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United Nations Model Tax Convention update

NOTE ON PROPOSED UPDATE OF UNITED NATIONS MODEL TAX CONVENTION

Summary

This note has been prepared by the Subcommittee on the United Nations Model Tax Convention Update. The Subcommittee is mandated to:

> "… collate all the work on the Model update that has been completed by the Committee, drawing upon the work of relevant Working Groups. It will also review the existing Commentary and identify desirable amendments to the Commentary. It will report back to the next annual session of the Committee with a report on work-in progress on the update. It will report back to the 2011 annual session with a proposed final draft of the Model Update."

This document reflects a text for discussion of the update, reflecting decisions already taken by the Committee as well as proposals to ensure that the new version of the UN Model best meets the needs of Member States.

Text that has already been agreed by the Committee to be deleted is denoted by black strikethrough type. Text now proposed for deletion is denoted by red strikethrough (matters regarded as substantive) and blue strikethrough (matters regarded as more editorial in nature).

Text already agreed for inclusion is denoted by black bold-faced type unless otherwise specifically noted. Text now proposed for inclusion is denoted by red bold-faced type (matters regarded as substantive) and blue bold-faced type (matters regarded as more editorial in nature).

For convenience, the proposed changes are outlined in Document CRP.2 and a series of additional (Add.) documents. The numbering sequence continues from CRP.2 to CRP.2/Add.1 and CRP.2/Add.2.

Commentary on chapter I

SCOPE OF THE CONVENTION

NOTE BY THE SECRETARIAT: THE COMMENTARY ON ARTICLE 1 REFLECTS THE REVISED COMMENTARY ADOPTED BY THE COMMITTEE AT ITS FOURTH ANNUAL SESSION IN 2008. TEXT IN MARK-UP REFLECTS SUGGESTED CHANGES TO THE AGREED NEW COMMENTARY ON ARTICLE 1[1].

Article 1

PERSONS COVERED

A. GENERAL CONSIDERATIONS

1. Article 1 of the United Nations Model Convention reproduces Article 1 of the OECD Model Convention.

2. The title of a**A**rticle 1 ~~has been~~ **was** changed in 1999 from “Personal scope” to “Persons covered”. The first article of the Convention should normally specify the types

mutandis, to other non-corporate entities. In this report, references to "partnerships" cover entities which qualify as such under civil

10. There are a number of different approaches used by countries to prevent and address the improper use of tax treaties. These include:

specific legislative anti-abuse rules found in domestic law
general legislative anti-abuse rules found in domestic law
judicial doctrines that are part of domestic law
specific anti-abuse rules found in tax treaties
general anti-abuse rule

a taxpayer beyond what is allowed by a tax treaty, this would conflict with the provisions of the treaty and these provisions should prevail under public international law.

16. As explained below, however, such conflicts will often be avoided and each case must be analysed based on its own circumstances.

17. First, a treaty may specifically allow the application of certain types of specific domestic anti-abuse rules. For example, Article 9 of the Convention specifically authorizes the application of domestic transfer pricing rules in the circumstances defined by that Article. Also, many treaties include specific provisions clarifying that there is no conflict (or, even if there is a conflict, allowing the application of the domestic rules) in the case, for example, of thin capitalization

tax rules that affect these transactions in ways that are contrary to treaty provisions constitute anti-abuse rules.

25. Under the guiding principle presented above, two elements must therefore be present for certain transactions or arrangements to be found to constitute an abuse of the provisions of a tax treaty:

> **a main purpose for entering into these transactions or arrangements was to secure a more favourable tax position, and**
> **obtaining that more favourable treatment would be contrary to the object and purpose of the relevant provisions.**

26. These two elements will also often be found, explicitly or implicitly, in general anti-avoidance rules and doctrines developed in various countries.

27. In order to minimize the uncertainty that may result from the application of that approach, it is important that this guiding principle be applied on the basis of objective findings of facts, not solely the alleged intention of the parties. Thus, the determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements.

Judicial doctrines that are part of domestic law

28. In the process of determining how domestic tax law applies to tax avoidance transactions, the courts of many countries have developed different judicial doctrines that have the effect of preventing domestic law abuses. These include the business purpose, substance over form, economic substance, step transaction, abuse of law and *fraus legis* approaches. The particular conditions under which such judicial doctrines apply often vary from country to country and evolve over time based on refinements or changes resulting from subsequent court decisions.

29. These doctrines are essentially views expressed by courts as to how tax legislation should be interpreted and as such, typically become part of the domestic tax law.

30. While the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties*, nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain transactions, there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty to similar transactions.

Specific anti-abuse rules found in tax treaties

31. Some forms of treaty abuses can be addressed through specific treaty provisions. A number of such rules are already included in the UN Model; these include, in particular, the reference to the agent who maintains a stock of goods for delivery purposes (subparagraph 5 b of Article 5), the concept of "beneficial owner" (in Articles 10, 11, and 12), the "special relationship" rule applicable to interest and royalties (paragraph 6 of Article 11 and paragraph 6 of Article 12), the rule on alienation of shares of immovable property companies (paragraph 4 of Article 13) and the rule on "star-companies" (paragraph 2 of Article 17). Another example would be the modified version of the limited force-of-attraction rule of paragraph 1 of Article 7 that is found in some tax treaties and that applies only to avoidance cases.

32. Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers. This is acknowledged in paragraph 9.6 of the Commentary of the OECD Commentary, which explains that such rules can usefully supplement general anti-avoidance rules or judicial approaches.[4]

33. One should not, however, underestimate the risks of relying extensively on specific treaty anti-abuse rules to deal with tax treaty avoidance strategies. First, specific anti-abuse rules ~~can only be~~ **are often drafted once a particular avoidance**

34. There are a few examples of treaty provisions that may be considered to be general anti-abuse rules. One such provision is paragraph 2 of Article 25 of the treaty between Israel and Brazil, signed in 2002:

> **A competent authority of a Contracting State may deny the benefits of this Convention to any person, or with respect to any transaction, if in its opinion the granting of those benefits would constitute an abuse of the Convention according to its purpose. Notice of the application of this provision will be given by the competent authority of the Contracting State concerned to the competent authority of the other Contracting State.**

37. Many countries, however, will consider that including such a provision in their treaties could be interpreted as an implicit recognition that, absent such a provision, they cannot use other approaches to deal with improper uses of tax treaties. This would be particularly problematic for countries that have already concluded a large number of treaties that did not include such a provision. For that reason, the use of such a provision would probably be considered primarily by countries that have found it difficult to counter improper uses of tax treaties through other approaches.

The interpretation of tax treaty provisions

38. Another approach that has been used to counter improper uses of treaties has been to consider that there can be abuses of the treaty itself and to disregard abusive transactions under a proper interpretation of the relevant treaty provisions that takes account of their context, the treaty's object and purpose as well as the obligation to interpret these provisions in good faith[5]. As already noted, a number of countries have long used a process of legal interpretation to counteract abuses of their domestic tax laws and it seems entirely appropriate to similarly interpret tax treaty provisions to counteract tax treaty abuses. As noted in paragraph 9.3 of the Commentary on Article 1 of the OECD Model Tax Convention:

> **Other States prefer to view some abuses as being abuses of the convention itself, as opposed to abuses of domestic law. These States, however, then consider that a proper construction of tax conventions allows them to disregard abusive transactions, such as those entered into with the view to obtaining unintended benefits under the provisions of these conventions. This**

typically be very difficult to find facts that would show that the change of residence has been done primarily to obtain treaty benefits, especially where the taxpayer has a permanent home or is present in another State for extended periods of time. Many countries have therefore found that specific rules were the best approach to deal with such cases.

43. One approach used by some of these countries has been to include in their tax treaties provisions allowing a State of which a taxpayer was previously resident to tax certain types of income, e.g. capital gains on significant participations in companies or lump-sum payments of pension rights, realized during a certain period following the change of residence. An

> **Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall by mutual agreement endeavour to settle the question and to determine the mode of application of the Agreement to such person. In the absence of such agreement, such person shall be considered to be outside the scope of this Agreement, except for the Article "Exchange of information".**

46. Example 3 raises the potential for tax avoidance arising from remittance-based taxation. This issue is dealt with in paragraph 26.1 of the Commentary on Article 1 of the OECD Model Tax Convention, which suggests that, in order to deal with such situations, countries may include a specific anti-abuse provision in their tax treaties with countries that allow that form of taxation:

> **26.1 Under the domestic law of some States, persons who qualify as residents but who do not have what is considered to be a permanent link with the State (sometimes referred to as domicile) are only taxed on income derived from sources outside the State to the extent that this income is effectively repatriated, or remitted, thereto. Such persons are not, therefore, subject to potential double taxation to the extent that foreign income is not remitted to their State of residence and it may be considered inappropriate to give them the benefit of the provisions of the Convention on such income. Contracting States which agree to restrict the application of the provisions of the Convention to income that is effectively taxed in the hands of these persons may do so by adding the following provision to the Convention:**
>
>> **Where under any provision of this Convention income arising in a Contracting State is relieved in whole or in part from tax in that State and under the law in force in the other Contracting State a person, in respect of the said income, is subject to tax by reference to the amount thereof which is remitted to or received in that other State and not by reference to the full amount thereof, then any relief provided by the provisions of this Convention shall apply only to so much of the income as is taxed in the other Contracting State.**
>
> **In some States, the application of that provision could create administrative difficulties if a substantial amount of time elapsed between the time the income arose in a Contracting State and the time it were taxed by the other Contracting State in the hands of a resident of that other State. States concerned by these difficulties could subject the rule in the last part of the above provision, i.e. that the income in question will be entitled to benefits in the first-mentioned State only when taxed in the other State, to the condition that the income must be so taxed in that other State within a specified period of time from the time the income arises in the first-mentioned State.**

Treaty shopping

47. "Treaty shopping" is a form of improper use of tax treaties that refers to arrangements through which persons who are not entitled to the benefits of a tax treaty use other persons who are entitled to such benefits in order to indirectly access these benefits. For example, a company that is a resident of a treaty country would act as a conduit for channelling income that would economically accrue to a person that is not a resident of that country so as to improperly access the benefits provided by a tax treaty. The conduit entity is usually a company, but may also be a partnership, trust or similar entity that is entitled to treaty benefits. Granting treaty benefits in these circumstances would be detrimental to the State of source since the benefits of the treaty would then be extended to persons who were not intended to obtain such benefits.

48. A treaty shopping arrangement may take the form of a "direct conduit" or that of a "stepping stone conduit", as illustrated below.[6]

49. Company X, resident of State A, receives dividends, interest or royalties from company Y resident of State B. Company X claims that, under the tax treaty between States A and B, it is entitled to full or partial exemption from the domestic withholding taxes provided for under the tax legislation of State B. Company X is wholly-owned by a resident of third State C who is not entitled to the benefits of the treaty between States A and B. Company X was created for the purpose of obtaining the benefits of the treaty between States A and B and it is for that purpose that the assets and rights giving rise to the dividends, interest or royalties have been transferred to it. The income is exempt from tax in State A, e.g. in the case of dividends, by virtue of a participation exemption provided for under the domestic laws of State A or under the treaty between States A and B. In that case, company X constitute a direct conduit of its shareholder resident of State C.

50. The basic structure of a stepping stone conduit is similar. In that case, however, the income of company X is fully taxable in State A and, in order to eliminate the tax that would be payable in that country, company X pays high interest, commissions, service fees or similar deductible expenses to a second related conduit company Z, a resident of State D. These payments, which are deductible in State A, are tax-exempt in State D by virtue of a special tax regime available in that State[7]. The shareholder resident of State C is therefore seeking to access the benefits of the tax treaty between States A and B by using company X as a stepping stone.

51. In order to deal with such situations, tax authorities have relied on the various approaches described in the previous sections.

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[6] " Double Taxation Convention and the Use of Conduit Companies", in volume II of the loose-leaf version of the *OECD Model Tax Convention*, OECD, R(6)-1, at page R(6)-4, paragraph 4.

[7] Id.

52. For instance, specific anti-abuse rules have been included in the domestic law of some countries to deal with such arrangements. One example is that of the US regulations dealing with financing arrangements. For the purposes of these regulations, a financing arrangement is a series of transactions by which the financing entity advances money or other property to the financed entity, provided that the money or other property flows through one or more intermediary entities. An intermediary entity will be considered a "conduit", and its participation in the financing arrangements will be disregarded by the tax authorities if (*i*) tax is reduced due to the existence of an intermediary, (*ii*) there is a tax avoidance plan, and (*iii*) it is established that the intermediary would not have participated in the transaction but for the fact that the intermediary is a related party of the financing entity. In such cases, the related income shall be re-characterized according to its substance.

53. Other countries have dealt with the issue of treaty shopping through the interpretation of tax treaty provisions. According to a 1962 decree of the Swiss Federal Council, which is applicable to Swiss treaties with countries that, under the relevant treaties, grant relief from withholding tax that would otherwise be collected by these countries, a claim for such relief is considered abusive if, through such claim, a substantial part of the tax relief would benefit persons not entitled to the relevant tax treaty. The granting of a tax relief shall be deemed improper (a) if the requirements specified in the tax treaty (such as residence rule, beneficial ownership, tax liability, etc.) are not fulfilled and (b) if it constitutes an abuse. The measures which the Swiss tax authorities may take if they determine that a tax relief has been claimed improperly include (a) refusal to certify a claim form, (b) refusal to transmit the claim form, (c) revoking a certification already given, (d) recovering the withholding tax, on behalf of the State of source state, to the extent that the tax relief has been claimed improperly, and (e) informing the tax authorities of the State of source that a tax relief has been claimed improperly.

54. Other countries have relied on their domestic legislative general anti-abuse rules or judicial doctrines to address treaty shopping cases. As already noted, however, legislative general anti-abuse rules and judicial doctrines tend to be the most effective when it is clear that transactions are intended to circumvent the object and purpose of tax treaty provisions.

55. Treaty shopping can also, to some extent, be addressed through anti-abuse rules already found in most tax treaties, such as the concept of "beneficial ownership".

56. Some countries, however, consider that the most effective approach to deal with treaty shopping is to include in their tax treaties specific anti-abuse rules dealing with that issue. Paragraphs 13 to 21.4 of the Commentary on Article 1 of the OECD Model Convention, which are reproduced below, include various examples of such rules. The Committee considers that these examples are helpful in dealing with

treaty shopping concerns that may arise with respect to treaties between developing and developed countries.

Conduit company cases

13. Many countries have attempted to deal with the issue of conduit

b) exercise directly or indirectly, alone or together, the management or control of such company,

any provision of this Convention conferring an exemption from, or a reduction of, tax shall apply only to income that is subject to tax in the last-mentioned State under the ordinary rules of its tax law.”

18. A provision of this kind appears to be the only effective way of combatting "stepping-stone" devices. It is found in bilateral treaties entered into by Switzerland and the United States and its principle also seems to underlie the Swiss provisions against the improper use of tax treaties by certain types of Swiss companies. States that consider including a clause of this kind in their convention should bear in mind that it may cover normal business transactions and would therefore have to be supplemented by a bona fide clause.

19. The solutions described above are of a general nature and they need to be accompanied by specific provisions to ensure that treaty benefits will be granted in bona fide cases. Such provisions could have the following wording:

a) General bona fide provision

"The foregoing provisions shall not apply where the company establishes that the principal purpose of the company, the conduct of its business and the acquisition or maintenance by it of the shareholding or other property from which the income in question is derived, are motivated by sound business reasons and do not have as primary purpose the obtaining of any benefits under this Convention."

b) Activity provision

"The foregoing provisions shall not apply where the company is engaged in substantive business operations in the Contracting State of which it is a resident and the relief from taxation claimed from the other Contracting State is with respect to income that is connected with such operations."

c) Amount of tax provision

"The foregoing provisions shall not apply where the reduction of tax claimed is not greater than the tax actually imposed by the Contracting State of which the company is a resident."

d) Stock exchange provision

"The foregoing provisions shall not apply to a company that is a resident of a Contracting State if the principal class of its shares is registered on an approved stock exchange in a Contracting State or if such company is wholly owned — directly or through one or more companies each of which is a resident of the first-mentioned State — by a company which is a resident of the first-mentioned State and the principal class of whose shares is so registered."

e) Alternative relief provision

In cases where an anti-abuse clause refers to non-residents of a Contracting State, it could be provided that the term "shall not be deemed to include residents of third States that have income tax conventions in force with the Contracting State from which relief from taxation is claimed and such conventions provide relief from taxation not less than the relief from taxation claimed under this Convention."

These provisions illustrate possible approaches. The specific wording of the provisions to be included in a particular treaty depends on the general approach taken in that treaty and should be determined on a bilateral basis. Also, where the competent authorities of the Contracting States have the power to apply discretionary provisions, it may be considered appropriate to include an additional rule that would give the competent authority of the source country the discretion to allow the benefits of the Convention to a resident of the other State even if the resident fails to pass any of the tests described above.

20. Whilst the preceding paragraphs identify different approaches to deal with conduit situations, each of them deals with a particular aspect of the problem commonly referred to as "treaty shopping". States wishing to address the issue in a comprehensive way may want to consider the following example of detailed limitation-of-benefits provisions aimed at preventing persons who are not resident of either Contracting States from accessing the benefits of a Convention through the use of an entity that would otherwise qualify as a resident of one of these States, keeping in mind that adaptations may be necessary and that many States prefer other approaches to deal with treaty shopping:

1. Except as otherwise provided in this Article, a resident of a Contracting State who derives income from the other Contracting State shall be entitled to all the benefits of this Convention otherwise accorded to residents of a Contracting State only if such resident is a "qualified person" as defined in paragraph 2 and meets the other conditions of this Convention for the obtaining of such benefits.

2. A resident of a Contracting State is a qualified person for a fiscal year only if such resident is either:

***a)* an individual;**

***b)* a qualified governmental entity;**

***c)* a company, if**

***(i)* the principal class of its shares is listed on a recognised stock exchange specified in subparagraph *a*) or *b*) of paragraph 6 and is regularly traded on one or more recognised stock exchanges, or**

(ii) **at least 50 per cent of the aggregate vote and value of the shares in the company is owned directly or indirectly by five or fewer companies entitled to benefits under subdivision *i*) of this subparagraph, provided that, in the case of indirect ownership, each intermediate owner is a resident of either Contracting State;**

d) **a charity or other tax-exempt entity, provided that, in the case of a pension trust or any other organization that is established exclusively to provide pension or other similar benefits, more than 50 per cent of the person's beneficiaries, members or participants are individuals resident in either Contracting State; or**

e) **a person other than an individual, if:**

(i) **on at least half the days of the fiscal year persons that are qualified persons by reason of subparagraph a), b) or d) or subdivision c) (i) of this paragraph own, directly or indirectly, at least 50 per cent of the aggregate vote and value of the shares or other beneficial interests in the person, and**

(ii) **less than 50 per cent of the person's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not residents of either Contracting State in the form of payments that are deductible for purposes of the taxes covered by this Convention in the person's State of residence (but not including arm's length payments in the or**

carried on in the other State. Whether a business activity is substantial

c) **any other stock exchange which the competent authorities agree to recognize for the purposes of this Article."**

Provisions which are aimed at entities benefiting from preferential tax regimes

21. Specific types of companies enjoying tax privileges in their State of residence facilitate conduit arrangements and raise the issue of harmful tax practices. Where tax-exempt (or nearly tax-exempt) companies may be distinguished by special legal characteristics, the improper use of tax treaties may be avoided by denying the tax treaty benefits to these companies (the exclusion approach). As such privileges are granted mostly to specific types of companies as defined in the commercial law or in the tax law of a country, the most radical solution would be to exclude such companies from the scope of the treaty. Another solution would be to insert a safeguarding clause which would apply to the income received or paid by such companies and which could be drafted along the following lines:

> **"No provision of the Convention conferring an exemption from, or reduction of, tax shall apply to income received or paid by a company as defined under section ... of the ... Act, or under any similar provision enacted by ... after the signature of the Convention."**

The scope of this provision could be limited by referring only to specific types of income, such as dividends, interest, capital gains, or directors' fees. Under such provisions companies of the type concerned would remain entitled to the protection offered under Article 24 (non-discrimination) and to the benefits of Article 25 (mutual agreement procedure) and they would be subject to the provisions of Article 26 (exchange of information).

21.1 Exclusion provisions are clear and their application is simple, even though they may require administrative assistance in some instances. They are an important instrument by which a State that has created special privileges in its tax law may prevent those privileges from being used in connection with the improper use of tax treaties concluded by that State.

21.2 Where it is not possible or appropriate to identify the companies enjoying tax privileges by reference to their special legal characteristics, a more general formulation will be necessary. The following provision aims at denying the benefits of the Convention to entities which would otherwise qualify as residents of a Contracting State but which enjoy, in that State, a preferential tax regime restricted to foreign-held entities (i.e. not available to entities that belong to residents of that State):

> **"Any company, trust or partnership that is a resident of a Contracting State and is beneficially owned or controlled directly or indirectly by one or more persons who are not residents of that State shall not be entitled**

to the benefits of this Convention if the amount of the tax imposed on the income or capital of the company, trust or partnership by that State (after taking into account any reduction or offset of the amount of tax in any manner, including a refund, reimbursement, contribution, credit or allowance to the company, trust or partnership, or to any other person) is substantially lower than the amount that would be imposed by that

21.4 The following provision has the effect of denying the benefits of specific Articles of the convention that restrict source taxation where transactions have been entered into for the main purpose of obtaining these benefits. The Articles concerned are 10, 11, 12 and 21; the provision should be slightly modified as indicated below to deal with the specific type of income covered by each of these Articles:

"

[…] If the Contracting State of which the enterprise is a resident exempts from tax the profits of the permanent establishment located in the other Contracting State, there is a danger that the enterprise will transfer assets

64. In almost all countries, interest is a deductible expense whereas dividends,

creditors (to the exclusion of resident creditors), then such treatment is prohibited by paragraph 4.

69. Paragraph 3 of the OECD Commentary on Article 9, which is reproduced under paragraph 6 of the Commentary on the same provision of this Model, clarifies that paragraph 1 of Article 9 allows the application of domestic rules on thin capitalisation insofar as their effect is to assimilate the profits of the borrower to an amount corresponding to the profits which would have accrued in an arm's length situation. While this would typically be the case of thin capitalisation rules that are based on the arm's length principle, a country that has adopted thin capitalisation rules based on a fixed ratio approach would, however, typically find it difficult to establish that its thin capitalisation rule, which does not refer to what independent parties would have done, satisfies that requirement.

70. For that reason, countries that have adopted thin capitalisation rules based on a fixed ratio approach often consider that they need to include in their treaties

the domestic law of a state uses the place of management of a legal person, or a similar criterion, to determine its residence).

73. The second approach is described in paragraph 10.2 of that Commentary, which reads as follows:

> **Careful consideration of the facts and circumstances of a case may also show that a subsidiary was managed in the state of residence of its parent in such a way that the subsidiary had a permanent establishment (e.g. by having a place of management) in that state to which all or a substantial part of its profits were properly attributable.**

74. These approaches, however, might not be successful in dealing with arrangements involving companies that have substantial management and economic activities in the countries where they have been established. One of the most effective approaches to dealing with such cases is the inclusion, in domestic legislation, of controlled foreign corporation (CFC) legislation. While the view has sometimes be expressed that such legislation could violate certain provisions of tax treaties, the Committee considers that this would not be the case of typical CFC rules, as indicated in paragraph 23 ~~if~~ **of the Commentary on Article 1 of the OECD Model Tax Convention (and as further explained in paragraphs** ~~10.1~~**13 of the Commentary on Article 7 and 37 of the Commentary on Article 10 of that Model):**

> **23. The use of base companies may also be addressed through controlled foreign companies provisions. A significant number of Member and non-member countries have now adopted such legislation. Whilst the design of this type of legislation varies considerably among countries, a common feature of these rules, which are now internationally recognised as a legitimate instrument to protect the domestic tax base, is that they result in a Contracting State taxing its residents on income attributable to their participation in certain foreign entities. It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 7 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation conflicted with these provisions. For the reasons explained in paragraphs** ~~10.1~~**13 of the**

75. According to Article 16 (Directors' Fees), directors' fees and the remuneration of officials in a top-level managerial position of a company may be taxed in the State of residence of the company regardless of where the services of these directors and top-level managers are performed. A "salary split" arrangement could be used in order to reduce the taxes that would be payable in that State pursuant to that Article. Assume, for example, that company A, a resident of State A, has two subsidiaries, companies B and C, which are residents of States X and Y respectively. Mr. D, a resident of State X, is a director and an official in a top-level managerial position of subsidiary B. State X levies an income tax at progressive rates of up to 50%. State Y has a similar income tax system but with a very low tax rate. Countries X and Y have a tax treaty781 ttr aysid7.5(4e)7.6ath(8(eat)8(%. (a)6t3(e)11.5(e)5.8(X)-9.8( )5.p7(n)4pl)

> **Interest on other government-approved types of investments (e.g., export finance).**

78. Where a tax treaty includes one or more of these provisions, it may be possible for a party that is entitled to such an exemption to engage into back-to-back arrangements with other parties that are not entitled to that exemption or, where a contract provides for the payment of interest and other types of income that would not be exempt (e.g. royalties), to attribute a greater share of the overall consideration to the payment of interest. Such arrangements would constitute improper uses of these exemptions.

79. While it could be argued that an easy solution would be to avoid including such exemptions in a tax treaty, it is important to note that these are included for valid policy purposes, taking into account that source taxation on gross payments of interest will frequently act as a tariff and be borne by the borrower. Also, as long as a country has agreed to include such exemptions in one of its treaties, it becomes difficult to refrain from granting these in treaty negotiations with other similar countries.

80. Many of the approaches referred to above in the case of treaty shopping may be relevant to deal with back-to-back arrangements aimed at accessing the benefits of these exemptions. Also, cases where the consideration provided for in a mixed contract has been improperly attributed to interest payments can be challenged using specific domestic anti-abuse rules applicable to such cases, general domestic anti-abuse rules or doctrines or a proper interpretation of the treaty provisions. Where the overall consideration is divided among related parties, paragraph 6 of Article 11 and paragraph 1 of Article 9 may also be relevant to ensure that the benefit of the treaty exemption only applies to the proper amount of interest. Finally, some states have included specific anti-abuse rules in their treaties to deal with such back-to-back arrangements. An example of such a rule is found in paragraph b) of Article 7 of the Protocol to the treaty signed in 2002 by Australia and Mexico, which reads as follows:

> **The provisions of […]paragraph [2 of Article 11] shall not apply to interest derived from back-to-back loans. In such case, the interest shall be taxable in accordance with the domestic law of the State in which it arises.**

Hiring out of Labour

81. [The Commentary on Article 15 reproduces the part of the Commentary on the OECD Model Convention that deals with arrangements known as "international hiring-out of labour"]. This refers to cases where a local enterprise that wishes to hire a foreign employee for a short period of time enters into an arrangement with a non-resident intermediary who will act as the formal employer. The employee thus appears to fulfil the three conditions of paragraph 2 of Article 15 so as to qualify for the tax exemption in the State where the employment will be exercised. The

Comment [MB1]: The OECD Commentary referred to here were updated as part of the 2010 update and this paragraph should probably be adjusted. The EGM in June suggested to address this paragraph in connection with the new OECD Commentary on Article 15.

Commentary on Article 15 includes guidance on how this issue can be dealt with, recognizing that domestic anti-abuses rules and judicial doctrines, as well as a proper construction of the treaty, offer ways of challenging such arrangements.

Artistes and sportspersons

82. A number of older tax treaties do not include paragraph 2 of Article 17 (Artistes and sportspersons), which deals with the use of so-called "star-companies". In order to avoid the possible application of provisions based on paragraph 1 of that Article, residents of countries that have concluded such treaties may be tempted to arrange for the income derived from their activities as artistes or sportspersons, or part thereof, to be paid to a company set up for that purpose.

83. As indicated in the Commentary on Article 17, which reproduces paragraph 11 of the OECD Commentary on that Article, such arrangements may ~~d~~be dealt with under domestic law provisions that would attribute such income to the artistes or sportspersons:

> **[…] The third situation involves certain tax avoidance devices in cases where remuneration for the performance of an artiste or sportsman is not paid to the artiste or sportsman himself but to another person, e.g. a so-called artiste**

11.1 The application of paragraph~~s~~ 2 is not restricted to situations where both the entertainer or sportsman and the other person to whom the income accrues, e.g. a star-company, are residents of the same Contracting State. The paragraph allows the State in which the activities of an entertainer or sportsman are exercised to tax the income derived from these activities and accruing to another person regardless of other provisions of the Convention that may otherwise be applicable. Thus, notwithstanding the provisions of Article 7, the paragraph allows that State to tax the income derived by a star-company resident of the other Contracting State even where the entertainer or sportsman is not a resident of that other State. Conversely, where the income of an entertainer resident in one of the Contracting States accrues to a person, e.g. a star-company, who is a resident of a third State with which the State of source does not have a tax convention, nothing will prevent the Contracting State from taxing that person in accordance with its domestic laws.

Transactions that modify the treaty classification of income

86. Articles 6 to 21 allocate taxing rights differently depending on the nature of

The term "royalties" as used in this Article means:
a) payments of any kind received as a consideration for the use of, or the

noted in the Commentary on Article 10, which reproduces paragraph 17 of the OECD Commentary on that Article:

> **The reduction envisaged in subparagraph a) of paragraph 2 should not be granted in cases of abuse of this provision, for example, where a company with a holding of less than 25 per cent has, shortly before the dividends become payable, increased its holding primarily for the purpose of securing the benefits of the above-mentioned provision, or otherwise, where the qualifying holding was arranged primarily in order to obtain the reduction. To counteract such manoeuvres Contracting States may find it appropriate to add to subparagraph a) a provision along the following lines:**
>
> **provided that this holding was not acquired primarily for the purpose of taking advantage of this provision.**

The following are other examples of arrangements intended to circumvent various thresholds found in the Convention.

Time limit for certain permanent establishments

96. Article 5(3) of the Convention includes a rule according to which, in certain circumstances, the furnishing of services by a foreign enterprise during a certain period under the same or connected projects will constitute a permanent establishment. Taxpayers may be tempted to circumvent the application of that provision by splitting a single project between associated enterprises or by dividing a single contract into different ones so as to argue that these contracts cover different projects. Paragraphs 11 and 12 of the Commentary on Article 5 deal with such arrangements.

Thresholds for the source taxation of capital gains on shares

97. Paragraph 4 of Article 13 allows a State to tax capital gains on shares of a company (and on interests in certain other entities) the property of which consists principally of immovable property situated in that State. For the purposes of that

99. Where the facts establish that assets have been transferred to an entity for the purpose of avoiding the application of paragraph 4 of Article 13 to a prospective alienation of shares or interests in that entity, a country's general anti-abuse rules or judicial doctrines may well be applicable. Some countries, however, may wish to provide expressly in their treaties that paragraph 4 will apply in these circumstances. This could be done by adding to Article 13 a provision along the following lines:

> **For the purposes of paragraph 4, in determining the aggregate value of all assets owned by a company, partnership, trust or estate, the assets that have been transferred to that entity primarily to avoid the application of the paragraph shall not be taken into account.**

3. The importance of proper mechanisms for the application and interpretation of tax treaties

100. The Committee recognizes the role that proper administrative procedures can play in minimizing risks of improper uses of tax treaties. Many substantive provisions in tax treaties need to be supported by proper administrative procedures that are in line with the procedural aspects of domestic tax legislation. Developing countries may consider developing their own procedural provisions regarding treaty application by learning from countries that have successful experience of treaty application.

101. The Committee also recognizes the importance of proper mechanisms for tax treaty interpretation. In many countries, there is a long history of independent

be applied to prospective transactions could help reduce that concern, it is important that such a system safeguards the confidentiality of transactions and, at the same time, avoids discretionary interpretations (which, in some countries, could carry risks of corruption). Clearly, a strong independent judicial system will help to provide taxpayers with the assurance that anti-abuse rules are applied objectively. Similarly, an effective application of the mutual agreement procedure ~~should contribute to the resolution of~~**will ensure that disputes concerning the application of anti-abuse rules according to internationally accepted principles so as to maintain the integrity of tax treaties.**

Article 2

TAXES COVERED BY THE CONVENTION

A. GENERAL CONSIDERATIONS

1. Article 2 of the United Nations Model Convention reproduces ~~paragraphs 1, 2 and 3 of~~ Article 2 of the OECD Model Convention.~~, whereas paragraph 4 differs from paragraph 4 of the OECD Model Convention.~~

2. This article is designed to clarify the terminology and nomenclature concerning the taxes to be covered by the convention. In this connection, it may be observed that 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 take into account all the taxes to which such income or capital is subject. Consequently, the terminology and nomenclature relating to the taxes covered by a treaty must be clear, precise and comprehensive as possible. As noted in the OECD Commentary on Article 2 of the OECD Model Convention, this is necessary:

> 1. ~~t~~**[T]**o ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, ~~and~~ to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified, ~~by means of the periodical exchange of lists and through a procedure for mutual consultation~~**and to ensure for each Contracting State notification of significant changes in the taxation laws of the other State.**~~"~~ ~~[para. 1]~~

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 2

Paragraph 1

3. This paragraph states that the Convention applies to taxes on income and on capital, irrespective of the authority on behalf of which such taxes are imposed (e.g., the State itself or its political subdivisions or local authorities) and irrespective of the method by which the taxes are levied (e.g., by direct assessment or by deduction at the source, in the form of surtaxes or surcharges or as additional taxes).

Paragraph 2

4. This paragraph defines taxes on income and on capital, as taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on capital appreciation and taxes on the total amounts of wages or salaries paid by enterprises. Practices regarding the coverage of taxes on the total amount of wages and salaries paid by enterprises vary from country to country and this matter should be taken into account in bilateral negotiations. According to **paragraph 3 of** the Commentary on Article 2~~, paragraph 2,~~ of the OECD Model Convention, ~~the last-named~~ taxes **on the total amount of wages** do not include “social security charges, or any other charges paid where there is a direct connection between the levy and the individual benefits to be received”. The OECD Commentary further observes: c.0218 Tw[(,)-2c(13.4(e)5.779399..50mcharges)]TJ/Cs6 cs.-.01868 (

Paragraph 4

6. The Commentary on Article 2, paragraph 4 of the OECD Model Convention is applicable:

7. This paragraph provides, since the list of taxes in paragraph 3 is purely declaratory, that the Convention is also to apply to all identical or substantially similar

Commentary on chapter II

DEFINITIONS

Article 3

GENERAL DEFINITIONS

A. GENERAL CONSIDERATIONS

1. Article 3 of the United Nations Model Convention ~~reproduces~~ is the same as Article 3 of the OECD Model Convention, except that Article 3 of the OECD Model Convention defines the terms “enterprise” and “business” while Article 3 of the United Nations Model Convention does not. This is because the OECD Model Convention has deleted Article 14 (Independent Personal Services) while the United Nations Model Convention still maintains it.

2. Several general definitions are normally necessary for the understanding and application of a bilateral tax convention, although terms relating to more specialized concepts are usually defined or interpreted in special provisions. On the other hand, there are terms whose definitions are not included in the convention but are left to bilateral negotiations.

3~~2~~. Article 3 of the United Nations Model Convention, like Article 3 of the OECD Model Convention, sets forth a number of general definitions required for the interpretation of the terms used in the Convention. These terms are “person”, “company”, “enterprise of a Contracting State”, “international traffic”, “competent authority” 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 convention are left free to agree bilaterally on a definition of the terms “a Contracting State” and “the other Contracting State”. They also may include in the definition of a Contracting State a reference to continental shelves.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 3 Paragraph 1

(a) The term “person”

4~~3~~. The term “person”, which is defined in subparagraph (a) as including an individual, a company and any other body of persons, should be interpreted very broadly. According to the Commentary on Article 3 of the OECD Model Convention, the term also includes “any entity ~~which~~**that**, although ~~itself not a body of persons~~ **not incorporated**, is treated as a body corporate for tax purposes [e.g., a foundation]”.

(b) The term “company”

54. The definition of the term “company”, like the corresponding definition in the OECD Model Convention, is formulated with special reference to **A**~~a~~rticle 10 on dividends. The definition is relevant to that **A**~~a~~rticle and to **A**~~a~~rticle 5, paragraph 8, and **A**~~a~~rticle 16, corresponding respectively to Article 5, paragraph 7, and Article 16 of the OECD Model Convention.

(c) The term “enterprise of a Contracting State”

6~~5~~. Subparagraph (c) defines the terms “enterprise of a Contracting State” and “enterprise of the other Contracting State”. It does not define the term “enterprise” per se, 10~~9~~. Initially, the definition of the term “national” occurred in paragraph 2 of ~~a~~**A**rticle 24 relating to “Non-discrimination”. As a result, the definition of the term “national” would have restricted application only for the purposes of Article 24. Since the term “national” has been referred to in other articles of the Convention as well, namely, ~~a~~**A**rticle 4.2 (c) and (d), ~~a~~**A**rticle 19, ~~a~~**A**rticle 24 and ~~a~~**A**rticle 25, it was decided in 1999 to shift the definition of the term “national” from paragraph 2 of ~~a~~**A**rticle 24 to subparagraph (f) of paragraph 1 of ~~a~~**A**

13. The OECD Commentary states:

12 "However, paragraph 2 specifies that this applies only if the context does not require an alternative interpretation. The context is determined in particular by 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 State concerned (the ‘State of residence’). This liability to tax is not imposed only on persons who are ‘domiciled’ in a State in the sense in which ‘domicile’ is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State. Some legislations impose full liability to tax on individuals who perform services on board ships which have their home harbour in the State.~~” [para. 3]~~

4. ~~“~~Conventions for the avoidance of double taxation do not normally concern themselves with the domestic laws of the Contracting States laying down the conditions under which a person is to be treated fiscally as ‘resident’ and, consequently, is fully liable to tax in that State. They do not lay down standards which the provisions of the domestic laws on ‘residence’ have to fulfil in order that claims for full tax liability can be accepted between the Contracting States. In this respect the States take their stand entirely on the domestic laws.~~” [para. 4]~~

5. ~~“~~This manifests itself quite clearly in the cases where there is no conflict at all between two residences, but where the conflict exists only between residence and source or situs. But the same view applies in conflicts between two residences. The special point in these cases is only that no solution of the conflict can be arrived at by reference to the concept of residence adopted in the domestic laws of the States concerned. In these cases special provisions must be established in the Convention to determine which of the two concepts of residence is to be given preference.~~” [para. 5]~~

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 4

Paragraph 1

3. The **former** Group **of Experts** decided to adopt as paragraph 1 of ~~a~~**A**rticle 4, the paragraph 1 of Article 4 of the OECD Model Convention, and had initially decided not to adopt the second sentence which reads: “This term [resident of a Contracting State], 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”. The second sentence, which was included in the OECD Convention to deal, for example, with the special situation of foreign diplomats and consular staffs serving in a country which taxed residents on the basis of their worldwide income, who might be considered (under the domestic law of the country in which they are serving) as residents but, because of their special status, might nevertheless be taxable only on income from sources in that State, has been incorporated in 1999 in paragraph 1 of ~~a~~**A**

be a resident according to the domestic laws but is subject only to a taxation limited to the income from sources in ~~the~~ **that**

all of the requirements for exemption specified in the tax laws. They are, thus, subject to the tax laws of a Contracting St

existing during the period when the residence of the taxpayer affects tax liability, which may be less than an entire taxable period. [Assume that] in one calendar year an individual is a resident of State A under that State's tax laws from 1 January to 31 March, then moves to State B. Because the individual resides in State B for more than 183 days, the individual is treated by the tax laws of State B as a State B resident for the entire year. Applying the special rules to the period 1 January to 31 March, the individual was a resident of State A. Therefore, both State A and State B should treat the individual as a State A resident for that period, and as a State B resident from 1 April to 31 December.~~" [para. 10]~~

11. ~~"~~The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, e.g. where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.~~" [para. 11]~~

12. ~~"~~Subparagraph ~~(~~a) means, therefore, that in the application of the ~~c~~**C**

considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.~~" [para. 15]~~

16. ~~"~~Subparagraph (b) establishes a secondary criterion for two quite distinct possible if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies, etc. also, special rules as to the preference must be established". [para. 21] According to the OECD Commentary, "It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed". [para. 22] It may be mentioned that, as in the case of the OECD Model Convention, the word "only" has been added in 1999 to the tie-breaker test for determining the residence of dual residents, other than individuals.

9. The OECD Commentary goes on to state:

> **23**. ~~"~~The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the 'place of management' of the enterprise is situated; other conventions attach importance to its 'place of effective management', others again to the 'fiscal domicile of the operator'.~~" [para. 23]~~
>
> [As a result of these considerations, the 'place of effective management' has been adopted as the preference criterion for persons other than individuals **[...]**" [para. 24]]

10. It is 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

the Contracting States.

Competent authorities having to apply such a provision to determine the residence of a legal person for purposes of the Convention would be expected to take account of various factors, such as where the meetings of its board of directors or equivalent body are usually

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"delivery" is not mentioned in the United Nations Model Convention, but is mentioned in the OECD Model Convention. Therefore a delivery activity might result in a permanent establishment under the United Nations Model Convention, without doing so under the OECD Model Convention;

– the actions of a "dependent agent" may constitute a permanent establishment, even without having and habitually exercising the authority to conclude contracts in the name of the enterprise, where that person habitually maintains a stock of goods or merchandise and regularly makes deliveries from the stock (para. 5 (b));

- this place of business must be “fixed”, i.e., it must be established at a distinct place with a certain degree of permanence;
- the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated.

The OECD Commentary goes on to observe:

3. It could perhaps be argued that in the general definition some mention should also be made of the other characteristic of a permanent establishment to which some importance has sometimes been attached in the past, namely that the establishment must have a productive character, i.e. contribute to the profits of the enterprise. In the present definition this course has not been taken. Within the framework of a well-run business organisation it is surely axiomatic to assume that each part contributes to the productivity of the whole. It does not, of course, follow in every case that because in the wider context of the whole organisation a particular establishment has ~~“~~a “productive character” it is consequently a permanent establishment to which profits can properly be attributed for the purpose of tax in a particular territory (cf. Commentary on paragraph 4).

4. The term “place of business” covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a customs depot (e.g.~~,~~ for the storage of dutiable goods). Again the place of major customer to take orders and meets the purchasing director in his office to do so. In that case, the customer's premises are not at the disposal of the enterprise for which the salesman is working and therefore do not constitute a fixed place of business through which the business of that enterprise is carried on (depending on the circumstances, however, paragraph 5 could apply to deem a permanent establishment to exist).

4.3 A second example is that of an employee of a company who, for a long period of time, is allowed to use an office in the headquarters of another company (e.g., a newly acquired subsidiary) in order to ensure that the latter company complies with its obligations under contracts concluded with the former company. In that case, the employee is carrying on activities related to the business of the former company and the office that is at his disposal at the headquarters of the other company will constitute a permanent establishment of his employer, provided that the office is at his disposal for a sufficiently long period of time so as to constitute a "fixed place of business" (see paragraphs 6 to 6.3) and that the activities that are performed there go beyond the activities referred to in paragraph 4 of the Article.

4.4 A third example is that of a road transportation enterprise which would use a delivery dock at a customer's warehouse every day for a number of years for the purpose of delivering goods purchased by that customer. In that case, the presence of the road transportation enterprise at the delivery dock would be so limited that that enterprise could not consider that place as being at its disposal so as to constitute a permanent establishment of that enterprise.

4.5 A fourth example is that of a painter who, for two years, spends three days a week in the large office building of its main client. In that case, the presence of the painter in that office building where he is performing the most important functions of his business (i.e. painting) constitute a permanent establishment of that painter.

4.6 The words "through which" must be given a wide meaning so as to apply to any situation where business activities are carried on at a particular location that is at the disposal of the enterprise for that purpose. Thus, for instance, an enterprise engaged in paving a road will be considered to be carrying on its business "through" the location where this activity takes place.

5. According to the definition, the place of business has to be a "fixed" one. Thus in the normal way there has to be a link between the place of business and a specific geographical point. It is immaterial how long an enterprise of a Contracting State operates in the other Contracting State if it does not do so at a distinct place, but this does not mean that the equipment constituting the place of business has to be actually fixed to the soil on which it stands. It is enough that the equipment remains on a particular site (but cf. paragraph 20 below).

> *5.1* Where the nature of the business activities carried on by an enterprise is such that these activities are often moved between neighbo**u**ring locations, there may be difficulties in determining whether there is a single "place of business" (if two places of business are occupied and the other requirements of Article 5 are met, the enterprise will, of course, have two permanent establishments). As recognised in paragraphs 18 and 20 below a single place of business will generally be considered to exist where, in light of the nature of the business, a particular location within which the activities are moved may be identified as constituting a coherent whole commercially and geographically with respect to that business.
>
> *5.2* This principle may be illustrated by examples. A mine clearly constitutes a single place of business even though business activities may move from one location to another in what may be a very large mine as it constitutes a single geographical and commercial unit as concerns the mining business. Similarly, an "office hotel" in which a consulting firm regularly rents different offices may be considered to be a single place of business of that firm since, in that case, the building constitutes a whole geographically and the hotel is a single place of business for the consulting firm. For the same reason, a pedestrian street, outdoor market or fair in different parts of which a trader regularly sets up his stand represents a single place of business for that trader.

The OECD Commentary then examines some examples relating to the provision of services. In quoting the following two paragraphs, the Committee notes that Article 5 (3) (b) of the U**nited** N**ations** Model **Convention**

> disagreements as to whether a particular place of business that exists only for a short period of time constitutes a permanent establishment.

The Committee agreed with the approach taken in paragraph 6 of the OECD Commentary, while recognizing that such **exceptional** situations will not often arise in practice, and that special care should therefore be taken when relying on paragraph 6 as applicable in an actual case. The OECD Commentary continues:

> *6.1* As mentioned in paragraphs 11 and 19, temporary interruptions of activities do not cause a permanent establishment to cease to exist. Similarly, as discussed in paragraph 6, where a particular place of business is used for only very short periods of time but such usage takes place regularly over long periods of time, the place of business should not be considered to be of a purely temporary nature.

> *6.2* Also, there may be cases where a particular place of business would be used for very short periods of time by a number of similar businesses carried on by the same or related persons in an attempt to avoid that the place be considered to have been used for more than purely temporary purposes by each particular business. The remarks of paragraph 18 on arrangements intended to abuse the 12-month period provided for in paragraph 3 would equally apply to such cases.

> *6.3* Where a place of business which was, at the outset, designed to be used

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with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary interruption of operations, however, cannot be regarded as **a** closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessors; in general, the lessors

~~(~~b) shall be deemed to carry on such activities through a permanent establishment in that other State; or

~~(~~c) shall be deemed to carry on such activities through a permanent establishment in that other State if such activities last longer than a specified period of time.

The Contracting States may moreover agree to submit the income from such activities to any other rule.

6. As mentioned above, in subparagraph (f) the expression “any other place of extraction of natural resources” should be interpreted broadly. Some have argued that, for this purpose, a fishing vessel could be treated as a place of extraction or exploitation of natural resources since “fish” constitute a natural resource. In their analysis, although it is true that all places or apparatus designated as “permanent establishments” in subparagraphs (a) to (e) in paragraph 2 have a certain degree of permanence or constitute “immovable property”, fishing vessels can be considered as a place used for extraction of natural resources, which may not necessarily mean only minerals embedded in the Earth. In this view, fishing vessels can be compared to the movable drilling platform that is used in off-shore drilling operations for gaining access to oil or gas. Where such fishing vessels are used in the territorial waters or the exclusive economic zone of the coastal State, their activities would constitute a permanent establishment, situated in that State. However, others are of the view that such an interpretation was open to objection in that it constituted too broad a reading of the term “permanent establishment” and of the natural language of the subparagraph. Accordingly, in their opinion, any treaty partner countries which sought to advance such a proposition in respect of fishing activities, should make that explicit by adopting it as a new and separate category in the list contained in this Article. Consequently, the interpretation on the nature of this activity has been left to

permanent establishments, subject to there being a specific six-month test. However, the Committee considers that where a building site exists for six months, it will in practice almost invariably also meet the requirements of paragraph 1. In fact, an enterprise having a building site, etc., at its disposal, through which its activities are wholly or partly carried on will also meet the criteria of paragraph 1.

8. Some countries support a more elaborate version of paragraph 3(a), which would extend the provision to encompass a situation "where such 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 activities exceed 10 per cent of the sale price of the machinery or equipment". Other countries believe that such a provision would not be appropriate, particularly if the machinery were installed by an enterprise other than the one doing the construction work.

9. Article 5(3)(b) deals with the furnishing of services, including consultancy services, the performance of which does not, of itself, create a permanent establishment in the OECD Model **Convention**. Many developing countries believe that management and consultancy services should be covered because the provision of those services in developing countries by enterprises of industrialized countries can generate large profits. In the (2011) version of the U**nited** N**ations** Model **Convention**, the Committee has agreed to a slight change in the wording of subparagraph 3(b), which was amended to read: "but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than 183 days in any ~~12~~**twelve**-month period commencing or ending in the fiscal year concerned", rather than, "but only if activities of that nature continue (for the same or a connected project) within a Contracting State for a period or periods aggregating more than six months within any ~~12~~**twelve**-month period", as it formerly read. This was seen as providing greater consistency with the approach taken in Article 14(1)(b).

10. A few developing countries oppose the six-month (or 183 days) thresholds in paragraph 3(a) and (b) altogether. They have two main reasons: first, they maintain that construction, assembly and similar activities could, as a result of modern technology, be of very short duration and still result in a substantial profit for the enterprise; second, and more fundamentally, they simply believe that the period during which foreign personnel remain in the source country is irrelevant to their right to tax the income (as it is in the case of artistes and sportspersons under Article 17). Other developing countries oppose a time limit because it could be used by foreign enterprises to set up artificial arrangements to avoid taxation in their territory. However, the purpose of bilateral treaties is to promote international trade, investment, and development, and the reason for the time limit (indeed for the permanent establishment threshold more generally) is to encourage businesses to undertake preparatory or ancillary operations in another State that will facilitate a more permanent and substantial commitment later on, without becoming immediately subject to tax in that State.

11. In this connection, the OECD Commentary observes, with changes in parentheses to take account of the different time periods in the two Models:

an enterprise subcontracting *all* parts of the project could never have a permanent establishment in the host State.

The Commentary of the OECD Model **Convention** continues as follows:

19.1 In the case of fiscally transparent partnerships, the [six]-month test is applied at the level of the partnership as concerns its own activities. If the period of time spent on the site by the partners and the employees of the partnership exceeds [six] months, the enterprise carried on by the partnership will therefore be considered to have a permanent establishment. Each partner will thus be considered to have a permanent establishment for purposes of the taxation of his share of the business profits derived by the partnership regardless of the time spent by himself on the site.

20. The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipelines laid. Similarly, where parts of a substantial structure such as an offshore platform are assembled at various locations within a country and moved to another location within the country for final assembly, this is part of a single project. In such ~~a~~ case**s**

15. The following passages of the **OECD** Commentary ~~on the OECD Model~~ are relevant to Article 5 (3) (a) of the U**nited** N**ations** Model **Convention**, although the reference to an "assembly project" in the U**nited** N**ations** Model **Convention** and not in the OECD Model **Convention**, and the six-month period in the U**nited** N**ations** Model **Convention** should, in particular, be borne in mind:

16. This paragraph provides expressly th-mon/TTdtruil0 1 sdtruil0 1 sdtrTc.11lti62.570 0 1 3-monttablish4 1 provisions of that Article were similar to those applicable to business profits but it used the concept of fixed base rather than that of permanent establishment since it had originally been thought that the latter concept should be reserved to commercial and industrial activities. The elimination of Article 14 in 2000 reflected the fact that there were no intended differences between the concepts of permanent establishment, as used in Article 7, and fixed base, as used in Article 14, or between how profits were computed and tax was calculated according to

which dealt with Independent Personal Services, was deleted from the Convention. This addition, which ensures that the term "business" includes the performance of the activities ~~that~~ **which** were previously covered by Article 14, was intended to prevent that the term "business" be interpreted in a restricted way so as to exclude the performance of professional services, or other activities of an independent character, in States where the domestic law does not consider that the performance of such services or activities can constitute a business. Contracting

15.22 Subparagraph 2 (c) of Article 15 should be amended by removing references to the fixed base concept, as follows:

"(c) the remuneration is not borne by a permanent establishment ~~or a fixed base~~ which the employer has in the other State."

15.23 The following amendments should be made to Article 17 so as to remove references to the deleted Article 14 and so as to add references to Article 7:

(a) Modify paragraph 1 of Article 17 to read as follows:

"1. Notwithstanding the provisions of articles ~~14~~ 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 sportsperson, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State."

(b) Modify paragraph 2 of Article 17 to read as follows:

16. This paragraph reproduces Article 5 (4) of the OECD Model **Convention** with one substantive amendment: the deletion of "delivery" in subparagraphs (a) and (b). In view of the similarities to the OECD Model **Convention** provision and the general relevance of its Commentary, the general principles of Article 5 (4) under both Models are first noted below and then the practical relevance of the deletion of references to "delivery" in the U**nited** N**ations** Model **Convention** is considered.

17. The deletion of the word "delivery" reflects the majority view of the Committee that a "warehouse" used for that purpose should, if ~~at least~~ the requirements of paragraph 1 are met, be a permanent establishment.

Comment [MB8]: Note by a member of the Subcommittee: I think it necessary to have a brief reference to the amendment highlighted in paragraph 16 above. Para. 20 then discusses the reasoning in more detail.

18. The OECD Commentary on paragraph 4 of the OECD Article reads as follows:

> *21.* This paragraph lists a number of business activities which are treated as exceptions to the general definition laid down in paragraph 1 and which are not permanent establishments, even if the activity is carried on through a fixed place of business. The common feature of these activities is that they are, in general, preparatory or auxiliary activities. This is laid down explicitly in the case of the exception mentioned in subparagraph *e*), which actually amounts to a general restriction of the scope of the definition contained in paragraph 1. Moreover subparagraph *f*) provides that combinations of activities mentioned in subparagraphs *a*) to *e*) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State, activities of a purely preparatory or auxiliary character.
>
> *22.* *Subparagraph a*) relates only to the case in which an enterprise acquires the use of facilities for storing, displaying or delivering its own goods or merchandise. Subparagraph *b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage, display or delivery. Subparagraph *c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph *d*) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many "tentacles" of the parent body; to exempt such a bureau is to do no more than to extend the concept of "mere purchase".
>
> *23.* Subparagraph *e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list of exceptions. Furthermore, this subparagraph provides a generalised exception to

such machinery, as this goes beyond the pure delivery mentioned in subparagraph *a*) of paragraph 4. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph *e*) applies only if the should be considered in the light of the particular circumstances. The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of subparagraph *e*) (cf. paragraphs 24 and 25 above). States which want to allow any combination of the items mentioned in subparagraphs *a*) to *e*), disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words "provided" to "character" in subparagraph *f*).

27.1 Subparagraph *f*) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs *a*) to *e*) provided that they are separated from each other locally and organisationally, as in such a case each place of business has to be viewed separately and in isolation for deciding whether a permanent establishment exists. Places of business are not "separated organisationally" where they each perform in **a** Contracting State complementary functions such as receiving and storing goods in one place, distributing those goods through another etc. An enterprise cannot fragment a cohesive operating business into several small operations in order to argue that each is merely engaged in a preparatory or auxiliary activity.

28. The fixed places of business mentioned in paragraph 4 cannot be deemed to constitute permanent establishments so long as their activities are restricted to the functions which are the prerequisite for assuming that the fixed place of business is not a permanent establishment. This will be the case even if the contracts necessary for establishing and carrying on the business are concluded by those in charge of the places of business themselves. The employees of places of business within the meaning of paragraph 4 who are authorised to conclude such contracts should not be regarded as agents within the meaning of paragraph 5. A case in point would be a research institution the manager of which is authorised to conclude the contracts necessary for maintaining the institution and who exercises this authority within the framework of the functions of the institution. A permanent establishment, however, exists if the fixed place of business exercising any of the functions listed in paragraph 4 were to exercise them not only on behalf of the enterprise to which it belongs but also on behalf of other enterprises. If, for instance, an advertising agency maintained by an enterprise were also to engage in advertising for other enterprises, it would be regarded as a permanent establishment of the enterprise by which it is maintained.

29. If a fixed place of business under paragraph 4 is deemed not to be a permanent establishment, this exception applies likewise to the disposal of movable property forming part of the business property of the place of business at the termination of the enterprise's activity in such installation (cf. paragraph 11 above and paragraph 2 of Article 13). Since, for example, the display of merchandise is excepted under subparagraphs *a*) and *b*), the sale of the merchandise at the termination of a trade fair or convention is covered by this exception. The exception does not, of course, apply to sales of merchandise not actually displayed at the trade fair or convention.

30. A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent

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of activity necessary to conclude that the agent is "habitually exercising" contracting authority will depend on the nature of the contracts and the business of the principal. It is not possible to lay down a precise frequency test. Nonetheless, the same sorts of factors considered in paragraph 6 would be relevant in making that determination.

24. The Committee's view is that where paragraph 33 of the OECD Commentary above refers to "(a) person who is authorised to negotiate all elements and details of a contract", this should be taken to include a person who has negotiated all the *essential* elements of the contract, whether or not that person's involvement in the negotiation also extends to other non-essential aspects.

25. With the addition of paragraph 5 (b), relating to the maintenance of a stock of goods, this paragraph is broader in scope than paragraph 5 of the OECD Model **Convention**. Some countries believe that a narrow formula might encourage an agent who was in fact dependent to represent himself as acting on his own behalf.

26. The former Ad Hoc Group of Experts on International Cooperation in Tax Matters understood that subparagraph 5 (b) was to be interpreted such that if all the sales-related activities take place outside the host State and only delivery, by an agent, takes place there, such a situation would not lead to a permanent establishment.[15] The Group of Experts noted, however, that if sales-related activities (for example, advertising or promotion) are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of such goods or merchandise, a permanent establishment may exist.[16]

Paragraph 6

27. This paragraph

companies of a State are deemed to have a permanent establishment in the other State if they collect premiums in that other State through an agent established there — other than an agent who already constitutes a permanent establishment by virtue of paragraph 5 — or insure risks situated in that territory through such an agent. The decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned. Frequently, therefore, such a provision will not be contemplated. In view of this fact, it did not seem advisable to insert a provision along these lines in the Model Convention.

28. Paragraph 6 of the U**nited** N**ations** Model **Convention**, which achieves the aim quoted above, is necessary because insurance agents generally have no authority to conclude contracts; thus, the conditions of paragraph 5 (a) would not be fulfilled. If an insurance agent is independent, however, the profits of the insurance company attributable to his activities are not taxable in the source State because the provisions of Article 5 (7) would be fulfilled and the enterprise would not be deemed to have a permanent establishment.

29. Some countries, however, favour extending the provision to allow taxation even where there is representation by such an independent agent. They take this approach because of the nature of the insurance business, the fact that the risks are situated within the country claiming tax jurisdiction, and the ease with which persons could, on a part-time basis, represent insurance companies on the basis of an “independent status”, making it difficult to distinguish between dependent and independent insurance agents. Other countries see no reason why the insurance business should be treated differently from activities such as the sale of tangible commodities. They also point to the difficulty of ascertaining the total amount of business done when the insurance is handled by several independent agents within the same country. In view of this difference in approach, the question how to treat independent agents is left to bilateral negotiations, which could take account of the methods used to sell insurance and other features of the insurance business in the countries concerned.

Paragraph 7

30. The first sentence of this paragraph reproduces Article 5 (6) of the OECD Model **Convention**, with a few minor drafting changes. The relevant portions of the Commentary orf0 rateraJO

37. A *person* will come within the scope of paragraph [7], i.e.~~,~~ he will not constitute a permanent establishment of the enterprise on whose behalf he acts only if:

~~(~~a) he is independent of the enterprise both legally and economically, and
~~(~~b) he acts in the ordinary course of his business when acting on behalf of the enterprise.

38. Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where

equipment, the enterprise has facilities at its disposal where business functions of the enterprise are performed.

42.6 Where an enterprise operates computer equipment at a particular location, a permanent establishment may exist even though no personnel of that enterprise is required at that location for the operation of the equipment. The presence of personnel is not necessary to consider that an enterprise wholly or partly carries on its business at a location when no personnel are in fact required to carry on business activities at that location. This conclusion applies to electronic commerce to the same extent that it applies with respect to other activities in which equipment operates automatically, e.g. automatic pumping equipment used in the exploitation of natural resources.

42.7 Another issue relates to the fact that no permanent establishment may be considered to exist where the electronic commerce operations carried on through computer equipment at a given location in a country are restricted to the preparatory or auxiliary activities covered by paragraph 4. The question of whether particular activities performed at such a location fall within paragraph 4 needs to be examined on a case-by-case basis having regard to the various functions performed by the enterprise through that equipment. Examples of activities which would generally be regarded as preparatory or auxiliary include:

- providing a communications link — much like a telephone line — between suppliers and customers;
- advertising of goods or services;
- relaying information through a mirror server for security and efficiency purposes;
- gathering market data for the enterprise;
- supplying information.

42.8 Where, however, such functions form in themselves an essential and significant part of the business activity of the enterprise as a whole, or where other core functions of the enterprise are carried on through the computer equipment, these would go beyond the activities covered by paragraph 4 and if the equipment constituted a fixed place of business of the enterprise (as discussed in paragraphs 42.2 to 42.6 above), there would be a permanent establishment.

42.9 What constitutes core functions for a particular enterprise clearly depends on the nature of the business carried on by that enterprise. For instance, some ISPs are in the business of operating their own servers for the purpose of hosting web sites or other applications for other enterprises. For these ISPs, the operation of their servers in order to provide services to customers is an essential part of their commercial activity and cannot be considered preparatory or auxiliary. A

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Commentary on chapter III

TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

A. GENERAL CONSIDERATIONS

1. Article 6 of the United Nations Model Convention reproduces Article 6 of the OECD Model Convention **with the exception of the phrase "and to income from immovable property used for the performance of indepe**

income from agriculture or forestry) to the State of source, that is, the State where the property in question is situated. In the words of the Commentary on the OECD Model Convention, this provision is based on “the fact that there is always a very close economic

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~~differences of opinion with other States. In this respect, the methods for solving~~

benefits. This recognizes that an enterprise may have legitimate business reasons for choosing not

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~~long duration. Turnkey contracts, however, often involve components other than normal construction activities, including the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, are sometimes completed before construction activities actually start (and hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment is situated.~~

~~11. The question thus arose how much of the total profits of the turnkey contract is properly attributable to the permanent establishment and thus taxable in the country in which it is situated. A member from a developed country said that he knew of instances in which countries had sought to attribute the entire profits of the contract to the permanent establishment. It was his view, however, that only the profits attributable to activities carried on by the permanent establishment should be taxed in the country in which the permanent establishment was situated, unless the profits included items of income dealt with separately in other articles of the Convention and were taxable in t~~

of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce." [para. 12]

"This raises the question as to what extent such accounts should be relied upon when they are based on agreements between the head office and its permanent establishments (or between the permanent establishments themselves). Clearly, such internal agreements cannot qualify as legally binding contracts. However, to the extent that the trading accounts of the head office and the permanent establishments are both prepared symmetrically on the basis of such agreements and that those agreements reflect the functions performed by the different parts of the enterprise, these trading accounts could be accepted by tax authorities. In that respect, accounts could not be regarded as prepared symmetrically unless the values of transactions or the methods of attributing profits or expenses in the books of the permanent establishment corresponded exactly to the values or methods of attribution in the books of the head office in terms of the national currency or functional currency in which the enterprise recorded its transactions. However, where trading accounts are based on internal agreements that reflect purely artificial arrangements instead of the real economic functions of the different parts of the enterprise, these agreements should simply be ignored and the accounts corrected accordingly. This would be the case if, for example, a permanent establishment involved in sales were, under such an internal agreement, given the role of principal (accepting all the risks and entitled to all the profits from the sales) when in fact the permanent establishment concerned was nothing more than an intermediary or agent (incurring limited risks and entitled to receive only a limited share of the resulting income) or, conversely, were given the role of intermediary or agent when in reality it was a principal." [para. 12.1]

"In this respect, it should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment [...]" [para. 12.2]

"Even where a permanent establishment is able to produce detailed accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with the arm's length principle [...] Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this principle, and profits have thus been diverted from the permanent establishment to the head office, or vice versa." [para. 13]

"In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied;

such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market; this may, for example, be a perfectly normal commercial method of establishing a competitive position in a new market and should not then be taken as evidence of an attempt to divert profits from one country to another. Difficulties may also occur in the case of proprietary goods produced by an enterprise, all of which are sold through its permanent establishments; if in such circumstances there is no open market price, and it is thought that the figures in the accounts are unsatisfactory, it may be necessary to calculate the permanent establishment's profits by other methods, for example, by applying an average ratio of gross profit to the turnover of the permanent establishment and then deducting from the figures so obtained the proper amount of expenses incurred. Clearly many special problems of this kind may arise in individual cases but the general rule should always be that the profits attributed to a permanent establishment should be based on that establishment's accounts insofar as accounts are available which represent the real facts of the situation. If available accounts do not represent the real facts then new accounts will have to be constructed, or the original ones rewritten, and for this purpose the figures to be used will be those prevailing in the open market." [para. 14]

"Many States consider that there is a reali~~z~~sation of a taxable profit when an asset, whether or not trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connection with such a transfer. Such profits may be determined as indicated below. In cases where such transfer takes place, whether or not it is a permanent one, the question arises as to when taxable profits are reali~~z~~sed. In practice, where such property has a substantial market value and is likely to appear on the balance sheet of the importing permanent establishment or other part of the enterprise after the taxation year during that in which the transfer occurred, the reali~~z~~sation of the taxable profits will not, so far as the enterprise as a whole is concerned, necessarily take place in the taxation year of the transfer under consideration. However, the mere fact that the property leaves the purview of a tax jurisdiction may trigger the taxation of the accrued gains attributable to that property as the concept of reali~~z~~sation depends on each country's domestic law." [para. 15]

"Where the countries in which the permanent establishments operate levy tax on the profits accruing from an internal transfer as soon as it is made, evd a29 TD.00twh(h).5(t)22(v1 -]TJ16.6511 -1.129 T4.

was made and the time it was finally disposed of. In such a case, the transferring branch should re

~~19~~**16**. The **Committee considers that the following part of the Commentary on paragraph 3 of Article 7 of the 2008** OECD **Model Convention** ~~Commentary on Article 7, paragraph 3,~~ is ~~relevant~~ **applicable to the first part of the corresponding paragraph of Article 7**:

> "This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recogni~~z~~**s**es that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for

and 4 of that Article)". [para 30].

arises in such circumstances. " [para. ~~17.3~~**33**]

"In the case of intangible rights, the rules concerning the relations between enterprises of the same group (e.g.~~,~~ payment of royalties or cost sharing arrangements) cannot be applied in respect of the relations between parts of the same enterprise. Indeed, it may be extremely difficult to allocate **'ownership'** of the intangible right solely to one part of the enterprise and to argue that this part of the enterprise should receive royalties from the other parts as if it were an independent enterprise. Since there is only one legal entity it is not possible to allocate legal ownership to any

case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated." [para. ~~23~~40]

"~~Special considerations apply to payments~~ **The treatment of interest charges raises** particular **issues. First, there might be amounts** which, under the name of interest, are ~~made to~~ **charged by** a head office ~~by~~ **to** its permanent establishment with respect to **internal "**loans**"** ~~made~~ by the former to the latter. ~~In that case, the main issue is not so much whether a debtor/creditor relationship should be recognized within the same legal entity as whether an arm's length~~ interest rate

~~are permitted by their domestic laws.~~

NOTE BY THE SECRETARIAT: THREE ALTERNATIVE VERSIONS TO REFLECT OECD PARAGRAPH 45 (2008) HAVE BEEN INCLUDED BELOW. ***OPTION A*** IS A VERY

~~establishment for "mere purchase" by that permanent establishment of goods or merchandise for the enterprise has been engaging the attention of the Group of Experts for some time. It has been considered that since under article 5 an office or facility maintained by an enterprise in a Contracting State in the other Contracting State for mere purchase of goods or merchandise does not constitute a permanent establishment, there would be very few cases where an enterprise having a permanent establishment dealing with other business would also have a purchasing facility for the enterprise. However, it has not been considered necessary to make any change in the existing provisions and the matter may be looked into during bilateral negotiations~~.

Paragraph 4

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allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say *in va*cuo that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a

~~24~~**19**. This paragraph reproduces Article 7, paragraph 7, of the **2008** OECD Model Convention. **The Committee considers that the following part of the Commentary on paragraph 7 of Article 7 of the 2008 OECD Model Convention is applicable to the corresponding paragraph of Article 7:** ~~The OECD Commentary on that paragraph is as follows:~~

> "Although it has not been found necessary in the Convention to define the term 'profits', it should nevertheless be understood that the term when used in this Article and elsewhere in the Convention has a broad meaning including all income derived in carrying on an enterprise. Such a broad meaning corresponds to the use of the term made in the tax laws of most OECD ~~M~~**m**ember countries." [para. ~~32~~**59**]

> "This interpretation of the term 'profits', however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other Articles of the Convention, e.g.~~,~~ dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc.**,** or by the provisions of this Article." [para. ~~33~~**60**]

~~"It should also be noted that, whilst the definition of 'royalties' in paragraph 2 of Article 12 of the 1963 Draft Convention and 1977 Model Convention included payments 'for the use of, or the right to use, industrial, commercial, or scientific equipment', the reference to these payments was subsequently deleted from that definition in order to ensure that income from the leasing of industrial, commercial or scientific equipment, including the income from the leasing of containers, falls under the provisions of Article 7 rather than those of Article 12, a result that the Committee on Fiscal Affairs considers to be appropriate given the nature of such income." [para. 37]~~

~~25~~**20**. ~~With respect to the last quoted paragraph from the OECD Model Convention Commentary, i~~**I**t is important to note that in the ~~revised~~ United Nations Model Convention, payments "for the use of, or the right to use, industrial, commercial or scientific equipment" are treated differently **than under the OECD Model Convention**. They remain within the definition of "royalties" in paragraph 3 of ~~a~~**A**rticle 12 and accordingly by reason of paragraph 6 of ~~a~~**A**rticle 7 continue to fall under the provisions of ~~a~~**A**rticle 12, rather than those of ~~a~~**A**rticle 7.

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

A. GENERAL CONSIDERATIONS

1. Two alternative versions are given for ~~a~~**A**rticle 8 of the United Nations Model Convention, namely ~~a~~**A**rticle 8 (alternative A) and ~~a~~**A**rticle 8 (alternative B)7POTd4-22fsnt BET TT4 1 Tf1 Tw[(r232 TD4 15

were not in a position to forgo 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 allocating the profit to the various countries concerned **in the course of the operation of ships in international traffic**.

4. ~~While some members from developed countries found taxation of shipping profits at the source acceptable, a large number of members from developed countries said they preferred the principle of exclusive taxation by the State in which the place of effective management of the enterprise was situated~~. Since no consensus could be reached on a provision concerning the taxation of shipping profits, the ~~Group agreed~~ **use of two alternatives in the Model Convention is proposed and** that the question of such taxation should be left to bilateral negotiations.

5. Although the texts of ~~a~~**A**rticle 8 (alternatives A and B) both refer to the "place of effective management of the enterprise", some countries may wish to refer instead to the "~~country~~ **State** of residence of the enterprise".

6. ~~There~~ **Although there** was a consensus ~~within the Group~~ to recommend ~~a~~**A**rticles 8 (alternatives A and B) as alternatives~~. However~~, some ~~members~~ **countries** who could not agree to ~~a~~**A**rticle 8 (alternative A) also could not agree to ~~a~~**A**rticle 8 (alternative B) because of the phrase "more than casual". They argued that some countries might wish to tax either all shipping profits or all airline profits, and acceptance of ~~a~~**A**rticle 8 (alternative B) might thus lead to **a** revenue loss~~es~~, considering the limited number of shipping companies or airlines whose effective management was situated in those countries. ~~The~~

other State.' " [para. 3]

12 It is also of importance to have consensus on the nature of the income covered by Article 8 as the operations of shipping and air transport enterprises will often include income from activities directly connected with the operations or ancillary to those operations. In this regard the OECD Model Convention observes:

"The profits covered consist in the first place of the profits **directly** obtained by the enterprise from the ~~carriage~~ **transportation** of passengers or cargo **by ships or aircraft (whether owned, leased or otherwise at the disposal of the enterprise) that it operates in international traffic. However, as international transport has evolved, shipping and air transport enterprises invariably carry on a large variety of activities to permit, facilitate or support their international traffic operations. The paragraph also covers profits from activities directly connected with such operations as well as profit**

(e.g. sale of a ticket issued by another enterprise for the domestic leg of an international voyage offered by the enterprise) or will be ancillary to its own sales. Profits derived by the first enterprise from selling such tickets are therefore covered by the paragraph. [para. 8]

Advertising that the enterprise may do for other enterprises in magazines offered aboard ships or aircraft that it operates or at its business locations (e.g. ticket offices) is ancillary to its operation of these ships or aircraft and profits generated by such advertising fall within the paragraph. [para. 8.1]

"~~Recently, 'containerization' has come to play an increasing role in the field of~~ **Containers are used extensively in** international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers ~~which is supplementary~~ **are usually either directly connected** or ~~incidental~~ **ancillary** to its ~~international~~ operation of ships or aircraft

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~~consideration had been given to the very substantial expenditure that developing countries incurred in the construction of airports. They considered that it would appear more reasonable to situate the geographical source of profits from international transportation at the place where passengers or freight were booked.~~

Paragraph 2 of ~~a~~***A****rticle* 8 (alternative B)

~~13~~**16**. This paragraph allows profits from the operation of ships in international traffic to be taxed in the source country if operations in that country are "more than casual". It **also** provides an independent operative rule for the shipping business and is not qualified by ~~a~~**A**rticles 5 and 7 relating to business profits governed by the permanent establishment rule. It ~~thus~~

~~16~~**19**. **The rules set out in paragraphs 9 to 12 above relating to taxing rights and profits covered will apply equally to this paragraph.**

Enterprises not exclusively engaged in shipping, inland waterways transport and air transport.

20. With regard to enterprises not exclusively engaged in shipping, inland waterways

"Where

Article 9

ASSOCIATED ENTERPRISES

A. GENERAL CONSIDERATIONS

1. Article 9 of the United Nations Model Convention reproduces Article 9 of the OECD Model Convention, except for ~~a new~~ paragraph 3. As noted in the OECD Commentaries, "[t]his Article deals with adjustments to profits that may be made for tax purposes where transactions have been entered into between associated enterprises (parent and subsidiary companies and companies under common control) on other than arm's length terms" [para. 1]. It should be considered in conjunction with ~~a~~**A**rticle 25 on mutual agreement procedure and ~~a~~**A**rticle 26 on exchange of information.

2. The application of the arm's length rule to the allocation of profits between the associated enterprises presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's length principle.

3. With regard to transfer pricing of goods, technology, trademarks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's length terms, the Contracting States will **normally** follow the OECD principles which are set out in the OECD Transfer Pricing Guidelines. These conclusions represent internationally agreed principles ~~and the Group of Experts~~ **it is** recommend**ed** that the Guidelines should be followed for the application of the arm's length principle which underlies the ~~a~~**A**rticle. **[In addition, the Committee of Experts is currently producing a manual on the practical aspects of transfer pricing with a focus on the issues faced by developing countries.]**

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 9

Paragraph 1

4. Paragraph 1 provides that in cases involving associated enterprises, the tax authorities of a Contracting State may for the purpose of calculating tax liabilities rewrite the accounts of the enterprises if as a result of the special relation**ship** between the enterprises the accounts do not show the true taxable profits arising in that State. It is evidently appropriate that **an** adjustment should be sanctioned in such circumstances, and this paragraph calls for little comment. The provision applies only if special conditions have been made or imposed between the two enterprises. ~~"No~~ **Clearly no** re-writing of the accounts ~~of associated enterprises is authorized~~ **with a consequential adjustment should be made** if the transactions between ~~such~~ **the associated** enterprises have taken place on **a** normal open market commercial ~~terms (on an~~**basis, in other words, at** arm's length ~~basis)." [para. 2]~~.

5. ~~The Group of Experts have made an amendment in 1999 of a~~

~~This portion of paragraph 1 has been modified in 1999 as under:~~

> ~~". . . 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 . . ."~~

~~6~~5. "As discussed in the Committee on Fiscal Affairs' Report on Thin enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B." The OECD Commentary observes that "[p]aragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation". [para. 5]

However, according to the OECD Commentary,

" [...] an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph may not be invoked and should not be applied where the profits of one

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dividends should be taxed only by the source country. According to them, if both the country of residence and the source country were given the right to tax, the country of residence should grant a full tax credit regardless of the amount of foreign tax to be absorbed and, in appropriate cases, a tax-sparing credit. One of those members emphasized that there was no necessity for a developing country to waive or reduce its withholding tax on

~~to paragraph 2 of articles 11 (interest) and 12 (royalties).~~

~~6~~5. The OECD Model Convention restricts the tax in the source country to 5 per cent in subparagraph (a) for direct investment dividends and 15 per cent in subparagraph (b) for portfolio investment dividends, but the United Nations Model Convention leaves these percentages to be established through bilateral negotiations.

company." [para. 27]

"Payments regarded as dividends may include not only distributions of profits decided by annual general meetings of shareholders, but also other benefits

"It has been suggested that the paragraph could give rise to abuses through the transfer of shares to permanent establishments set up solely for that purpose in countries that offer preferential treatment to dividend income. Apart from the fact that such abusive transactions might trigger the application of domestic anti-abuse rules, it must be recognised that a particular location can only constitute a permanent establishment if a business is carried on therein and, also, that the requirement that a

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that other State, in accordance with its laws, but the additional charge shall not exceed ___ per cent of the amount of those profits."

~~23~~**22.** The suggested provision does not recommend a maximum branch profits rate. 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 **former** 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 branch profits tax rate was the 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 ~~a~~**A**rticle 10, rather than in ~~a~~**A**rticle 7, because the tax is intended to be analogous to a tax on dividends.

~~24~~**23**. The provision allows the branch profits tax to be imposed only on profits taxable under ~~a~~**A** rights in respect of which the dividend is paid to take advantage of this ~~a~~**A**rticle by means of that creation or assignment."

Article 11

INTEREST

A. GENERAL CONSIDERATIONS

1. Article 11 of the United Nations Model Convention reproduces the provisions of Article 11 of the OECD Model Convention

sacrifice that the latter would accept in such conditions will be matched by a relief to be given by the State of residence, in order to take into account the tax levied in the State of source (~~cf~~ **see**. Article 23 A or 23 B)." [para. 3]

"Certain countries do not allow interest paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the interest is paid by a resident of a Contracting State to a resident of the other State is dealt with in paragraph 4 of Article 24." [para. 4]

COMMENTARY ON THE PARAGRAPHS OF ARTICLE 11

Paragraph 1

6. This paragraph reproduces Article 11, paragraph 1, of the OECD Model Convention, the Commentary on which reads as follows:

"Paragraph 1 lays down the principle that interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in the latter. In doing so, it does not stipulate an exclusive right to tax in favour of the State of residence. The term 'paid' has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the creditor in the manner required by contract or by custom." [para. 5]

"The Article deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to interest

(e) Interest on long-term loans;

narrow powers which render it, in relation to the income concerned, a mere fiduciary or administrator acting on account of the interested parties. [para. 10]

"Subject to other conditions imposed by the Article, the limitation of tax in the State of source remains available when an intermediary, such as an agent or nominee located in a Contracting State or in a third State, is interposed between the beneficiary and the payer but the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all member countries). States which wish to make this more explicit are free to do so during bilateral negotiations." [para. 11]

"The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment. Procedural questions are not dealt with in

~~arises cannot be allowed as a credit in the beneficiary's State of residence and so~~

Paragraph 3

~~20~~**19**. This paragraph reproduces Article 11, paragraph 3, of the OECD Model Convention, the Commentary on which reads as follows:

> "Paragraph 3 specifies the meaning to be attached to the term 'interest' for the application of the taxation treatment defined by the ~~a~~**A**rticle. The term designates, in general, income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits. The term 'debt claims of every kind' obviously embraces cash deposits and security in the form of money, as well as government securities, and bonds and debentures, although the three latter are specially mentioned because of their importance and of certain peculiarities that they may present. It is recogni~~z~~**s**ed, on the one hand, that mortgage interest comes within the category of income from movable capital (*revenus de capitaux mobiliers*), even though certain countries assimilate it to income from immovable property. On the other hand, debt claims, and bonds and debentures in particular, which

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Paragraph 5

~~22~~**21**. This paragraph reproduces Article 11, paragraph 5, of the OECD Model Convention, which specifies that interest is from sources in the residence country of the payer**, except that the United Nations version refers to a fixed base as well as a permanent establishment**. The first sentence of paragraph 5 was amended in 1999 **in line with the OECD Model Convention**. However, in the course of discussion, the **former** Group **of Experts** agreed that countries might substitute a rule that would identify the source of interest as the State in which the loan giving rise to the interest was used. Where, in bilateral negotiations, the two parties differed on the appropriate rule, a possible solution would be a rule which, in general, would accept the place of residence of the payer as the source of interest; but where the loan was used in the State having a "place of use" rule, the interest would be deemed to arise in that State. The OECD Commentary on Article 11, paragraph 5, reads as follows:

Comment [MB23]: Suggested wording during the EGM in June.

> "This paragraph lays down the principle that the State of source of the interest is the State of which the payer of the interest is a resident. It provides, however, for an exception to this rule in the case of interest-bearing loans which have an obvious economic link with a permanent establishment owned in the other Contracting State by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, the paragraph determines that the source of the interest is in the Contracting State in which the permanent establishment is situated, leaving aside the place of residence of the owner of the permanent establishment, even when he resides in a third State." [para. 26]
>
> "In the absence of an economic link between the loan on which the interest arises and the permanent establishment, the State where the latter is situated cannot on that account be regarded as the State where the interest arises; it is not entitled to tax such interest, not even within the limits of a 'taxable quota' proportional to the importance of the permanent establishment. Such a practice would be incompatible with paragraph 5. Moreover, any departure from the rule fixed in the first sentence of paragraph 5 is justified only where the economic link between the loan and the permanent establishment is sufficiently clear-cut. In this connection, a number of possible cases may be distinguished:
>
> ~~(~~a) The management of the permanent establishment has contracted a loan which it uses for the specific requirements of the permanent establishment; it shows it among its liabilities and pays the interest thereon directly to the creditor.
>
> ~~(~~b) The head office of the enterprise has contracted a loan the proceeds of which are used solely for the purposes of a permanent establishment situated in another country. The interest is serviced by the head office but is ultimately borne by the permanent establishment.
>
> ~~(~~c) The loan is contracted by the head office of the enterprise and its proceeds are used for several permanent establishments situated in different countries.
>
> In cases ~~(~~a) and ~~(~~b) the conditions laid down in the second sentence of paragraph 5 are fulfilled, and the State where the permanent establishment is situated is to be

regarded as the State where the interest arises. Case ~~(~~c), however, falls outside the

Paragraph 6

~~23~~**22**. This paragraph reproduces Article 11, paragraph 6, of the OECD Model Convention, the Commentary on which reads as follows:

"The purpose of this paragraph is to restrict the operation of the provisions

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