PART TWO

UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

PREFACE

1. In order to take advantage of the accumulated technical expertise embodied in the reports of the meetings of the Group of Experts and also the texts of different model conventions for the purpose of the negotiation of bilateral tax treaties between developed and developing countries, the Ad Hoc Group of Experts on International Cooperatio

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

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

The reading to follow are based on the United Natio

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~~4. The Convention shall apply also to any identical or substantially similar taxes which are~~ imposed after the date of signature of the Conventi

~~CHAPTER II~~

~~DEFINITIONS~~

~~*Article 3*~~
~~GENERAL DEFINITIONS~~

~~1. For the purposes of this Convention, unless the context otherwise requires:~~

~~(a) The term "person" includes an individual, a company and any other body of persons;~~

~~(b) The term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;~~

~~(c) The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;~~

~~(d) The term "international traffic" means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;~~

~~(e) The term "competent authority" means:~~
~~(i) (in State A): ....~~
~~(ii) (in State B): ....~~

~~(f) The term "national" means:~~
~~(i) any individual possessing the nationality of a Contracting State;~~
~~(ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.~~

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

~~*Observations*~~

~~A number of general definitions are normally necessary for the understanding and application of a treaty, although terms relating to more specialized concepts are usually defined or interpreted in special provisions. There are other terms whose definitions are not included in the treaty but are left to bilateral negotiations by the parties to the treaty. The United Nations Model Convention groups in its article 3 a number of general definitions required for the interpretation of the terms used in that~~

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

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

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

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

~~*Article 4*~~
~~RESIDENT~~

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

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

~~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~~

(b) The furnishing of services, including consultan

~~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~~

~~“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. Howeve255(e)13.1.157404(e)13.177(v)

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

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

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

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

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

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

~~Concerning the time limit established in paragraph 3, subparagraphs (a) and (b), of article 5, some developing countries would prefer to remove the time limit altogether for two main reasons: first, because construction, assembly and similar activities could as a result of modern technology be of very short duration and still result in a considerable profit for the enterprise carrying on those activities; and, second, because the period during which the foreign personnel involved in the activities remained in the source country was irrelevant to the definition of the right of developing countries to tax the corresponding income. Other developing countries believe that any time limit should have been removed because such a limitation was apt to be used by enterprises of capital exporting countries to evade taxation in the source country. The view has been expressed that there~~

~~is no reason why a construction project should not be treated in the same manner as persons covered by article 17 of the OECD Model Convention, who are taxed at the place where their activities are performed irrespective of the duration of those activities. Nevertheless, the goal of the treaty is to promote international trade and development, and the idea behind the time limit is that business enterprises of one Contracting State should be encouraged to initiate preparatory or ancillary operations in the other Contracting State without becoming immediately subject to the tax of the~~ latter State, so as to facilitate a more permanent

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

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

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

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

~~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~~

Teisei Fire and Marine Insurance Co., 104 T.C.535 9 (1995). That case also illustrates problem of exemption re-insurance.

~~**CHAPTER III**~~

~~**TAXATION OF INCOME**~~

~~*Article 6*~~
~~INCOME FROM IMMOVABLE PROPERTY~~

1. Income derived by a resident of a Contracting St

~~*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~~

~~attributable to a permanent establishment, especially with regard to "turn-key" contracts. Under a turn-key contract, a contractor agrees to construct a factory or similar facility and make it ready for operation. When the facility is ready for operation, it is handed over to the purchaser, who can then begin operations. The international tax problems occur when the facility is constructed in one country by a contractor resident in another country. The actual construction activities carried on in one country clearly constitute a permanent establishment within that country if of sufficiently long duration. Turn-key contracts, however, often are concluded before the creation of the permanent establishment and involved many components other than normal construction activities. They also include the purchase of capital goods, the performance of architectural and engineering services and~~

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

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

~~In the discussions leading to the 1980 United Nations Model Convention, the Group could not reach a consensus on provisions relating to the matters covered by article 7, paragraph 5, of the OECD Model Convention. Since no compromise could be worked out, the Group included in the article a note indicating that the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise should be settled in bilateral negotiations. The members from developing countries considered that that paragraph should either be omitted or restated to provide that in the case of a permanent establishment engaged in purchasing and other activities, profits derived from purchasing activities should be attributed to the permanent establishment. Furthermore, some members from developing countries felt that when purchasing constituted the~~

~~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).

~~(b) the same persons participate directly or indirectly in the management, control or capital~~

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

~~*Article 10*~~
~~DIVIDENDS~~

~~1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.~~

~~2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State, but if the beneficial owner of the dividends is a resident of the other Contracting State, the tax so charged shall not exceed:~~

~~(a) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 10 per cent of the capital of the company paying the dividends;~~
~~(b) ___ per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.~~

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

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

~~3. The term "dividends" as used in this article means income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares or other rights, not being debt-claims, participating in profits, as well as income from other corporate rights which is subjected to the same taxation treatment as income from shares by the laws of the State of which the company making the distribution is a resident.~~

~~4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the dividends, being a resident of a Contracting State, carries on business in the other Contracting State of which the company paying the dividends is a resident, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the holding in respect of which the dividends are paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.~~

~~5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the~~

~~company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed~~ profits to a tax on the company's undistributed pro

~~which the dividends are paid. It was possible that the combined effective tax rate levied by the source country might reach a level that significantly exceeds the effective tax rate in the beneficiary's home country.~~

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

~~beneficiary's country of residence, as was the case under the traditional tax-credit method whenever the reduction lowered the cumulative tax rate of the source country below the rate of the beneficiary's country of residence.~~

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

~~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~~

~~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~~

Attention was drawn at the Group’s 1991 meeting to

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

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

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

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

~~*Observations*~~

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

~~At the domestic level, interest is usually deductible from the figures used for calculating profits. In this context, any tax on interest is paid by the beneficiary unless a special contract~~

~~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

~~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~~

~~change is the deletion of the phrase "shall not exceed 10 per cent of the gross amount of the interest" from the first sentence of paragraph 2 and its replacement by the phrase "shall not exceed ___ per cent of the gross amount of the interest (the percentage is to be established through bilateral negotiations)." As a result, the commentary to the United Nations Model Convention generally incorporates the OECD commentary to article 11.~~

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

~~Paragraph 2 reproduces the provisions of article 11, paragraph 2, of the OECD Model Convention with the substantive change mentioned above. The members from developing countries agreed to the solution of taxation by both the country of residence and the source country embodied~~ in article 11, paragraphs 1 and 2, of the OECD Mode

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

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

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

~~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

~~article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.~~

~~*Observations*~~

~~When the user of a patent or similar property is resident in one country and pays royalties to the owner thereof who is resident in another country, the amount paid by the user is generally subject to withholding tax in the user's country, that is, in the source country. The source country imposes~~ its withholding tax on the gross royalty payments.

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

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

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

Members from developed countries considered that it

~~may have provided tax incentives to the licensor in the hope of obtaining those~~

Convention retains the words “or the use of, or rig

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

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

~~*Observations*~~

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

~~Paragraph 4 of article 13 allows a Contracting State to tax gains on an alienation of shares of a company or on an alienation of interests in other entities when the property of the company or other entity consists principally of immovable property located in that State. The paragraph is not found in the OECD Model Convention. It is designed to prevent avoidance of taxes on the gains from the sale of immovable property through the use of real-estate holding companies and similar devices. Taxing the gain derived from the sale of an interest in such an entity is necessary, due to the ease with which taxpayers otherwise would avoid tax on the sale of immovable property. In some cases, the ownership of the shares carries the right to occupy the 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 the ownership of immovable property by an entity means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the entity.~~

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

~~an agreed percentage of voting power might be used to determine what constituted "substantial participation" in a company.~~

~~The Group noted that some countries might take as their negotiating position that the Contracting State where the company was resident should tax the alienation of shares in that~~ company only when a substantial portion of the assets were located withntt

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

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

~~*Observations*~~

~~The OECD Model Convention previously contained separate articles on independent personal~~ servi, l5789(r)2.36

~~services may be taxable only if the taxpayer has a fixed base or is present in the source country for a period exceeding the threshold number of days.~~

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

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

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

~~*Article 15*~~
~~DEPENDENT PERSONAL SERVICES~~

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

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

- ~~(a) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in any twelve-month period commencing or ending in the fiscal year concerned; and~~

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

~~*Observations*~~

~~As in the case of the United Nations Model Convention, the OECD Model Convention contains a separate article on directors' fees, which applies solely to payments received in the~~ recipient's capacity as a member of the Board of D( )59.6354()-120.75181ceors'(o)-0.956417(f)2.3678( )59.6354(

Astt ticle

~~*Observations*~~

The United Nations Model Convention stipulates that

~~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."~~[6]

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

~~Some members of the Group felt that students or business apprentices should be exempted from tax on income received from employment in the Contracting State which they were visiting during their period of study or training. However, it was recognized that this exemption could in some situations be regarded as discriminatory against local students or business apprentices receiving employment income. It was observed that some countries in bilateral negotiations might wish to expand the exemption in article 20 by adding a paragraph permitting a further exemption (beyond that generally applicable as a personal exemption or similar allowance under the internal law of the Contracting State) of employment income under certain conditions. That further exemption would be limited, however, by some income ceiling or by confining the exemption to amounts required for maintenance and support. In setting a ceiling amount, some countries might wish to utilize as a guide the additional costs incurred as a result of the fact that the students or business apprentices~~ were visitors. If such further exemption were to be permitted, it would be appropriate to place a 7( )-30.anm15789(

~~*Observations*~~

The United Nations Model Convention contains a sepa

~~**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.~~

~~This article does not provide any rule about the deductions of debts. The laws of different~~ countries are too diverse to allow a common solutio

~~*Observations*~~

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

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

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

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

~~*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~~

~~through diplomatic channels and, if it seems advisable to them, to have an oral exchange of opinion through a joint commission appointed especially for the purpose. It has been suggested that the Contracting States may provide an arbitration clause through which the controversies concerning the interpretation or the application of the Convention may be resolved.~~

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

~~may need to modify this grant of power to their competent authorities in conformity with their domestic laws.~~

With regard to paragraph 4 of article 25, the Group

~~the disposal of the other Contracting State. Information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons, provided that the tax authorities would make similar investigations or examination for their own purposes. Contracting States do not have to supply information the disclosure of which would be contrary to public policy.~~

~~Mention may be made here of the Convention on Administrative Assistance in Tax Matters concluded by the Nordic countries, which contains detailed provisions on the exchange of information. The Nordic Multilateral Convention is divided into five parts, the most essential of which are those concerning the procurement of information and tax enforcement, including assistance in collecting taxes due. The Convention also contains general provisions, provisions concerning the service of documents and special provisions. In addition to the income and capital taxes dealt with in the conventions for the avoidance of double taxation between the Nordic countries, the Nordic Multilateral Convention covers inheritance or estate taxes, gift taxes, certain indirect taxes (such as motor vehicle taxes and value added taxes), social security and some other public charges and advance payments of taxes. The Nordic Multilateral Convention originally provided that the assistance could take the form of tax collection and enforcement, service of~~ documents and exchange of information, either autom

~~(d) Royalties and other charges paid periodically for the utilization of copyrights, patents, designs, trade marks or other such rights or property;~~

~~(e) Wages, salaries, fees, pensions and annuities;~~

~~(f) Damages, insurance payments and other similar compensation obtained in connection with trade or business activities; and~~

~~CHAPTER VII~~

> ~~“If the Contracting States are unable to agree on the way in which the Conver~~ [redacted]
> ~~modified to restore the balance of benefits, the affected State may terminate t~~ [redacted]
> ~~in accordance with the procedures of Article 29, notwithstanding the requi~~ [redacted]
> ~~Article that the Convention remain in effect until after the year ____ or take su~~ [redacted]
> ~~regarding this Convention as may be permitted under the general principles o~~ [redacted]
> ~~law.”~~

~~It may be relevant to mention that a treaty override in violation of internation~~ [redacted] ~~negative effects on mutual trust among Contracting States. It should be noted th~~ [redacted] ~~terminate a treaty under customary international law, as embodied in the Vienna Con~~ [redacted] Law of Tf thstom