident in a State using the credit mechanism, the foreign investor has to pay the corresponding increase in the amount of tax due to its State of residence. With some ex38pion s,the

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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 attr

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(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. Unde0int06o009oinrules,State A and State B himipse r]TJ-14.95 01.

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 taxincentives 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

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

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 incom 7-1.2(c s incomotherlishm)8.6(e7-1.2te)e

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-

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[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. grelatg584 Tw[(r)-3.9(e)-3ch-0.5(nner in which ts25g.165 Tyd purposedsTwty

66. Like the 1928 model bilateral conventions, which never won wide acceptance, the model conventions of Mexico and London were never fully

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

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

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

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 of 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

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 coll

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 viol

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

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and collection of taxes. The efforts in the field of administrative assistance in tax matters has been

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

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

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 or

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

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,

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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 csieo06nt25 t.0606 Tec-.0606 o C0601.1J-19.315 -1.165 two act

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 clai

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.

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TITLE OF THE CONVENTION

Convention between (State A) and (State B)
with respect to taxes on income and on capital[1]

PREAMBLE OF THE CONVENTION[2]

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

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 ta

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

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

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.

(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 rela

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

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

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

Article 7

BUSINESS PROFITS

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

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

Article 8 (alternative B)

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 princi0ertxe85ref d m

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 accorda0607sthethe

(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

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:

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 sucou.o inve055 0 TD0I

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 recogni

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

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

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

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.

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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 pafact bers fromExperts,t bfat 9.7bn6(bo7787n42 w[(m)8.7(4act

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 provisi

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

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

(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

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

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 paragraph~~s~~ (paragraph~~s~~ 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 paragraph~~s~~. 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 immoveable 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 immoveable property they own consists principally of immoveable 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

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

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

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

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 incoma-.4.3(t)-5.3(i)-5.3(n)-3s(-19.16 v(n) s50 scn/G his c6)his 90 scn/G-5.3(n)ndc

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.

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.

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

OTHER INCOME

1. Items of income of a resident of a Contracti

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 mova

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.

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 OE

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 inciple w delother Ce.294a-0.3(nk a)ger paerentuag of tlocl twnership of ehe este

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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

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 c0.9r

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

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

(a) Dividends paid by joint stock companies and similar legal persons;
(b) Interest on bonds and similar securities;

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.

"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

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 arrange

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 departm

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

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

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 PRICING[47]

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. Nsigni0.1141ni NEgnia h9.82 -9i

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 costse of the MNEm(e)- the M0.05ldTD0.00ods depends on thes3(of the indivcsfes0.0597s they set un

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

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

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.

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

(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 expensesbutordDpartlesárlaXcadpelseofs74art)8.7(i)-1. 4art

3. Role of form chosen by associated enterprises

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

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

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[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

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 [illegible]
independent enterprises rarely set their prices in order to achieve any pa brofi its,the

(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.

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

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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;

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 reasona

(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 transm

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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)

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

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.

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 handl4(t)]T.845 -1.165 TD00.084 Tw[(6 a chang5 -1(nistr65 . Tw[(ro-0.0

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

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 remunerado5, barnndrys during ht eyble thvertho[(shads nnd)]TJJ19.755

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

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 Contrac

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.

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.

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

(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 usractin21s[(ting State from)d equip

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.

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

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

Article 25

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 24.71.

Article 28rticle 2.7j/TT12 1 Tf-4.6J18.5981T0.00ENTRY6.1(TwIN
TERRITORIAL EXTENSION[70]

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 31]

(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 CLAUSE[71]

[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

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

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

(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 D0.000vGPLf na

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 that e, thn urthNdTc0.1789 Tw[(thr.1adinegis of)3i48.6(e)k-0.0089 T.ut.

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.

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 Depositaries, 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 Depositary.

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 Depositaries. 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 Depositary.

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,

IN WITNESS WHEREOF the undersigned, being duly authorized thereto, have signed this Convention.

DONE at Strasbourg, the 25th

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

(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 perf

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 –

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

(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,

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

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.*"

> "

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*

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

(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 (a)

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.

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

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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

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 th

XXI. Article 21 (3): Source State taxation of other income

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