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

Preface

Domestic resource mobilization, including tax revenues, is central to achieving sustainable development. Taxes represent a stable source of finance that, complemented by other sources, is critical to financing the 2030 Agenda for Sustainable Development, including the Sustainable Development Goals (SDGs). Taxation is essential to providing public goods and services, increasing equity and helping manage macroeconomic stability. SDG 17 on the means of implementation and global partnership for sustainable development calls on the international community to strengthen domestic resource mobilization, including through international support to developing countries, to improve domestic capacity for tax and other revenue collection.

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Introduction

Historical background

1. The *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* was initially published in 1979[5] and first revised in 2003.[6] In its resolution 2004/69 of 11 November 2004, the Economic and Social Council mandated the Committee of Experts on International Cooperation in Tax Matters (the Committee) to "keep under review and update as necessary" both the Manual and the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (the UN Model).[7]

2. From 2005 to 2011, work on updating the Manual was undertaken by 0 Dø • ø • •

11. The core of the Manual is contained in Section III, which introduces the different provisions of the UN Mode Section III is not intended to replace the explanations provided in the Introduction and Commentaries on the Articles of the UN Model, but rather to provide a simple tool for familiarizing less experienced negotiators with these provisions. Based on the structure of the UN Model, the Title and Preamble are followed by the Articles, which are organized in seven chapters:

Chapter I (Scope of the Convention) presents Articles 1 and 2, which deal with persons and taxes covered.

Chapter II (Definitions) analyses the definitions of key terms used in the UN Model, as provided in Articles 3 to 5. These include the definitions of “Resident” and “Permanent establishment” (PE). Negotiators are encouraged to exercise particular care when defining terms in order to avoid unintended consequences, in particular where differences exist between the UN Model and the OECD Model.

Chapter III (Taxation of income) deals with the distributive rules contained in Articles 6 to 21, which determine the allocation of the taxing rights between the treaty parties with respect to different categories of income. Special attention is devoted to some of the most controversial aspects of tax treaty negotiations, including the issues regarding the taxation of business profits and the determination of rates of withholding taxes applicable on payments of dividends, interest, royalties and fees for technical services.

Chapter IV (Taxation of capital) briefly describes the provisions contained in Article 22 dealing with taxes on capital.

Chapter V (Methods for the elimination of double taxation) illustrates the operation of Article 23, which requires the country of residence of the taxpayer to provide relief from double taxation. This may be done by either the exemption method or the credit method.

Chapter VI (Special provisions) analyses Articles 24 to 29, which include the provisions dealing with non-discrimination, mutual agreement procedure, exchange of information, assistance in collection, relationship with fiscal privileges of diplomats and entitlement to treaty benefits.

Chapter VII (Final provisions) covers the procedures for the entry into force and termination of treaties, as included in 9(bl-F2 12 Tf 1 0 0 1)6(I 1 0 0 r21 98.784 423.65 Tm

The electronic version of this Manual is available, free of charge, [to be added when available]

The United Nations Financing for Sustainable Development Office intends to continue its capacity development activities in the area of tax treaties and will use the Manual and other relevant publications for that purpose, with a view to strengthening the capacity of developing countries and promoting South-South cooperation. More information about the ongoing capacity development activities of FSDO may be found at http://www.un.org/esa/ffd/topics/capacity-development.html.

Section I - General introduction

A. Introduction

The growth of investment flows between countries depends to a large extent on the prevailing investment climate. The prevention or elimination of international double taxation in respect of the same income — the effects of which are harmful to the exchange of goods and services and to the movement of capital and persons, constitutes a significant component of such a climate.

United Nations Model Double Taxation Convention between Developed and Developing Countries, Introduction

13. The aim of this Manual is to provide a guide to all aspects of the negotiation of a tax treaty, including a brief description of the Articles of the UN Model, to negotiators with little or no experience in that area. As indicated in the Preface, however, this Manual is not intended to replace the more detailed explanations that are included in the Commentary on the UN Model, which is the most authoritative source on issues of interpretation of the provisions of the UN Model.

14. Since the beginning of the twentieth century, there has been an exponential growth in crossborder trade and investment, resulting today in a highly integrated, mobile and complex global economy. All countries are involved in international trade and investment, whether it be crossborder trade in goods or services, foreign investment, transfer of technology or movement of workers. All countries, whether developed or developing, require rules to address the ever-increasing number of international tax issues that arise as a result of such activities.

15. International income and capital taxation revolve

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systems can be properly applied and administered. Tax treaties contribute to the elimination of double taxation and other tax barriers. They also contribute to the prevention of cross-border tax evasion and avoidance.

B. Concepts and issues

1. Concept of residence

18. Under the residence principle, a country's claim to tax is based on the residential status of the taxpayer. In the case of income taxation, where the person is regarded as a resident for tax purposes, the country may tax the income of that person regardless of where the income has its source. Most countries tax their residents on their worldwide income, although a few countries only tax income derived by their residents from sources in these countries (so-called territorial taxation).

19. Domestic law rules for determining residence for tax purposes differ from country to country. With respect to individuals, residence is typically based on factors such as the economic and family ties that the individual has with the country, the existence of a place of abode in that country and the duration of physical presence in that country. Citizenship is different from residence but it is imm8Brtvn io ie membr the tUnite S-3(tsat)4(s)9132(re)7(s

23. Rules for determining the source of income vary, but source taxation is generally applied where the income has a relevant connection (or nexus) with that country. For example, income derived from the exploitation of natural resources located in a country would clearly have a strong connection with that country and would normally be regarded as having its source in that country.

24. Income will typically be taxed in accordance with the source principle where the assets or activities that generate the income are located within a country. For example, income from capital invested in a jurisdiction (e.g. dividends and interest) or from personal activities performed in a country (e.g. salaries) will usually be regarded as having its source in that country for purposes of income taxation.

25. Some countries have statutory rules for determining the source of income for tax purposes. These rules may seek to provide an exhaustive list of all categories of income that will be treated as sourced in that country or may be merely indicative of common situations where the income will be regarded as having its source there. Other countries do not have statutory source rules and rely solely on general source principles.

26. As a result of differences in domestic source rules and how they apply, an item of income may be considered to have its source in more than one country. For example, royalties may be paid by a resident of one country so as to be sourced in that country under that country's source rules but be paid in respect of intellectual property used in another country so as to also be sourced in that other country under that country's own source rules. As another example, a company may derive profits from the sale in one country of goods manufactured by that company in another country so that these profits may be viewed by each country as at least partly sourced in that country. In these situations, both countries may seek to tax the income on the basis of the source principle. Tax treaties will assist in eliminating potential double taxation by allocating taxing rights between the signatory countries on the basis of commonly agreed source rules.

27. The same issue is less frequent but may also arise with respect to capital taxation. Countries that levy taxes on capital may have different rules for the purposes of determining where property is situated. For instance, a person may own business assets in one country but temporarily used in another country. Tax treaties will assist by allocating taxing rights over capital on the basis of commonly agreed rules dealing with the location of property.

C. International double taxation

28. Double taxation can take different forms and can occur in different situations. Cases where the same taxpayer is taxed in two countries on the same income or capital are generally referred to as juridical double taxation. Cases where the same income or capital is taxed in two different countries but in the hands of different taxpayers are generally referred to as economic double taxation. Tax treaties seek to eliminate (or at least reduce) double taxation in a number of ways. Since the issue of double taxation arises most frequently in the case of income taxes

often provide solutions to problems of double taxation based on source in the case of income derived by a resident of one of the treaty partner countries.

4. Economic double taxation

35. Tax treaties seek to address problems of economic double taxation (where the same income is taxed in more than one country in the hands of different taxpayers) only in certain circumstances.

36. A common form of economic double taxation arises where associated enterprises (a foreign parent and a domestic subsidiary company, for example) are treated in different countries as having derived the same profits following transfer pricing adjustments. Through the "arm's length" standard and the corresponding adjustment rules applicable to transactions

41. Two main methods are commonly used for this purpose: the exemption and the credit methods. Under the exemption method, a country will exempt certain items of income derived by its residents from other countries. Under the credit method, a country will give a credit, in computing the tax payable by its residents, for the tax paid in other countries by those residents with respect to income derived from these countries.[18]

42. Treaties will assist in elimin

48. Tax treaties can assist in achieving this objective by adopting internationally-accepted rules for the allocation of taxing rights over different types of income and for the determination of profits of permanent establishments and associated enterprises. Such rules can help to reduce complexity for taxpayers with cross-border activities, particularly where the treaty provides for taxation only in one country. These rules are discussed further in section III.

49. If the internationally-accepted tax treaty provisions of the UN and OECD models are followed, this will help ensure a more consistent interpretation of treaty provisions and thereby increase certainty for taxpayers and tax administrations.

50. As tax treaties are usually in effect for an extended period (on average more than 15 years), they also provide a level of comfort to taxpayers that the tax treatment afforded to the income from their activities or investments in the other country will be reasonably stable.

51. Importantly, tax treaties also provide a mechanism for tax administrations to resolve disputes and to agree on how to interpret or apply treaty provisions, thereby contributing to a more consistent application of the treaty by both countries.

E. Tax avoidance and evasion, and double non-taxation

52. The globalization of the economy has exacerbated the difficulties that tax administrations face in taxing cross-border transactions because of problems in obtaining relevant information or in collecting taxes where taxpayers or their assets are located abroad. It is in the interests of both developed and developing countries to minimize cross-border tax evasion and avoidance as all countries are vulnerable to capital flight and erosion of their tax base.

53. One reason why a country may wish to enter into a tax treaty with another country is to improve coordination and cooperation between tax administrations in order to address tax avoidance or evasion. Tax treaties provide for the exchange of tax information, which may help ensure that a country that taxe

Section II ±Treaty policy, domestic model, negotiations

A. Why negotiate tax treaties?

55. Countries enter into tax treaties for a variety of reasons. The reasons are likely to be different for each country, and even for each treaty entered into by a country, and will depend on the tax system as well as the political and economic situation of the country (e.g. whether it is a net capital exporter – typically a developed country – or a net capital importer – typically a developing country) and its relations with the potential treaty partner country. Considerations that are important in one case may be less important in another case depending on the circumstances prevailing in each country and having regard to the relationship between the two countries. In some countries, the desire to attract foreign investment will be paramount, whereas in other countries revenue or political considerations may be more important. Some common reasons why a country may decide to negotiate a tax treaty with another country may include some or all of the following:[23]

(a) To facilitate outbound investment by its residents;

(b) To facilitate and encourage inbound investment and inbound transfers of skills and technology by residents of the other country;

(c) To reduce cross-border tax avoidance and evasion;

a result of the limitations on source taxation that such treaties impose and the risks of treaty abuse, including treaty shopping, that they present. They may also be concerned about the challenges and administrative burden (especially for countries with limited resources) associated with the negotiation of tax treaties and the application of the provisions of these treaties and their interaction with domestic tax law.

59. The decision to enter into a tax treaty with another country is therefore not one to be undertaken lightly, especially for developing countries. Countries entering into tax treaty negotiations need a good understanding of the benefits and costs that arise from having tax treaties. Having a better understanding of these potential benefits and costs, and of the ways in which treaties operate, will assist in ensuring that priority is given to treaties that are most beneficial to a country and that treaty negotiations result in the most beneficial outcomes.

60. This requires the development of a comprehensive tax treaty strategy, (if agreed possible) across the whole of government (especially with ministries in charge of foreign affairs), before embarking on tax treaty negotiations. By providing a better analysis of the reasons for entering into specific tax treaties, such a comprehensive tax strategy will also help tax treaty negotiators to better design treaty policies that are best suited to achieving the desired objectives, better assess the relative importance of the different provisions of a tax treaty and determine to what extent they can depart from their original positions during the negotiations.

61. Regardless of the reasons for entering into a tax treaty, tax policy considerations should play a key role in the decision of whether to do so. While a country may wish to have a tax treaty with a particular country in order to facilitate foreign investment, it must understand how a tax treaty will interact with the tax systems of both treaty partners in order to assess whether and to what extent it is realistic to expect a tax treaty to achieve that objective.

62. Paragraph 17.4 of the Introduction of the UN Model quotes the section of the Introduction to OECD Model that discusses the tax policy considerations that are relevant to the decision of whether to enter into a tax treaty, amend an existing tax treaty, or, as a last resort, terminate a tax treaty. The following are some of the tax policy considerations that are described in that paragraph and which a country should take into account in developing a comprehensive tax treaty strategy:

> *What are the actual risks of double taxation between the two countries?* This should be the primary tax policy concern. Since most of the provisions of tax treaties are aimed at avoiding double taxation, it is logical to consider that a country that accepts treaty provisions that restrict its right to tax income and capital does so on the understanding that thnegpecbeinta27 8(the229o6(ther)5( )20(c)4(ountr)-18(y)2.(x)-9(y)2Ffr)6

To what extent are such risks of double taxation already eliminated through domestic provisions for the relief of double taxation? It should be acknowledged, however, that such domestic provisions will not cover all cases of double taxation, especially

65. The model treaty should reflect the choices made when developing the country's tax treaty policy framework and should take the form of a draft treaty showing the different provisions that the country would ideally want its tax treaties to include.

66. Countries should be forward-looking in designing their policy framework and model. Treaties usually last for many years – often decades. Renegotiation of a treaty is time-consuming and expensive; it is worthwhile to consider policies that are robust and sustainable in the long term.

67. If possible, the policy framework and the model should be agreed on a whole-of-government basis. In particular, if treaties are negotiated by the tax administration rather than by the ministry in charge of finance, the support of the latter is important in order to ensure that the treaty policy is consistent with the Government's economic objectives. The input of other ministries, such as those in charge of foreign affairs or trade, may also be important.

68.

71. Departures from the international models will almost always increase the difficulty of negotiating a satisfactory treaty. Accordingly, countries, especially those with limited negotiating capacity, should deviate from the international norms only sparingly, that is to say, where there is a clear national interest in doing so. On these aspects, each country should determine:

(a) Its preferred position;

(b) The priority the country places on achieving that position; and

interpreters, that should be avoided as far as possible as it will slow down progress and may create drafting problems.

86. Each country will need to decide on the number of members to be included in its negotiating team as well as the persons to be included as members of the negotiating team.

87. The negotiating team will generally include officials from the ministry in charge of finance and the tax administration. In many countries, officials from the ministry in charge of finance have the primary responsibility for the negotiation of tax treaties but in some countries, that responsibility has been given to the tax administration. Absent constitutional or other impediments, it is recommended that the tax administration be at least present and participate in the negotiations since it is the tax administration that will be in charge of applying the treaty provisions and will best be able to determine whether some proposed treaty provisions would be difficult to administer.

88. In some countries, officials from the ministries in charge of foreign affairs, justice or economic affairs may also be included in the negotiating team.

89. If it is intended to include outside consultants in the negotiating team, this should be discussed and agreed upon with the other country in advance of the negotiations. This is important since some countries consider that tax treaty negotiations are strictly government-to-government discussions and might therefore object to the presence of outside consultants. Arrangements should also be made to ensure that any such consultants are subject to confidentiality obligations that are similar to those that are applicable to the government officials who will participate in the negotiations.

90. As a matter of courtesy, the names, titles and contact details of each team member should be provided to the other country.

The host country should provide:

A draft agenda showing, as far as possible, the starting and finishing times for each

Travel arrangements such as flights, trains and so forth.

Accommodation and local transportation.

In many countries, notification to its embassy in the country of the visit.

3. Defining the roles of each member of the team

93. In the preparations for the negotiations, as well as during them, it is important that all members of the negotiating team know which duties they are allocated, and what their roles will be:

a) The leader of the team:

The leader of the team (head of delegation) should be a senior official with the authority to make important decisions during the negotiations.

The leader will typically have comprehensive knowledge of domestic tax legislation and its interaction with other domestic legislation and tax treaties, will be experienced in tax treaty negotiations and will lead the discussions and present the team's arguments. These responsibilities, however, may be delegated by the head of delegation to one experienced member of the team.

b) Other team member(s):

Most negotiating teams include at least one or two members of the team who advise the leader on technical issues.

These other members generally have a good knowledge of tax treaties and domestic tax legislation. They may have specialist knowledge of certain areas of domestic law or of their country's tax treaty practice.

They may, if invited by the leader, lead the discussion on specific parts of the treaty.

These notes are very useful when preparing for a subsequent round (if any), in particular where members of the negotiating team have been replaced or where it becomes necessary to draft compromise proposals or discuss remaining issues with tax officials who did not attend the negotiation meeting.

The team should be aware of where and why such changes have been made, and of their effects.

The team should have a clear understanding of why the provisions of its own draft text have been drafted the way they are and be able to explain them. The team, should, in particular,be prepared to explain any divergences between its own draft text and the provisions of the UN and OECD models.

6. Preparing alternative provisions

96. Where the draft text includes provisions that are likely to be controversial, it is advisable to prepare alternative provisions that may be acceptable to both countries:

Provisions that merely reflect a strong preference should not be presented as completely non-negotiable.

To be prepared for the positions of the other country, it is helpful to check the various country reservations, observations and positions set out in the Commentaries to the OECD Model. While these do not necessarily reflect a non-negotiable position, they are a very valuable indicator of strongly held positions.

8. Understanding the interaction between domestic legislation and treaty provisions

98. It is important to have a clear understanding of the interaction between treaty provisions and the domestic tax law of each country:

During the negotiations, a team will often be asked to explain features of its domestic tax legislation and how proposed provisions of the draft treaty would interact with that legislation.

Understanding how a treaty provision would affect the application of a country's tax legislation will also be necessary to determine the costs and benefits of that provision and whether it would be favorable for that country.

It is strongly advisable for each team to research and understand the key features of the domestic tax legislation of the other country. This will help it to identify issues, such as the existence of preferential tax regimes, that may need to be specifically addressed during the treaty negotiations and to better anticipate and understand the position of the other country concerning certain proposed treaty provisions.

9. Transmitting a short explanation of the domestic tax system and the draft text to the treaty partner

10. Preparing a comparison of the drafts

100. The comparison of each country's draft text begins with the identification of the issues that will need to be addressed during the negotiations:

Identifying these issues in a working draft may be done in several ways, but using colors simplifies the identification of the differences between the models.

All differences between the two drafts should be identified beforehand because all differences, whether on major or on minor items, have to be addressed during the negotiations.

It is advisable for each team to decide which differences are important and which are of less importance.

Important issues should be discussed internally by each team to find arguments to be used and to determine the strategy that should be followed in order to convince the treaty partner to accept a proposed solution.

101. Another part of the comparison between the two countries' draft texts involves the identification of provisions proposed by a country that deviate from provisions agreed to by that country in treaties with third countries:

A team should be aware of the treaties that its country has concluded with third

behaviors that may be considered offensive. Consultation with one's embassy in the other country may help to avoid incidents and embarrassing situations.

D. Conduct of negotiations[27]

confirm the wording that they have agreed to (for example, after negotiating each Article of the treaty) and at the end of the meeting, to carefully compare each country's working draft in order to confirm the wording of the provisions that have been agreed to and those that need further discussion ~~and to be reconciled periodically or at the end of the meeting~~.

2. Negotiation style

106. The negotiation style adopted by each team can play a significant role in the way the negotiation meeting proceeds. Negotiating styles can vary from what could be called "soft" to "aggressive":

discussions or contacts taking place during a break, or at lunches or dinners, may contribute to building a good relationship.

110. Formality also shows through respect for the role of the leader of the team. As a general rule, the leader of a team decides what to say and by whom it should be said and no other member of the team should take the floor without being invited by the leader. When speaking, the other team's leader should be addressed unless it is obvious that someone else should be addressed, e.g. when responding to a question from another member of that team.

111. Punctuality is important. If one is late for some reason, an apology should be made and an explanation provided.

112. Arguments put forward should be listened to with respect – even if one is not in agreement with them:

> One should avoid interrupting, shaking one's head or telling the other team that they are wrong.

115. For an effective discussion to take place, a team should identify the difference between the two models and present its position clearly. A country that seeks to include a

in particular those that have a direct and immediate effect with respect to the previously concluded treaty. Other countries, however, consider that such clauses offer a useful guarantee that when a country indicates that its position is not negotiable, that view will not change shortly after. It may also be argued that such clauses can play an important role in ensuring that when a treaty is one of the first ones negotiated by a country, investors of the treaty partner are not put at a competitive disadvantage in relation to investors of countries that will negotiate subsequent treaties with the same country, in particular as regards treaty issues that have the most impact on foreign direct investment such as the maximum rate of source taxation allowed on payments such as dividends, interest, royalties and fees for technical services.

121. If two countries agree to include a most favored nation clause in a treaty, they should make it clear when that clause will be triggered (i.e. at the time of signature or entry into force of another treaty or when the provisions of that later treaty will become effective); when that clause will have effect (e.g. in the case of a clause that is intended to make a direct and immediate change to the rate of source taxation of dividends, what is the date from which dividends will benefit from that change) and, most importantly, what will be the effect of the clause (i.e. will the treaty be immediately amended and if yes, how; will the countries be required to conclude a protocol to change the treaty; will the change be implemented through another mechanism and if yes, which one; will the countries be merely required to enter into negotiation with the view of possibly making the change).

122.

126. During the discussions, a new provision will sometimes be suggested as a way to

been ~~initialled~~ initialed. In other cases, the agreed minutes refer to the meeting that took place and indicate that a subsequent meeting will take place on specific dates and location in order to continue the negotiation of the working draft attached to these minutes. ~~a subsequent meeting will take place on specific dates.~~ Some countries, however, prefer to produce ~~In other~~ cases, the agreed minutes that

In the two official versions of the treaty that will be signed (or more than two if the treaty is signed in more than one official language), each country should be mentioned first in the Title, Preamble and signature block of its own copy (or copies, if in more than one language). The other country should be mentioned first in its own copy (or copies). There should be no alternation in the rest of the text.

139. In some countries, the procedures before signing are comprehensive and time consuming. In many countries, the draft treaty must be submitted for comments or approval to one or more governmental or judicial bodies (e.g. ministries in charge of foreign affairs or legal affairs, the Supreme Court or an authority established for the purpose of commenting on new tax legislation proposals and proposed tax treaties) before the preparations for signature can begin.

140. In order for both countries to be aware of the time usually required for preparing the treaty for signature, it is recommended that each country's procedures for the approval of the signature be discussed during the negotiation of the treaty.

141. Unless the two teams agree to make the contents of the treaty public before its signature, the draft treaty should be treated as confidential until it is signed. If, prior to signature, one or both countries want to issue a press release informing the public that an agreement has been reached and that a treaty will soon be signed, it is recommended that the wording of that press release be agreed to by both countries.

2. Translation and official texts

142. At the end of the negotiations, the two teams will normally determine in which official languages the treaty will be signed, after consultation with their respective ministry in charge of foreign affairs if necessary. The terminal clause of the proposed treaty will indicate the languages in which the treaty will be signed and will normally indicate that each version is equally authentic or authoritative.

143. A treaty will often be negotiated in a foreign language, for example English, even if that language is not an official language of either country. In such cases, countries will generally agree to sign the treaty in their respective official languages as well as in the language in which it was negotiated. These countries may then also agree to provide that the language in which the treaty was negotiated will prevail in case of divergence of interpretation between the other versions.

144. When a draft treaty negotiated in one language is to be signed in one or more other languages, it needs to be carefully translated. The translation in another official language will typically be done by the country that uses that official language.

145. A thorough proofreading of the text should be done prior to translation. Editorial or substantive mistakes are often found at that stage or in the translation process; the correction

of these mistakes can be done informally but should be agreed to in writing by the two countries (typically by members of the teams that negotiated the proposed treaty)

146. The selection of the translator varies from one State to another. In some States, the translation is done by members of the team that negotiated the proposed treaty; in others, another governmental office does the translation or a professional translator is hired for that purpose. In the latter cases, it is recommended that the translation be thoroughly reviewed by members of the team that negotiated the treaty before being communicated to the other country. It is important that the translations be correct and that all official versions of the treaty have consistent wording, even if the languages are different. In particular, the translations should be checked to ensure that, as far as possible, it uses the same terminology as the official versions of the UN and OECD models and of previously concluded treaties that have used similar wording. For example, the term “permanent establishment” is used in almost all treaties and it would therefore be rare not to have a previous treaty concluded in the same language that would already include a translation of that term.

147. When the proposed treaty has been translated into another official language in which it will be signed, that translation must be transmitted to the other country for approval. Both countries mu

158. The entry into-

(which, in the case of taxes that are determined on the basis of taxable years, avoids the treaty having effect for only part of a taxable year). There are, however, many variations and it is not unusual to provide that some provisions will have effect at a different time, sometimes even before the entry into force of the treaty.

164. It is a good practice to inform all interested parties when a new treaty enters into force and when the provisions of that treaty will have effect. This may be done through a press release, notice in the official gazette or journal or on the website of the tax administration or of the ministry in charge of finance. As already noted, the text of the treaty will normally have been published after the signature of the treaty so should already be available when that treaty enters into force.

165. The service in charge of the negotiation of tax treaties should ensure that the different parts of the tax administration that may be involved in the application of the provisions of tax treaties are aware of the contents of a treaty that has entered into force and should be available to assist officials of these parts of the tax administration with respect to any issues related to the interpretation and application of the treaty. A good filing system that will of7a1.58 Tm

“Any other body of persons” has a wide meaning and would include entities other than companies such as partnerships, in some countries the trustees of a trust and unincorporated associations, such as some sport clubs, education clubs and charities. The term “resident of a Contracting State” is defined in Article 4.

171 Since a tax treaty that follows the UN and OECD models generally applies to persons who are residents of the countries that sign that treaty, a person who is not a resident of either Contracting State will generally not be entitled to the benefits of the treaty between the two countries. Thus, the mere fact that a person has the nationality of one of the Contracting State is in principle not relevant for the application of the provisions of such treaties except as regards

"notional deductions for equity";[36] and

"remittance based taxation".[37]

Paragraph 2

174.

187. Coverage of capital taxes would ensure that, if a country subsequently introduces such taxes, any double taxation arising in respect of those taxes would be relieved, because their imposition in the future would be limited in accordance with the treaty provisions.

188. If a country that does not currently impose capital taxes decides to cover such taxes, and is concerned about how the treaty may limit their imposition, one option may be to address the issue in negotiation of the provisions of Article 22 (Capital).[47]

Subnational taxes

189. Coverage of taxes should be comprehensive so as to ensure that all double taxation imposed on income or capital is relieved as much as possible. Where there are constitutional or other reasons for wishing to limit the scope of the treaty to taxes imposed by the national Government, however, some countries may prefer to delete the reference to political subdivisions and/or local authorities in paragraph 1. In this case, however, it should be noted that the treaty would not apply to subnational taxes imposed by the other state, which may result in unrelieved double taxation.

190. A different issue may arise where one state is responsible for the international relations of other states (sometimes referred to as "dependencies") or of territories. As these do not constitute political subdivisions, Article 2 would generally not apply to the taxes levied by such other states or territories absent special provisions. Such provisions may be included, for example, in Article 2, in the definition of the state found in Article 3, in a separate Article similar to Article 30 (Territorial extension) of the OECD Model or in a protocol.

Paragraph 2

191. Paragraph 2 describes the taxes that are to be treated as taxes on income and on capital for purposes of the treaty. While the definition includes "taxes on the total amounts of wages or salaries paid by enterprises", the Commentary notes that practices regarding the coverage of such taxes vary.[48] Whether or not such taxes should be covered is a matter for discussion during negotiations. In this regard, negotiators should take account of paragraph 3 of the Commentary on Article 2 of the OECD Model,[49] where the scope of such taxes is considered.

Paragraph 3

192. Paragraph 3 identifies the existing taxes in each country to which the treaty will apply. Although the list is "not exhaustive",[50] negotiators should be careful to ensure that the list is as clear, precise and comprehensive as possible.

193.

be covered.[51] It should be noted, however, that this may limit the range of future taxes that could come within the scope of the treaty in accordance with paragraph 4. Without the general descriptions provided in paragraphs 1 and 2, it might be more difficult to conclude that a new tax is identical or substantially similar to the listed taxes. For example, a newly introduced capital gains tax may not be regarded as substantially the same as existing income taxes.

Paragraph 4

194. The competent authorities are required under this paragraph to notify each other of significant changes to their tax laws. Negotiators should discuss when and how notification will take place, and whether other important changes, for example, judicial decisions, significant changes to regulations or procedures, and so forth, should also be notified. Some countries provide annual updates to their treaty partners, while others prefer that changes, especially important ones, be notified immediately.

A tax treaty will normally apply to new taxes introduced after the entry into force of that

given to the term. Paragraph 14 of the Commentary on Article 3 of the UN Model, quoting paragraph 12 of the Commentary on Article 3 of the OECD Model, notes that 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". Also, paragraph 3 of Article 25 (Mutual agreement procedure) authorizes the competent authorities to resolve by mutual agreement any doubts arising as to the interpretation of the Convention and the competent authorities may use that power to agree on the interpretation of certain treaty terms. In that case, the treaty negotiators could consider providing expressly in paragraph 2 of Article 3 that any meaning agreed to in this manner would prevail over the domestic law meaning of a treaty term. That approach has been followed in paragraph 2 of Article 3 of the 2017 OECD Model.

204. If a treaty term has a domestic law meaning under more than one branch of a country's law, paragraph 2 provides that the meaning under tax law will prevail over any meaning

purposes of the treaty and do not, by themselves, affect the person’s residential status under

royalties, f

OECD Model.[62] In 2017, however, a number of additional clarifications were added to the Commentary on paragraph 1 of the OECD Model and these changes have not yet been considered for inclusion in the UN Model.

Paragraph 2

224. Paragraph 2 lists a number of examples of what typically constitutes a permanent establishment. These places will constitute a permanent establishment, however, only if they fall within the definition of paragraph 1, that is to say, where there is a fixed place of business through which the business of the enterprise is wholly or partly carried on. The paragraph is identical to paragraph 2 of Article 5 of the OECD Model.

225. Treaty practice shows that some countries like to add other specific examples to the list in paragraph 2, for example, places for the exploration of natural resources, warehouses or agricultural or forestry properties. While these additions may emphasize their importance to that country, their inclusion makes no difference in substance, as they will in any event constitute a permanent establishment if, and only if, they meet the "fixed place of business" test of paragraph 1. Care should be taken, however, not to include in paragraph 2 rules that are intended to deem a permanent establishment to exist where the conditions of paragraph 1 are not met (such as a rule that would seek to include in the definition of permanent establishment activities that are carried on at different places of business during a certain period of time). Such rules, which extend rather than illustrate the definition of paragraph 1, should rather be included in paragraph 3, which, in the UN Model, has the effect of extending the scope of the definition.

Paragraph 3

226. Paragraph 3 of the UN Model deals with construction activities and the furnishing of services. The paragraph provides that these activities will constitute a permanent establishment where a time threshold has been met.

Article 5[63]

than 12 months and most provide for six months.[70] While some developing countries seek a shorter period for this paragraph, the six

paragraph 3 of the UN Model does not explicitly deem the activity to give rise to a permanent establishment, it provides that the term permanent establishment "encompasses" that situation. The OECD alternative provision also puts beyond doubt that the services must be physically performed in the country – although the phrase "if activities of that nature continue within a Contracting State", which is found in paragraph 3 (*b*) of the UN Model, probably lead to the same conclusion.

239. Paragraph (*b*) of the UN Model is limited to services provided by an enterprise through its employees or other personnel engaged by the enterprise for this purpose. This may not cover services such as independent personal services provided by an individual directly which, under the UN Model, are dealt with under Article 14. As Article 14 has been deleted from the OECD Model, the OECD alternative provision makes it clear that independent personal services are addressed in this paragraph.

240. While Article 14 has been retained in the UN Model, the Commentary includes alternative provisions that should be inserted in Article 5 by countries that wish to delete Article 14, as well as a list of consequential changes that should be made to other articles.[74]

the services must be provided for “the same or connected projects” during at least 183 days in any 12month period, though they may be provided by different employees or other personnel on behalf of the enterprise.

246. The Commentary provides detailed explanations on the meaning of the phrase "preparatory or auxiliary character" as well as on the scope of each type of activities specifically listed in paragraphs 4(a) to (*f*).[79] It also discusses the position of countries that prefer alternative versions of the paragraph (including a version corresponding to the way in which it was drafted before the 2017 changes)[80] or even its complete omission.

Paragraph 4.1

247. Paragraph 4.1 is an anti-avoidance rule that was added to Article 5 of both the UN and OECD models as a result of the final report on BEPS Action 7.[81] That report observed that because it was easy for a company to establish any number of subsidiaries, the preparatory or auxiliary requirement of paragraph 4 should not be applied exclusively with respect to activities taking place at one location or within one company but should be extended to cover all the locations in a state where closely related companies carry on business activities that belong to a cohesive business operation. This new rule was therefore seen as the logical consequence of the decision to restrict the scope of paragraph 4 of Article 5 to activities that have a "preparatory and auxiliary" character because, without

251. Paragraph 5 *a*) is similar to paragraph 5 of the OECD Model. Paragraph 5 *b*), which has no equivalent in the OECD Model, constitute an additional set of circumstances in which a dependent agent will be deemed to create a permanent establishment for the enterprise.

252. Paragraph 5 of both models and the related exceptions applicable to independent agents were substantially amended in 2017 as a result of the G20/OECD work on BEPS Action 7, which dealt with strategies for avoiding the permanent establishment definition. The final report on Action 7[84] explains that the changes were made because "in many cases *commissionnaire* arrangements and similar strategies were put in place primarily in order to erode the taxable base of the State where sales took place" and to reflect the policy that "where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise sg8Cul-2(rd)-15

scope of paragraph 5) (by omitting the phrase "that are routinely concluded without material modification by the enterprise".[86]

257. As regards paragraph 5), the Commentary suggests that if all sales-related activities take place outside the source state and only delivery by an agent takes place there, this would not lead to a permanent establishment; however, a permanent establishment could exist if sales-related activities (for example, advertising or promotion) are also conducted in the source state on behalf of the resident and have contributed to the sale of the goods or merchandise that are delivered.[87]

258. Treaty practice shows that a few countries have extended the scope of paragraph 5 to cover other situations where a permanent establishment would be deemed to exist, for example, where a dependent agent habitually secures orders for sales of goods in the state wholly or almost wholly on behalf of a foreign enterprise or related enterprises,[88] or where a dependent agent manufactures or processes goods belonging to the enterprise.[89]

Paragraph 6

259. Paragraph 6 addresses the particular situation of an insurance enterprise which, through the activities of another person, collects premiums or insures risks in a state. Unless the other person is an independent agent to whom paragraph 7 applies, the insurance enterprise will be deemed to have a permanent establishment in that state. Reinsurance activities of an insurance enterprise, however, are excluded from the scope of the paragraph.

260. The Commentary[90] explains the reason for paragraph 6. It also indicates[91] that some countries prefer to delete the exception that relates to activities performed by an independent agent. Some countries take a broader approach and simply excludes the profits of the enterprise from the application of the treaty, leaving these profits to be taxed in accordance with domestic law.[92]

261. Although this paragraph has no equivalent in the OECD Model, the Commentary on Article 5 of that Convention[93] recognizes that foreign insurance enterprises can make substantial profits in a country without establishing a fixed place of business there and without using agents that would trigger a permanent establishment under paragraph 5. It notes that "[t]he decision as to whether or not a provision along these lines should be included in a

86 Paragraph 24 of the Commentary on Article 5 of the UN Model.

87 Paragraph 26 of the Commentary on Article 5 of the UN Model.

266. The Commentary[98] also provides additional explanations concerning the interpretation and application of the paragraph, including the criteria to apply in order to determine whether a person acts as an independent agent.

Paragraph 8

267. Paragraph 8, which is identical to paragraph 7 of the OECD Model, clarifies that the mere fact that there is a parent/subsidiary relationship between two companies will not automatically make one of those companies a permanent establishment of the other. That paragraph, which is found in almost all treaties and is usually non-controversial, was introduced in treaties many decades ago because the domestic law of some countries provided that a subsidiary constituted a permanent establishment of the parent.

268. As indicated in the Commentary, however, a permanent establishment may arise under paragraph 1 if one of the two companies has at its disposal and uses for its own business part of a building belonging to the other company. Also, the provisions of paragraph 5 may apply to deem the activities of one company to constitute a permanent establishment of the other, for example, if one company acts on behalf of the other in a way that meets the conditions for the

272. As indicated in the Commentary,[101] the concept of a person or enterprise closely related to an enterprise must be distinguished from the concept of "associated enterprises" which is used for the purposes of Article 9; although the two concepts overlap to a certain extent, they are not intended to be equivalent.

D. Chapter III ±Taxation of income

273. One of the main effects of a tax treaty is to allocate taxing rights over income derived by a resident of one treaty partner from sources in the other treaty partner country. Treaties provide for different methods for allocating tax rights and for certain minimum thresholds for taxation of income derived by non-residents. The treaty may allocate exclusive taxing rights to one country (that is to say, the other country is not permitted to tax the income), unlimited primary source taxing rights (where the source country's right to tax is not limited by the treaty, and the residence country is required to relieve any resulting double taxation), limited primary source taxing rights (where the source country must limit its taxation, and the residence country must relieve double taxation) or, in a few treaties, shared taxing rights (where both countries are allocated exclusive taxing rights over an agreed portion of the income). The method and threshold depend on the category of income derived.[102]

274. Generally, the phrase "shall be taxable only" in a state signifies that that state has been alloc

domestic or foreign) to operate the relevant mine. In that case, these royalties would fall under Article 6 as income from immovable property even if the license does not constitute immovable property under the domestic law of the state which granted the mining license.

282.

carried on through a permanent establishment in a country, the Article specifies the profits that may be taxed in that country.

288. The term "enterprise of a Contracting State" is defined in Article 3 (General definitions) as an enterprise carried on by a resident of that state. The term "enterprise" itself is not defined in the UN Model[111] and the non-exhaustive definition of "enterprise" found in the OECD Model[112] is merely intended to clarify that Article 7 applies to the carrying on of professional and other independent activities (which are covered by Article 14 in the UN Model). Paragraph 2 of the Commentary on Article 5 of the OECD Model, which was added wa. 595.383.26 04

business activities covered by paragraphs 1 (*b*) and (*c*) of Article 7, on the basis that profits from activities that are not part of those carried on through the permanent establishment, and which do not themselves give rise to a permanent establishment, should not be subjected to tax in the PE country. On the other hand, some developing countries consider that, where an enterprise sells goods or services in their country both directly and through a permanent establishment, the same tax treatment should apply, both to discourage abusive arrangements and to simplify administration.[114]

In some treaties, taxing rights in the PE country extend to the profits covered by paragraphs 1 (*b*) or (*c*) only in cases of abuse.[115] Also, since these provisions only apply to goods or services provided by the enterprise that has the permanent establishment and not to those provided by associated enterprises, these provisions have a fairly narrow application.

Paragraph 2

293. Paragraph 2, which mirrors paragraph 2 of the former OECD Article 7, determines the meaning of "profits attributable to a permanent establishment". In effect it requires that the profits be determined in both states in accordance with the separate entity and arm's length principles, that is to say, for purposes W* n BT /F2 12h(7,)- a

296. More importantly, paragraph 2 of the new OECD Article 7 also makes specific reference to the method by which profits attributable to the permanent establishment are to be determined, that is to say, by reference to the functions performed, assets used and risks assumed through the permanent establishment and the rest of the enterprise. This wording was added to the OECD Model for the purpose of allowing the application of the so-called "Authorized OECD Approach" (AOA), a comprehensive approach for determining the profits of a permanent establishment that was developed by the OECD between 1998 and 2008.

the effect of obliging a state to grant a deduction for such expenses. Some countries prefer to clarify this principle explicitly in their treaties.[121]

302. The second and third sentences of paragraph 3 in Article 7 of the UN Model provide that deductions are not allowed in respect of any charge between the permanent establishment and any other part of the enterprise by way of internal royalties, commissions, management or other services or interest (except in the case of banks), unless the charge was as made reimbursement to the other part of the enterprise for actual expenses incurred. Thus, for example, where an enterprise owns a patent or copyright, no deduction will be allowed, in calculating the profits attributable to the permanent establishment for purposes of Article 7, in respect of any "royalties" charged by the head office or another part of the enterprise to a permanent establishment of the same enterprise. These sentences in paragraph 3 have no equivalent in the former OECD Article 7, although the UN Model provision largely reflects the interpretation found in the Commentary on paragraph 3 of the former OECD Article 7.[122] The new OECD Article 7, which has no provision equivalent to paragraph 3, does not limit deductions to actual expenses, and requires the recognition and arm's length pricing of all dealings where one part of the enterprise performs functions for the benefit of the permanent establishment.[123]

303. Paragraph 3 of the new OECD Article 7 performs a completely different function. It provides for corresponding adjustments to profits where one state adjusts the profits of the permanent establishment. It is intended to ensure that all double taxation is relieved[124] and operates in a way similar to paragraph 2 of Article 9.

Paragraph 4

304. Paragraph 4 allows countries that customarily determine the profits of a permanent establishment by apportioning the total profits of the enterprise according to a formula (for example, on the basis of receipts, expenses or capital) to continue to do so provided that the method of apportionment provides for a result that is in accordance with the arm's length principle.

305. The Commentary notes that the paragraph may be deleted where neither state uses such methods.[125] In practice, few countries use formulary apportionment methods to determine the profits of a permanent establishment. Even where such methods are used, it is difficult to ensure

that the method produces arm's length results. For these reasons, paragraph 4, which was also found in the former OECD Article 7, was not included in the new OECD Article 7.[126]

Paragraph 5

306. Paragraph 5, which mirrors paragraph 6 of the former OECD Article 7, is intended to give an assurance of continuous and consistent tax treatment by providing that, unless there is good reason to change, the same method of attributing profits to the permanent establishment is to be used each year. This refers generally to the use of direct or indirect methods, or of formulary apportionment methods. In most countries, it would be expected that the same method would be used each year even in the absence of this provision.

307. This paragraph was omitted from the new OECD Article 7 because such different methods of attribution of profits are not available under that Article.[127]

Paragraph 6

308. Paragraph 6, which is identical to paragraph 7 of the former OECD Article 7 and paragraph 4 of the new OECD Article 7, provides that Article 7 will not affect the application of another article of the treaty where an item of income is dealt with separately in that other article. In case of conflict, the provisions of that other article will therefore prevail over those of Article 7.

309. For example, dividends or interest dealt with respectively under Article 10 or 11 will be taxed in accordance with the rules of those Articles, rather than those of Article 7. It should be noted, however, that some articles have a "throwback" rule (such as paragraph 4 of Article 10), under which, in certain circumstances, the provisions of Article 7 will apply instead of those of the other article.

310. The Commentary notes that while the term "profits" is not defined in the treaty, it is open to countries to agree bilaterally upon special explanations or definitions concerning this term, for example, where, under domestic law, the term includes special classes of receipts, such as income from the alienation of a business.[128]

311. Article 7 of the UN Model includes a note indicating that the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase, by that permanent establishment, of goods and merchandise for the enterprise has not been resolved and should be settled in bilateral negotiations. This ct ther-7( )20(ifa-2(c)4(t)l)1hat -9( )]2(the)19 0

included in the new OECD Article 7. Since the paragraph was deleted from the OECD Model because there was broad consensus that is was not consistent with the arm's length principle and was not justified,[129] treaty negotiators from developing countries may prefer to avoid the inclusion of that paragraph in their treaties.

3. Article 8 International shipping and air transport

312. Article 8 deals with profits from shipping and air transport in international traffic.

313. The term "international traffic" is defined in paragraph 1 *d*) of Article 3 (paragraph 1 *e*) of Article 3 of the OECD Model) to mean essentially any transport by a ship or aircraft except where the ship or aircraft is operated by a foreign enterprise within the territory of a state. It therefore covers transport activities conducted by an enterprise of one state between places within the same state, the qualification of such transportation as international traffic being relevant for the purposes of taxation by the other state. It may also cover transport by an enterprise of a third state, this being relevant for the purposes of paragraph 3 of Article 15 dealing with the taxation of employees working aboard a ship or aircraft operated by such an enterprise.

314. The profits from transportation that does not constitute international traffic and from any form of transportation other than by ship or aircraft (such as rail or road) are not covered by Article 8 and will instead fall under the general rules of Article 7 (Business profits). Accordingly, profits from such transport5fD9(b)-9(y)20(10)4(a)4(n a)-5(nter)5(prise)4(1290(of1306(o

While the previous version of Article 8 allocated exclusive taxing rights to the state in which the place of effective management of the enterprise was located, a majority of countries preferred that the profits from ships or aircraft operated in international traffic by an enterprise of a state be allocated to that state. Since the term "enterprise of a Contracting State" is defined in Article 3 (General definitions) as an enterprise carried on by a resident of that state, this formulation allocates taxing rights to the state of residence.

Few countries, and almost none outside Europe, included in their treaties the provisions of the previous version of paragraph 2 of Article 8 dealing with profits from the operation of boats engaged in inland waterway transport.

318. At the same time, corresponding changes were made to the definition of "international traffic" in paragraph 3 of Article 3 as well as to paragraph 2 of Article 6 and to paragraph 3 of Articles 13, 15 and 22.

not specify a percentage. A reduction of 50 or 60 per cent is typically provided for in the very small number of treaties that include this provision.[134]

322. Countries that are considering using alternative B should ensure that they can effectively administer this provision, that is to say, that they can identify the relevant operations, determine the appropriate allocation of overall net profits, and collect the tax while providing the necessary reductions.

Paragraph 2 (alternative A), paragraph 3 (alternative B)

324. Paragraph 2 of alternative A and paragraph 3 of alternative B ensure that where the enterprise participates in pooling arrangements or other similar profit-sharing arrangements with other international transport enterprises, the provisions of Article 8 will also apply to the share of profits derived by the enterprise through those arrangements.

4. Article 9 Associated enterprises

325. The following excerpt from the *United Nations Practical Manual on Transfer Pricing for Developing Countries* provides the background for Article 9:[135]

> The structure of transactions within an MNE group is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. A large and growing number of international transactions are therefore not governed entirely by market forces, but driven by the common interests of the entities of a group.
>
> In such a situation, it becomes important to establish the appropriate price, called the "transfer price", for intra-group, cross-border transfers of goods, intangibles and services. "Transfer pricing" is the general term for the pricing of cross-border, intra firm transactions between related parties.

326. Article 9 recognizes that a country may, for tax purposes, increase the profits of an enterprise where, as a result of non-arm's length conditions between that enterprise and an associated enterprise, the profits of the enterprise are less than arm's length profits. To ensure that the adjustment does not result in economic double taxation, the treaty partner is generally required to make a corresponding adjustment to reduce the profits of the associated enterprise.

327. Article 9 of the UN and OECD models incorporate the arm's length principle that forms the basis for allocating profits resulting from transactions between associated enterprises. The *United Nations Practical Manual on Transfer Pricing for Developing Countries* and the *OECD*

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134 Wim Wijnen and Jan de Goede, "The UN Model in Practice 1997–2013", *Bulletin for International Taxation* No. 3 (2014), section 2.10.2.

135 Paragraphs B.1.1.5 and B.1.1.6, United Nations, Department of Economic and Social Affairs, *United Nations Practical Manual on Transfer Pricing for Developing Countries* (United Nations publication, Sales No. E.17.XVI.2), 2017, available at http://www.un.org/esa/ffd/wp-content/uploads/2017/04/ManualTP-2017.pdf.

343. Other issues that may arise in the application of the lower limit applicable to direct investment dividends are addressed in the Commentary on Article 10 of the UN Model.[139] In addition, the Commentary on Article 10 of the OECD Model was amended in 2017 to address the issue of the application of that lower limit where shares are held through an entity or arrangement (such as a partnership in many countries) that is not treated as a taxpayer under domestic law.[140]

344. A change made in 2017 to paragraph 2 of both the UN and OECD models requires that the minimum shareholding be maintained for a period of at least 365 days which includes the day the dividend is paid. This change, which was made as a result of the report on Action 6 of the OECD/G20 BEPS project,[141] was intended to prevent abusive transactions in which the holder of shares that did not meet the required threshold for the lower limit applicable to direct investment dividends would, shortly before the payment of dividends, temporarily transfer his shares to a shareholder that met the threshold. The 365-day minimum holding period does not need to be met before the dividend is paid; it can also be met after that payment. Changes of ownership that result from corporate reorganizations should be disregarded for the purposes of the computation of that minimum holding period.

345. Some countries seek an exemption from source country taxation in respect of certain categories of dividends, in particular where the dividend recipient is exempt from tax on such income in the recipient's country of residence. The Commentary discusses the cases of dividends paid to pension funds and to a state or state-owned entities (including sovereign wealth funds).[142] On the one hand, a withholding tax imposed by the source state on dividends received by such entities may have the effect of making it more advantageous for these entities to invest in other countries that grant them an exemption similar to the one to which they are entitled in the state in which they are established. On the other hand, the source state may be concerned that granting an exemption to such entities will give then an unfair advantage over other taxpayers deriving similar income and it may also be concerned that if no equivalent exempt entities of a similar size exists under its own law, the exemption would primarily benefit entities of the other state. The application of paragraph 2 in these circumstances could be discussed during the negotiations.

346. A few (mainly developed) countries may wish to include special rules to deal with the particular case of dividends paid by companies that qualify as real estate investment trusts. The

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which render it, in relation to these dividends, a mere fiduciary or administrator acting on account of the other parties.

351. The Commentary on the OECD model was amended in 2014 to provide additional explanations on the meaning of "beneficial owner".[147] As noted in that Commentary, the fact that a person may qualify as the beneficial owner of dividends does not mean that it is automatically entitled to the limits provided for in paragraph 2 under the rules of Article 29 (Entitlement to treaty benefits), the source[148]

extending the definition of “interest” in paragraph 3 of Article 11 by adding wording such as: “The term ‘interest’ shall not include any item of income which is considered as a dividend under the provisions of paragraph 3 of Article 10.”

Paragraph 4

356. Under paragraph 4, the rules of paragraphs 1 and 2 for the allocation of taxing rights over dividends do not apply where the dividends form part of the profits of a permanent

6. Article 11 Interest

365. Article 11 allocates taxing rights over interest arising in one Contracting State (source state) and derived by a resident of the other Contracting State (residence state). To prevent excessive taxation and to achieve a sharing of revenue from such income between the two countries, source taxation is limited to a percentage of the gross amount of the interest.

366. It should be noted that Article 11 of the UN Model does not deal with interest arising in the residence state or in a third state.[157] Such income is dealt with under Article 21 (Other income).

Paragraph 1

367. Paragraph 1 provides that interest to which the Article applies is interest which arises in the source state and that interest may be taxed in the residence state. There are no limits imposed under the treaty on the taxing rights of the residence state (although the residence state is required to relieve double taxation where the source state is also permitted under the treaty to tax the interest).

Paragraph 2

368.

their treaties, bearing in mind that high rates of withholding may deter investment or may result in the tax cost being passed on to resident payers through increased interest rates.

If, for example, a developing country agrees to a limit in one of its treaties that is significantly lower than the limits found in its other treaties, the negotiators from other countries will typically insist in getting an equivalent lower limit in order to avoid the

Example

Z Bank, a resident of state Z, lends an amount of 10,000 to X Ltd., a cor
resident in state X, at an interest rate of 8 per cent. Z Bank's cost of funds is
7 per cent, being the cost of borrowing plus a small amount of administ
costs.

state X imposes withholding tax at the rate of 10 per cent of the gross ar
of the interest (800 x 10 per cent). state Z taxes the net interest (800 - 700)
at 25 per cent, and allows a tax credit for state X tax up to the amount o
Z tax.

	state X	**state Z**
Interest derived by Z Bank	800	800
Deductible expenses	0	700
Taxable income	800	100
Tax	80	25
Tax credit	-	25 (max)
Total tax	80	0

The result is that, although the net interest (before tax) derived by Z Ba
100, the tax paid by Z Bank is 80, an effective tax rate of 80 per cent.
avoid such excessive taxation and to make a reasonable profit fro
transaction, Z Bank is likely to require X Ltd. to bear the cost of the sta

[162] with respect to the use of these words in the context of Article 10 are equally applicable in the context of Article 11.

reference to any other amount assimilated to (or subjected to the same tax treatment as) income from money lent under the domestic law of the country in which the income arises.[166] Countries

is effectively connected with other business activities carried on in the source state that are of the same or similar kind as the activities of the permanent establishment and which are covered by paragraph 1*c*) of Article 7. If the treaty does not include paragraph 1*c*) in A871 71 0 598te W* n

in the report on Action 4 of the OECD/G20 BEPS project,[173] however, issues related to excessive payments of interest may be more appropriately dealt with through domestic rules that would restrict the amount that may be deducted as interest.

7. Article 12 Royalties

391. Article 12 allocates taxing rights over royalties derived by a resident of one state from the other state.

treaty partners. In practice, limits in developing country treaties typically range between 5 and 15 per cent.

398. Royalties to which the treaty applies will predominantly arise in the developing country, since the licenses of intangible property giving rise to such royalties are typically made by enterprises of developed countries to enterprises of developing countries. Accordingly, the immediate impact of revenue reductions as a consequence of treaty rate limits will fall on the developing country (although there may be long-term revenue gains as a result of increased technology flows and their effects on the economy). Developing countries will need to decide

B who receives them as agent or nominee for a resident of state C, then state A is not obliged to limit its source taxation under the treaty between state A and state B.

402. On the other hand, if the resident of state B receives the royalties as agent for another resident of state B and the latter person is the beneficial owner of the royalties, then the limit provided by paragraph 2 of the treaty between state A and state B applies since the beneficial owner is a resident of state B. Where the immediate recipient of the royalties (acting as agent or nominee) is a resident of a third state, the Commentary of the UN Model states that the restriction on source taxation provided in the treaty between the source state and the treaty partner remains available if the beneficial owner of the royalties is a resident of the treaty partner.[178]

403. The explanations of the concept of "beneficial owner" provided above[179] with respect to the use of these words in the context of Article 10 are equally applicable in the context of Article 12.

404. The treaty does not prescribe how the rate limit is to be applied. The second sentence in paragraph 2 authorizes the competent authorities to settle by mutual agreement the mode of application of the limitation. As with source tax limits imposed under Articles 10 and 11, each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment. The source state may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.[180] Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

Paragraph 3

405. Paragraph 3 of the UN Model and paragraph 2 of the OECD Model include the definition of the term "royalties" for purposes of the treaty. Both definitions cover payments for the use of, or the right to use copyright of literary, artistic or scientific work (including copyright in cinematograph films), patents, trademarks, designs, models, plans, secret formulae or proces-

406. While the inclusion of payments for equipment rentals, including container leasing, are quite widely accepted in treaties with developing coum7Triewant ivelnin treti-11(eie)561(b)4(ltwe4(e

term “effectively connected” with a permanent establishment or fixed base is not discussed in

ties, or between individuals and companies, such as the relationship between a company and its majority shareholder.

41.5 Depending on the circumstances, tax avoidance arrangements involving the payments of excessive royalties might also be dealt with through the general abuse rule of paragraph 9 of Article 29 (Entitlement to benefits). Issues related to excessive payments of royalties would,

429. The Commentary[199] provides detailed explanations of the concept of "beneficial owner" in the context of Article 12A which mirror the explanations of that concept found in the OECD Commentaries on Articles 10, 11 and 12 since 2014.[200]

430. Paragraph 2 does not prescribe how the limit is to be applied. As with source tax limits imposed under Articles 10, 11 and 12, each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment. The source state may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.[201] Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of

434. The exclusion of payments to employees means that employment income is covered exclusively by Article 15 of the United Nations Model Convention. Thus, payments to a non resident employee by an employer for employment services performed outside the country in which the employer is resident or carrying on business through a permanent establishment or fixed base are not taxable by that country even if the services are of a managerial, technical or consultancy nature.[208]

435. The exclusion of payments for teaching in or by an educational institution covers payments that an educational institution of one state would make for teaching services provided

payments for technical services from related parties. Where payments of fees for technical services exceeding an arm's length amount are paid as a result of a special relationship between the payer and the recipient (or between both of them and a third party), paragraph 7 provides that the treaty limit on source taxation applies only to the arm's length amount, that is, the fees that would have been payable if an arm's length amount of fees had been agreed to.

447. "Special relationship" commonly refers to the relationship between associated enterprises such as that described in Article 9 (Associated enterprises). It may, however, also refer to a relationship between individuals, such as individuals related by marriage or family ties, or between individuals and companies, such as the relationship between a company and its majority shareholder.

448. Depending on the circumstances, tax avoidance arrangements involving the payments of excessive fees for technical services might also be dealt with through the general anti-abuse rule of

As explained in the Commentary, however, in certain circumstances a tax capital appreciation even if there is no alienation (for example, on a revaluation of business assets for

is adopted. In treaties that allocate taxing rights in Article 8 on the basis of the place of effective

469. Some countries, however, including many developing countries, prefer to retain taxing rights over capital gains arising in their state.[234] This approach will allow both countries to tax such gains in accordance with their domestic law, with the country of residence of the alienator providing double tax relief where necessary. Since the place where capital gains may be said to "arise" can give rise to difficulties, negotiators adopting this approach should clarify during negotiations how the source of capital gains is to be determined.

470. Some countries also seek to confi

475. Income from personal services may be covered by the provisions of both Articles 12A (Fees for technical services) and 14. Since paragraph 2 of Article 12A states that the article applies "notwithstanding the provisions of Article 14", source taxation is allowed by Article 12A even if paragraph 1 of Article 14 would otherwise prevent taxation by a country because the income is not attributable to a fixed base situated in that country and is not derived from activities performed in that country by a person whose stay in that country has exceeded the period of 183 days referred to in paragraph 1 (b) of Article 14 (see below). Where, however, income from personal services to which article 12A would otherwise apply is attributable to a fixed base situated in the state in which the payment arises, paragraph 4 of Article 12A expressly provides that such income will be covered by Article 14 rather than Article 12A. Thus, for example, if a resident of state S pays a fee for independent personal services to an individual resident of state R and the payment falls within the definition of "fee for technical service" in paragraph 3 of Article 12A, Article 12A shall govern the taxation of the fee unless the fee is attributable to a fixed base in state S that is regularly available to the individual.

Paragraph 1

476. Paragraph 1 limits source taxation of income derived by a resident of a treaty partner country from independent personal services to two situations, namely: where the income is attributable to a fixed base that is regularly available to the person in the source country, or where the person is present in the source country for at least 183 days in any 12-month period and the income is attributable to activities performed in the source country.

477. The "fixed base" criterion (paragraph 1 (a) of Article 14) mirrors the former Article 14 criterion of the OECD Model and is widely accepted in treaties with developing countries, even since the deletion of Article 14 in that Model.[238] Most countries consider the concept of "fixed base" to be essentially the same as the "fixed place of business" concept in the permanent establishment definition, so this criterion effectively provides the same threshold for source taxation as is provided for income under Article 7 (Business profits).

478. A length-of-stay criterion (paragraph 1 (b) of Article 14) is found in most treaties with developing countries, although the time during which the person must be present in the source country sometimes varies.[239] As the Commentary of the UN Model explains, a length of stay criterion for source taxation of independent personal services income is comparable to the 183 day presence test for employment income.[240]

479. The provision in the current UN Model refers to 183 days in any 12-month period beginning or ending in a fiscal year. This ensures that source countries do not lose taxing rights where the 12-month period during which the person is present in the country extends over two

b

480.

traffic, enters the territory of state S, paragra
individual's remuneration to state R.

494. The Commentary explains how this ne
countries may wish to consider if they do not agree with the policy underlying the new rule.

12. Article 16 emuneration of top level managerial officials

the phrase “except to the extent that such salaries, wages and other similar remuneration are borne by a permanent establishment which the company has in the first United State.”

method by which entertainers' and sportspersons' income is taxed should be discussed during negotiations.

512. Article 17 as drafted applies regardless of the amount of the remuneration. Some countries, however, consider that the unlimited source taxation allowed under Article 17 is appropriate primarily for individuals that are highly remunerated for a performance that requires only a short period of physical presence in a country (which, absent Article 17, would likely not trigger any source taxation according to the other provisions of the treaty). Those countries consider that Article 17 should not apply to entertainers and sportspersons who derive

14. Article 18 Pensions and social security payments

Article 18 allocates taxing rights over pensions paid in respect of past employment and social security payments. There are two versions of this Article in the UN Model. Article 18 (alternative A) gives to the recipient's country of residence the exclusive right to tax pensions, while Article 18 (alternative B) allows source taxation if the pension is paid by a resident of the source country or a permanent establishment situated there. In both versions, social security payments are taxable only in the paying country.

In practice, the treatment of pensions under tax treaties varies considerably. This reflects the fact that there are very different pension systems found in different countries. There are three stages of retirement savings at which tax may be imposed, namely, contributions to a pension fund, fund earnings and pension payments. A country's tax treaty policy with respect to pensions may be strongly influenced by its domestic law treatment of the three stages. In some countries, for example, deductions are allowed for contributions, and fund earnings are exempt, with the pension payments being fully taxed. These countries are likely to want to preserve taxing rights over the pension, since tax has been deferred at all other stages. In other countries, however, no deductions are allowed for contributions and the pension earnings are taxed, but the pension payments are exempt. These countries may have no objection to giving up source taxing rights, but may wish to preserve exemption of the pension, particularly if the amount of the pension reflects its tax-exempt status in the paying country.

Paragraph 1 of alternative A, paragraphs 1 and 2 of alternative B

518. Paragraph 1 of alternative A, like Article 18 of the OECD Model, assigns taxing rights over pensions paid in respect of past employment, other than government service, exclusively to the country of residence of the recipient.

519. Although this provision is limited to pensions from past private employment, some countries prefer to provide for the same tax treatment of all pensions, including annuities, pensions paid in respect of independent personal services and government service pensions. The Commentary notes that countries are free to agree on this bilaterally.[255]

520. Allocation of sole taxing rights to the country of residence of the recipient simplifies the taxation affairs of pensioners. Many countries also consider that the residence country is in a better position to determine the pensioners' overall ability to pay tax, since their total income is often relatively low.[256]

A significant number of countries, however, consider that the source country should also have a right to tax pensions arising in their jurisdiction, particularly those countries where

should apply only to certain business activities conducted by public bodies, such as public railways or postal services, this may be specified in those paragraphs.[278]

16. Article 20 Students

545. Under Article 20, payments received from abroad by visiting students, business trainees and apprentices for their maintenance, education or training are exempted from tax in the country in which they are studying or training.

546. The Article is the same as Article 20 of the OECD Model except that the latter provision does not expressly cover "business trainees".

547. The Article applies only to students, business trainees and apprentices who are visiting the country solely for the purpose of their education or training and covers payments for maintenance, education or training only when the source of these payments is outside the

provisions such as Articles 10, 11, 12 or 12A). Under paragraph 3 of Article 24, state B, in which the permanent establishment is situated, should give relief to the permanent establishment for any double taxation to the same extent as it would give relief to a local enterprise deriving similar income from state A.[28A]

560. Opportunities for abuse may arise in cases where an item of other income arising in one state is attributed to a permanent establishment of a resident of the other state, that other state applies the exemption method to the profits attributable to the permanent establishment and that permanent establishment is located in a third state that does not tax such income (or taxes

564. Another alternative provision seeks to clarify when income may be said to "arise" in a state of the purposes of paragraph 3. That source rule is similar to that in paragraph 5 of Article 11, Article 12 and Article 12A.[287]

E. Chapter IV ±Taxation of capital

1. Article 22 Capital

565. Article 22 allocates taxing rights over capital owned by a resident of one of the treaty partner countries.

566. The Article deals with taxes on capital as referred to in Article 2, which exclude taxes triggered by the transfer of assets, such as estate, inheritance taxes, gift duties or transfer duties.

567. As discussed in relation to Article 2 (Taxes covered), when negotiating a tax treaty, countries must decide whether or not to cover capital taxes. If neither country imposes such taxes, or if double taxation of capital is unlikely to arise because only one country has capital taxes, negotiators may decide not to cover capital taxes in the treaty and, therefore, to omit Article 22. Consequential changes would then also be required to the title of the treaty, paragraphs 1 and 3 of Article 23 A, paragraphs 1 and 2 of Article 23 B and paragraph 4 of Article 24 in order to remove all references to capital taxes.[288]

Paragraph 1

568. Paragraph 1 permits the country in which immovable property is situated to tax

23 A provides for relief by the exempti

588. The Commentary discusses a number of issues that can arise in the application of the exemption method, including the amount to be exempted, the treatment of losses, and taxation of the rest of the income.[296]

Paragraph 2

589. Paragraph 2 provides for the credit method to apply in respect of dividends, interest, royalties and fees for technical services which may be subjected to limited taxation in the source state in accordance with the treaty.

590. Since it is clearly intended under the treaty that taxation of such income is to be shared by the two states, the country of residence should not be required to exempt the income. For the same reason, this paragraph may be extended to other categories of income where source taxation is limited, for example, in some treaties, pension payments.

591. As is generally the case in respect of the credit method, the residence country is not obliged to provide a credit for the foreign tax to the extent that the foreign tax exceeds the amount of tax which is payable on that income in the residence state (ordinary credit).[297]

Paragraph 3

taxpayer's income or capital by the amount of the foreign income or capital, the taxpayer's tax liability is reduced by the amount of tax applicable to that foreign income or capital.[301] If this alternative formulation of paragraph 1 of Article 23A is adopted in a treaty, paragraph 3 is not necessary and may be omitted.

2. Article 23 B Credit method

595. Under the credit method for addressing double taxation provided for in Article 23 B, the country of residence is obliged to reduce the tax payable by its residents on income that the other state may tax in accordance with the treaty by the amount of tax the residents have already paid to the other state on that income.

596. Under the credit method, when the tax rate in the country of source is lower than the domestic rate in the country of residence, only the excess of the domestic tax over the foreign tax is effectively payable in the country of residence. When the foreign tax is higher than the domestic tax, the country of residence does not collect any tax. The effective overall burden on the taxpayer is therefore the higher of the domestic tax and the foreign tax.

Paragraph 1

597. Paragraph 1 allows the country of residence of a taxpayer to tax income and profits derived from (or capital owned in) the treaty partner country, but imposes an obligation on the country of residence to deduct from its residents' tax liability an amount equal to the tax paid in the treaty partner country.

598. In accordance with the second sentence of paragraph 1, the credit that must be provided by the residence country is limited to the tax that would otherwise be payable on that income in the country of residence. In computing the limitation, the country of residence typically computes income according to its own laws, not according to the tax rules applicable in the source state.

599. Sometimes domestic law allows for aggregation of foreign tax credits, for example, by providing that the limit relates to all income from each source country ("per country limitation"), or to specific types of income regardless of source ("separate baskets

be imposed in the residence country.[302] While the Commentary recognizes that possibility,[303] it would be very unusual for a country to agree to do so in a treaty.

601. Paragraph 1 of Article 23 B, like paragraph 1 of Article 23 A, makes it clear that the obligation for the state of residence to provide relief of double taxation only applies where the income is taxed by the other state as the state of source or as the state of location of a permanent establishment or fixed base to which the income is attributable. As already explained,[304] this addresses situations where the two states tax the same item of income as states of residence because they attribute that income to different taxpayers who have a different residence for treaty purposes.

602. The Commentary also provides guidance on various issues related to the application of the credit method, such as the computation of the credit, the treatment of losses,[305] etc.

Paragraph 2

602.1 Paragraph 2 provides for exemption with progression where income 1.ionm 595.3 Tm 0 g 0 G [

recurrent corporate taxation may still occur where corporate profits are taxed first at the level of the subsidiary and again upon distribution at the level of the parent company.

608. Such recurrent taxation, which may occur at several levels in a chain of companies, has been addressed by some countries through their domestic law or through treaties.

609. The Commentary discusses this issue[308] and identifies three possible solutions:

> Exemption with progression in respect of the dividends received by a parent company from its subsidiary in a treaty partner country
>
> Credit for underlying taxes imposed on the subsidiary in respect of the profits out of which the dividends are paid (in addition to credit for tax on the dividends themselves)
>
> Assimilation to a holding in a domestic subsidiary, for example, access to imputation credits or participation exemptions

Tax sparing

610. The benefit of special tax concessions offered by the source state to foreign investors may be lost if the investor is a resident of a country that uses the credit method. In these cases, the reduction in source taxation merely results in an increase in the amount of tax collected by the country of residence of the taxpayer.

611. By contrast, the exemption method ensures that no further tax will be imposed in the country of residence on the income that has benefited from the tax incentive in the source country. However, if the treaty partner is not prepared to use the exemption method, developing countries often seek to include tax-sparing provisions in their treaties. For some developing countries, preservation of the benefit of their tax incentives through relief of double taxation by the exemption method or by the inclusion of tax-sparing provisions "is a basic and fundamental aim in the negotiation of tax treaties".[309]

612. Tax sparing is an arrangement under which the developed country will agree to provide a credit for the source tax of the developing country notwithstanding that the tax has not actually been imposed because of tax incentives provided by the developing country. The purpose of tax sparing is to ensure that the benefit of the incentive is not lost to the taxpayer as a result of taxation of the income by the country of residence.[310]

613. While some developed countries are prepared to agree to such provisions with their least developed treaty partners, many are resistant to a tax-sparing provision, as recognized in the OECD report entitled *Tax Sparing: a Reconsideration*, which recommended caution as regards the inclusion to tax-sparing provisions in treaties.[311] In particular, the report noted that tax sparing was vulnerable to taxpayer abuse and was not necessarily an effective tool for promoting economic development.[312] The report did not recommend that tax-sparing should never be granted but suggested that it should be considered only in the case of states whose economic level was considerably below that of OECD member states. It also recommended the use of "best practices", such as the inclusion of the limitations described below, in order to minimize the potential for abuse.

614. The Commentary suggests three different forms that tax-sparing provisions may take, namely, a deduction for the tax that the source state could have imposed, a deduction for a fixed rate of tax or an exemption of the income.[313]

615. Countries that are prepared to include tax-sparing provisions should ensure that the incentives for which tax sparing is sought are described with sufficient precision so that the

Making the granting of the tax incentive under domestic law of the source country conditional upon the income being exempted (or the tax forgone credited) in the investor's country of residence,

of state A. Issues relating to the meaning of "in the same circumstances" should be resolved by reference to the Commentaries and the examples provided therein.[818]

628.

permanent establishment.[321] As the application of the branch profits tax is then specifically authorized by the treaty, such treatment cannot be regarded as a violation of paragraph 3 of Article 24.

Paragraph 4

633. Under paragraph 4, a payment made by a resident of one state to a resident of the other state in respect of interest, royalties or other disbursements must be deductible under the same conditions as if it had been made to a resident of the payer's own state of residence. Accordingly, foreign lenders or suppliers of technology or services cannot be subjected to a tax disadvantage compared to local lenders or suppliers through the imposition of limitations, or additional requirements, on deductions in respect of payments to those foreign lenders or suppliers.

634. The paragraph clarifies that, under a U.S. reservation, a resident of the other

Paragraph 6

In accordance with paragraph 6, the operation of Article 24 is not limited to taxes covered by the treaty as specified in Article 2. The non-discrimination rules in the UN and OECD models apply to all taxes, including national and subnational level taxes, income tax, value added tax (VAT), property taxes, petroleum taxes, and so forth.

640. However, in some countries, there may be constitutional or other barriers to the application of the non-discrimination rules to all taxes. While it is desirable that the rules apply as widely as possible, these countries may need to limit the application of these rules in their treaties to taxes covered by the treaty, or to those taxes and other major taxes imposed in the two countries.

2. Article 25 Mutual agreement procedure

641. Article 25 provides a mechanism, the mutual agreement procedure (MAP), which allows

Article 25 of the OECD Model in their treaties, although it allows them to use alternative mechanisms instead of strictly following the wording of the first sentence of paragraph 1 and the second sentence of paragraph 2.[326]

Statistics[327] prepared in accordance with the minimum standard show that the vast majority of mutual agreement procedure cases involve two developed countries. Few mutual agreement cases involve developing countries (other than large emerging economies such as India and China). Despite that fact, countries that enter into tax treaties must be in a position to meet their obligations with respect to the mutual agreement procedure, that is to say, they must establish processes within their tax administrations to enable taxpayers, or competent authorities (ot

to the profits of an enterprise or a permanent establishment under paragraph 2 of Article 7 or paragraph 1 of Article 9.[339]

655. As explained in the first sentence of paragraph 2, the first stage of the MAP process concerns the competent authority of the state that receives a request for MAP that conforms to paragraph 1. That competent authority must first consider whether the request is justified.[340] If it concludes that this is the case and that the taxation not in accordance with the treaty results from the action of its own state, the competent authority must resolve the matter through unilateral action, for example, by providing relief of double taxation in accordance with Article 23.[341]

656. If, on the other hand, it considers that the taxation not in accordance with the treaty results from the action of the other state, it must initiate the second stage of the mutual agreement procedure, which requires that it consult the competent authority of the other state with a view to resolving the case.[342]

657.

agreement should be drafted at the same time as the treaty so that it can be implemented as soon as the arbitration provision becomes effective.[348]

669. Various design issues related to MAP arbitration are discussed in the Commentary.[349] In addition, the Annex to the Commentary on paragraph 5 of Article 25 (alternative B) reproduces with the necessary adaptations the sample mutual agreement with detailed explanations that is found in the Annex to the Commentary on Article 25 of the OECD Model. That sample mutual agreement is intended to be used by the competent authorities as a basis for drafting the mutual agreement that would provide the practical details of the arbitration process.

Interaction with the General Agreement on Trade in Services

670. A number of countries include in their treaties a provision that deals with the application of the dispute resolution mechanism of the *General Agreement on Trade in Services* (GATS) to a dispute related to a measure that falls within the scope of a tax treaty.

671.

A detailed discussion of administrative issues relating to exchange of information may also be found in chapter IX of the United Nations *Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*.[360]

681. While historically the exchange of information upon request has been considered the most crucial form of transparency, over the past decade exchange of information on an automatic basis has grown significantly in importance. For example, one of the international minimum standards that was established in 2013 as part of the OECD/G20 BEPS Project was that all participating countries should engage in the automatic exchange of so-called "country-by-country" data that shows the business activities of multinational groups across all of the jurisdictions in which they operate. This data is intended to be used strictly for transfer pricing risk assessment purposes. Additionally, many countries are now implementing agreements or arrangements that provide for the automatic exchange of information about the bank activities of their residents in other countries as a means to improve income tax compliance.[361] While as a theoretical matter the exchange of information on an automatic basis has the potential to improve tax compliance, countries must be equipped with sufficient technological capabilities to handle and process large amounts of data properly, as well as both legal and administrative protections to keep the data confidential.

Paragraph 1

682. Paragraph 1 authorizes and requires the exchange of relevant information on all taxes, whether or not they are taxes covered by the treaty. Information must be obtained and exchanged by the competent authorities if it is "foreseeably relevant"[362] to the administration of either the treaty provisions or domestic law provisions (provided that the tax treatment under the domestic law is not contrary to the treaty).

683. The only difference between paragraph 1 of Article 26 of the UN Model and the equivalent paragraph in the OECD Model in that the paragraph of the UN Model specifies that "[i]n particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes". This statement of purpose is intended to provide explicit guidance to Contracting States on the interpretation of the Article.[363] Even in the absence of this statement, it is clear that this is the main purpose of the exchange of information provisions.

684. The paragraph is intended to have broad application. Provided the information sought is relevant to the application of the treaty or domestic taxes, exchange is not limited to information

360 Diane M. Ring, "Exchange of information", United Nations *Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (United Nations publication, Sales No. 13.XVI.2).

361 See http://www.oecd.org/tax/transparency/automatic-exchange-of-information.

362 The meaning of "foreseeably relevant" is discussed in paragraphs 7.1 and 7.2 of the Commentary on Article 26 of the UN Model.

363 Paragraph 4.2 of the Commentary on Article 26 of the UN Model.

about residents of the two Contracting States, or indeed, to taxpayer-specific information at all. General information, for example, about tax avoidance schemes, may also be exchanged.

685. Information about all taxes, whether or not they are taxes covered by the treaty, may be exchanged. Countries for which this is problematic, for example, where the competent authority cannot obtain information about subnational taxes, may seek to limit the obligation to treaty taxes and other important taxes, such as the value added tax (VAT).[364]

686. Examples of common situations where exchange of information would be useful are set out in paragraphs 10 to 10.2 of the Commentary on Article 26 of the UN Model.

Paragraph 2

687. Paragraph 2 ensures that tax information that is provided by one country to the other remains confidential and is used only for tax purposes. That information may be disclo

692. A country generally has to provide information to the other country only if that type of information would be obtainable under the law and normal practices of both countries. This should not, however, be interpreted in a way that would prevent effective exchange of information.[366] If there are certain types of information that cannot be obtained, this should be raised before or during negotiations.[367] Significant changes, after entry into force of a treaty, to domestic laws or administrative practices relating to obtaining or supplying information should be disclosed to the other country.[368]

693. A country is not obliged to provide to the other country certain confidential information specified in paragraph 3, for example, information that would disclose trade secrets or disclosure of which would be contrary to public policy.

694. The scope of these limitations, and drafting options to clarify some of their more controversial aspects, are discussed in paragraphs 15 to 25 of the Commentary on Article 26 of the UN Model.

Paragraph 4

695. Paragraph 4 clarifies that a state that is requested to provide information under Article 26 must use the information

698. Paragraphs 27.2 to 27.7 of the Commentary on Article 26 of the UN Model discuss the application of this paragraph as well as alternative provisions for dealing with issues concerning confidential communications between legal representatives and their clients.

Paragraph 6

699. Paragraph 6 of Article 26 of the UN Model, which has no equivalent in Article 26 of the OECD Model,[371] provides that the competent authorities shall develop, through consultation, "appropriate methods and techniques" concerning exchange of information. Countries should consider what procedures are appropriate for the competent authority of their country to provide effective exchange of information, including exchanges made upon request or automatically or spontaneously.

700. Section C of the Commentary on Article 26 provides useful guidance on some of the procedural aspects that countries may wish to agree upon.

4. Article 27 Assistance in collection

701. Article 27 requires the tax administration of each country to provide assistance to the other in collecting taxes owed in that other country as if the debt were its own tax claim. These provisions are a useful adjunct to exchange of information in that they ensure that taxpayers cannot evade taxes in one country by moving their residence or assets to a treaty country.

702. It is recognized that not all countries will be in a position to accept to provide assistance in the collection of taxes.[372]

where there is a risk that a taxpayer will move its assets outside a country before a tax claim becomes legally enforceable.

705. Paragraph 1 of the Article allows the competent authorities to settle how the Article is to be applied in practice. Before including an article providing for assistance in collection in a treaty, countries should have a clear view on the issues raised in paragraphs 9 to 16 of the Commentary on Article 27 of the UN Model, for example, what documentation is required, how costs will be dealt with, time limits on requests, possible minimum thresholds for requests, how amounts collected are to be remitted, and so forth.

706. Negotiators and competent authorities may also find it useful to read the provisions

Provide that the treaty will not apply to international organizations and their officials if they are not treated as residents of either state for tax purposes.

6. Article 29 Entitlement to benefits

3) both the principal purposes test rule of paragraph 9 and the limitation-on-benefits rule of paragraphs 1 to 7 or a variation thereof.[382]

2.71 When developing its country's tax treaty policy framework and model treaty, a country should carefully consider these three approaches before determining which one it prefers and which ones it would be willing to accept as a compromise, keeping in mind that a treaty could allow each state to apply a different approach through unilateral provisions. In doing so, it may want to review the different ways of addressing treaty abuses that are described in Section IV on Improper use of tax treaties.

713. While Article 29, which is by far the longest article of the UN Model, looks different from Article 29 of the OECD Model, the differences are primarily attributable to the inclusion, in the UN Model, of the provisions of the detailed version of the limitation-on-benefits rule found in paragraphs 1 to 7 of the Article. In the OECD Model, Article 29 only includes a short description of each paragraph between brackets. Alternatives versions (the simplified and detailed versions) of the provisions that should be included in each of these paragraphs are found in the Commentary.

Paragraphs 1 to 7

714. The limitation-on-benefits rule found in paragraphs 1 to 7 of the UN Model constitutes a specific anti-avoidance rule that is intended to deny treaty benefits in various situations of treaty shopping. That rule applies to arrangements that are known to cause treaty-shopping concerns by referring to certain features of these arrangements (such as the fact that the majority of the shares of a company resident of one treaty state are owned by shareholders who are not residents of that state). It applies regardless of whether or not the arrangement was set up for treaty-shopping purposes while recognizing that in some cases persons who are not residents of a treaty state may establish an entity in that state for legitimate business reasons; for instance, it allows the compd112 h7.07 Tm 0 g 0 G [( )] spapplies regardless of whether or not

however, does not include the "detailed" version included in the OECD

720. Paragraph 2 determines who constitutes a “qualified person” by reference to the nature or attributes of various categories of persons; any person to which the paragraph applies is therefore entitled to all the benefits of the treaty. Persons who constitute “qualified persons” under paragraph 2 are:

any individual;

a Contracting State, its political subdivisions and their agencies and instrumentalities;

tax. In that case, neither the third country nor the country of residence of the company (which applies the exemption method to these profits) would tax the profits attributable to the permanent establishment and, since there is no risk of double taxation, the source state should not have to apply the provisions of its tax treaty with the state of residence of the company.

727. Paragraph 8 is the same in both the UN and OECD models. Paragraph 8(*a*) is the substantive rule. It applies where one of the treaty states exempts the income of enterprises of that state that is attributable to permanent establishments situated in third jurisdictions. In that case, the benefits of the treaty will not be granted with respect to income from the state which the state of the enterprise attributes to the permanent establishment in the third jurisdiction unless the income bears a minimum level of tax in the state in which the permanent establishment is situated. That minimum level of tax corresponds to the lower of

- the tax payable at a rate to be determined through bilateral negotiations, or
- 60 per cent of the tax that would have been payable in the state of the enterprise if the permanent establishment had been situated there rather than in the third jurisdiction or, if the amount of tax.

728. Paragraph 8(*b*) constitutes an exception to the rule. It provides that paragraph 8(*a*) does not apply to income that "emanates from, or is incidental to, the active conduct of a business through the permanent establishment, excluding an investment business that is not carried on by a bank, insurance enterprise or registered securities dealer." This exception

Paragraph 8(*c*) is a discretionary relief provision which, like paragraph 6 applicable to the limitation-on-benefits rule and the optional addition to the principal purposes test rule proposed by the Commentary,[389] gives the competent authority of the source state the discretion of granting the treaty benefits. Before granting or denying a request for such discretionary relief, however, the competent authority should consult the competent authority of the other state (although the final decision remains that of the competent authority of the source state.

730. The Commentary[389] explains various aspects of paragraph 8. It also includes an alternative provision that countries wishing to extend the scope of paragraph 8 could use.[390] Under that alternative, the paragraph applies not only where the state of the enterprise exempts the profits of the permanent establishment situated in a third jurisdiction but also where it subjects these profits to low taxation so that the combined rate of tax in the state of the enterprise and the permanent establishment jurisdiction is less than 60 per cent of the statutory corporate tax rate of the state of the enterprise. In addition, that alternative does not include the exception of paragraph 8(*b*).

388 Paragraph 39 of the Commentary on Article 29 of the UN Model, quoting paragraph 184 of the Commentary on Article 29 of the OECD Model.

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736. The simplicity of the principal purposes test rule of paragraph 9 and the fact that it is potentially applicable to all forms of treaty abuse explains why most countries are willing to include it in their treaties. Some countries, however, do not like the uncertainty that is inherent to this general anti-abuse rule[393] and, for that reason, may oppose its inclusion in a tax treaty. If these countries are members of the Inclusive Framework on BEPS, however, they will only be able the satisfy the BEPS Action 6 minimum standard on treaty shopping if they include the limitation-on-benefits rule of paragraphs 1 to 7. In that case, however, they still will need to satisfy the requirement of implement a mechanism that will address treaty shopping strategies referred to as "conduit arrangements".[394] Since very few countries have such a mechanism in their domestic law, that may require the inclusion of a provision in the treaty for that purpose. Such a provision could take the form of principal purpose test rule similar to that in paragraph 9 but only applicable to transactions defined to constitute conduit arrangements.

H. Chapter VII – Final provisions

737. The UN Model, like the OECD Model, suggests provisions for the entry into force and termination of a tax treaty that are based on provisions typically found in international agreements. According to these provisions, a tax treaty enters into force when both countries have completed their respective procedures for the ratification of the treaty and have exchanged the instruments confirming such ratification; it remains in force until terminated, which may be done by either state giving notice of termination at least six months before the end of a calendar year. Once the treaty has entered into force or has been terminated, its provisions start to have effect or cease to have effect, as the case may be, from the date or dates which must be set out in the treaty. While these dates are usually in the future (for example, the beginning of the next fiscal year commencing after the date of entry into force), some provisions related to the entry into effect are sometimes given retroactive effect.

738. As discussed in subsections 4 and 5 of section II.E, the entry-into-force and termination provisions of a treaty need to be adapted to the particular requirements of each country.

1. Article 30 – Entry into force

739. Article 30 deals with the entry into force of the treaty and the dates on which the provisions of the treaty will have effect.

that country, the provisions of the treaty will have effect with respect to such taxes from the first day of the first tax year that follows the entry into fo

751. Although tax treaties are rarely terminated in practice (other than by replacement with a new, updated tax treaty), the Article sets out the procedure by which a treaty may be terminated by one state after the expiration of the initial period. This procedure involves one country giving the other country a formal notice of termination through diplomatic channels. The Article specifies that the notice of termination must be given at least six months before the end of any calendar year. As the treaty will then normally cease to have effect from the beginning of the next calendar year, this allows taxpayers sufficient time to prepare before the treaty provisions cease to have effect.

752.

Section IV – Improper use of treaties

A. Introduction

756. Tax avoidance strategies aimed at obtaining treaty benefits are an important concern for most countries but are particularly problematic for developing countries that have limited experience in dealing with sophisticated tax avoidance strategies.[396] Tax treaty negotiators should be aware of these concerns and of the ways of addressing these strategies through tax treaty provisions or other mechanisms. A detailed discussion of tax avoidance strategies aimed at obtaining treaty benefits and of ways of addressing them is included in the section "Improper use of tax treaties" in the Commentary on Article 1 of the UN Model.[397] That discussion takes account of the various changes that were made in 2017 to the UN and OECD models in order to address some of these strategies. These changes, which are discussed in section III under the relevant articles of the UN Model, resulted primarily from the reports on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6 – 2015, Final Report*)[398] and Action 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7 - 2015 Final Report*)[399] of the G20/ OECD project.[400]

757. The part of the Commentary on "Improper use of tax treaties" includes a number of examples of strategies involving the improper use of tax treaties and possible approaches (including additional treaty provisions, in some cases) to deal with these issues. These examples deal with:

- Transactions involving dual residence or a transfer of residence.[401]
- Treaty shopping arrangements.[402]
- Transactions involving triangular cases (i.e. situations where three states are involved).[403]
- Transactions through which income that would normally accrue to a taxpayer accrues to a related person or entity so as to obtain treaty benefits that would not otherwise be available,[404] including through
  - non-arm's length transfer prices,[405]

396 Paragraph 10 on the Commentary on Article 1 of the UN Model.
397 Paragraphs 10 to 117 of the Commentary on Article 1 of the UN Model.
398 Note 21.
399 Note 68.
400 Note 21.
401 Paragraphs 58 to 63 of the Commentary on Article 1 of the UN Model.
402 Paragraphs 64 to 76 of the Commentary on Article 1 of the UN Model.
403 Paragraphs 77 to 80 of the Commentary on Article 1 of the UN Model.
404 Paragraph 81 of the Commentary on Article 1 of the UN Model.
405 Paragraph 82 of the Commentary on Article 1 of the UN Model.

759. Treaty negotiators and taxnd

include specific provisions clarifying that there is no conflict or allowing the application of the specific domestic anti-abuse rule even if there is a conflict. This would be the case, for example, of a treaty provision that would expressly allow the application of the thin capitalization rules of each state even if they would otherwise conflict with the non-discrimination rule of paragraph 4 of Article 24.

770. Second, many tax treaty provisions depend on the application of domestic laws. This is the case, for instance, for the determination of the residence of a person, the determination of

both a proper interpretation of the treaty and as result of the application of domestic specific anti-abuse rules.

2. General anti-abuse rules in domestic law

774. Many countries have included in their domestic law a legislative anti-abuse rule of general application intended to prevent abusive arrangements that are not adequately dealt with through specific anti-abuse rules or judicial doctrines.

775. The application of such general anti-abuse rules also raises the question of a possible conflict with the provisions of a tax treaty. In the vast majority of cases, however, no such conflict will arise. Conflicts will first be avoided for reasons similar to those presented in paragraphs 769 to 773 above. In addition, where the main aspects of these domestic general anti-abuse rules are in conformity with the guiding principle in paragraph 763 above and are therefore similar to the main aspects of paragraph 9 of Article 29, which incorporates the guiding principle, it is clear that no conflict will be possible since the relevant domestic general anti-abuse rule will apply in the same circumstances in which the benefits of the treaty would be denied under paragraph 9 of Article 29 or, in the case of a treaty that does not include that Article, under the guiding principle of paragraph 763.

3. Judicial doctrines and principles of interpretation that are part of domestic law

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

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

778. While the interpretation of tax treaties is governed by certain rules that have been codified in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties*,[429] 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 decided 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.[430]

429 Note 29.

430 See the example in paragraph 39 of the Commentary on Article 1 of the UN Model.

779. As a general rule and having regard to the principle in paragraph 763 above, therefore, the preceding analysis leads to the conclusion that there will be no conflict between tax treaties and judicial anti-

specific anti-abuse rules in tax treaties is the most appropriate approach to deal with certain situations, it cannot, by itself, provide a comprehensive solution to treaty abuses.

5. General anti-abuse rules in tax treaties

783. As explained in section III, the general anti-abuse rule of paragraph 9 of Article 29 was added to the UN and OECD models in 2017 in order to prevent the improper use of tax treaties by denying treaty benefits where a main purpose of a transaction or arrangement is to obtain those benefits and granting those benefits would be contrary to the object and purpose of the relevant provisions of the treaty.

784. Paragraph 9 of Article 29 is consistent with and confirms the guiding principle stated in paragraph 763. Thus, many countries are able to deny treaty benefits in abusive cases without the need for a general anti-abuse rule such as paragraph 9 of Article 29 in their treaties. For this purpose, these countries can apply a general anti-abuse rule found in domestic law, judicial doctrines or principles of interpretation found in domestic law or they can interpret the provisions of their tax treaties in order to deny the benefits of a treaty in abusive cases.

785. Most countries that are members of the Inclusive Framework on BEPS[432] want to include paragraph 9 of Article 29 in their treaties as their preferred approach for complying with the requirements of the Action 6 minimum standard on treaty shopping.[433] Other countries that do not feel confident that their domestic law approach to the interpretation of tax treaties would allow them to adequately address improper uses of their tax treaties should obviously consider the inclusion of paragraph 9 of Article 29.

6. The interpretation of tax treaty provisions

786. Another approach that has been used to counter improper uses of treaties has been to disregard abusive transactions under a proper interpretation of the relevant treaty provisions that takes account of their context, the object and purpose of the treaty as well as the obligation to interpret these provisions in good faith in accordance with Article 31 of the *Vienna Convention on the Law of Treaties*.[434] As already mentioned, 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.

787. The guiding principle in paragraph 763 above is equally applicable for the purpose of interpreting the provisions of a treaty to prevent the abuse of the treaty as it is for purposes of determining whether the provisions of a treaty prevent the application of specific or general anti-abuse rules found in domestic law.

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432 Note 24.

As noted in paragraph 166, the title of the UN and OECD models was amended in 2017 to include an express reference to the prevention of tax avoidance and evasion as a purpose of the treaty. At the same time, a new preamble was added to that effect that the Contracting States