ST/ESA/102

UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

UNITED NATIONS

ST/ESA/102

Department of International Economic and Social Affairs

UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

UNITED NATIONS

New York, 1980

NOTE

Symbols of United Nations documents are composed of capital letters combined with figures. Mention of such a symbol indicates a reference to a United Nations document.

The designations employed and the presentation of the material in this publication do not imply expression of any opinion whatsoever on the part of the Secretariat of the United Nations concerning the legal status of any country or territory or of its authorities, or concerning the delimitation of its frontiers.

ST/ESA/102

UNITED NATIONS PUBLICATION

Sales No. E.80.XVI.3

Price: $U.S. 14.00

CONTENTS

Part One

Articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries

Part Two

Commentaries on the articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries

INTRODUCTION

A. ORIGIN OF THE UNITED NATIONS MODEL CONVENTION

The desirability of promoting greater inflows of foreign investment to developing countries on conditions which are politically acceptable as well as economically and socially beneficial has been frequently affirmed in resolutions of the General Assembly and the Economic and Social Council of the United Nations and the United Nations Conference on Trade and Development. The countries participating in the Paris Conference on International Economic Cooperation recognized that foreign private capital flows and investment play an important complementary role in the economic development process, particularly through the transfer of resources, managerial and administrative expertise and technology to the developing countries, the expansion of productive capacity and employment in those countries and the establishment of export markets.

The growth of investment flows from developed to developing countries depends to a large extent on what has been referred to as the international investment climate. The prevention or elimination of international double taxation—i.e., the imposition of similar taxes in two or more States on the same taxpayer in respect of the same base—whose effects 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. Broadly, the general objectives of bilateral tax conventions may today be seen to include the full protection of taxpayers against double taxation (whether direct or indirect) and the prevention of the discouragement which taxation may provide for the free flow of international trade and investment and the transfer of technology. They also aim to prevent discrimination between taxpayers in the international field, and to provide a reasonable element of legal and fiscal certainty as a framework within which international operations can be carried on. With this background, tax treaties should contribute to the furtherance of the development aims of the developing countries. In addition the treaties have as an objective the improvement of co-operation between tax authorities in carrying out their duties.

Substantial progress towards the elimination of double taxation has been made through unilateral relief measures and more particularly through bilateral tax conventions, which have emerged since the 1960s as a salient feature of inter-State economic relations. However, only a relatively small number of treaties have been concluded between developed and developing countries, the reason being probably the fact, acknowledged in 1965 by the Fiscal Committee of the Organisation for Economic Co-operation and Development, that "the traditional tax conventions have not commended themselves to developing countries".[1] According to that Committee, "the essential fact remains that tax conventions which capital-exporting countries have found to be of value to improve trade and investment among themselves and which might contribute in like ways to closer economic relations between developing and capital-exporting countries are not making sufficient contributions to that end. . . . Existing treaties between industrialized countries sometimes require the country of residence to give up revenue. More often, however, it is the country of source which gives up revenue. Such a pattern may not be equally appropriate in treaties between developing and industrialized countries because income flows are largely from developing to industrialized countries and the revenue sacrifice would be one-sided. But there are many provisions in existing tax conventions that have a valid place in conventions between capital-exporting and developing countries too".[2]

The desirability of encouraging the conclusion of bilateral tax treaties between developed and developing countries was recognized by the Economic and Social Council of the United Nations, which in its resolution 1273 (XLIII) adopted on 4 August 1967 requested the Secretary-General "to set up an *ad hoc* working group consisting of experts and tax administrators nominated by Governments, but acting in their personal capacity, both from developed and developing countries and adequately representing different regions and tax systems, with the task of exploring, in consultation with interested international agencies, ways and means for facilitating the conclusion of tax treaties between developed and developing countries, including the formulation, as appropriate, of possible guidelines and techniques for use in such tax treaties which would be acceptable to both groups of countries and would fully safeguard their respective revenue interests". Pursuant to that resolution, the Secretary-General set up in 1968 the *Ad Hoc* Group of Experts on Tax Treaties between Developed and Developing Countries, composed of tax officials and experts from the following countries, appointed in their personal capacity: Argentina, Chile, France, Federal Republic of Germany, Ghana, India, Israel, Japan, the Netherlands, Norway, Pakistan, the Philippines, the Sudan, Switzerland, Tunisia, Turkey, the United Kingdom of Great Britain and Northern Ireland and the United States of America. At the request of the Economic and Social Council, the

---

[1] Organisation for Economic Co-operation and Development, *Fiscal Incentives for Private Investment in Developing Countries: Report of the OECD Fiscal Committee* (Paris, 1965), para. 164.

[2] *Ibid.*, paras. 163 and 165.

Secretary-General increased the number of members of the Group of Experts by adding an expert from Sri Lanka in 1972 and an expert from Brazil in 1973.

The Group of Experts completed the formulation of guidelines for the negotiation of bilateral treaties between developed and developing countries in the course of seven meetings, which were attended by observers from Austria, Belgium, Finland, the Republic of Korea, Mexico, Nigeria, Spain, Swaziland and Venezuela and from the following international organizations: the International Monetary Fund, the International Fiscal Association, the Organisation for Economic Co-operation and Development, the Organization of American States and the International Chamber of Commerce. The guidelines are contained in the *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries*.[3] According to Economic and Social Council resolution 1541 (XLIX), the guidelines should represent "an important form of technical assistance for the conclusion of future treaties".

At its Seventh Meeting, the attention of the Group of Experts was drawn to the fact that the Group of Eminent Persons appointed in 1974 by the Secretary-General pursuant to Economic and Social Council resolution 1721 (LIII) had stated in its report to the Secretary-General that "If, through the work of the Group of Experts on Tax Treaties, the provisions of these treaties could be standardized, with only a small number of clauses to be negotiated in particular cases, they would in fact amount to an international agreement on taxation, which . . . [the Group of Eminent Persons considers] to be the final objective".[4]

The Group of Experts took the view that the world-wide multilateral tax agreement recommended by the Group of Eminent Persons would not seem feasible during the forthcoming decade but, recognizing the seriousness and urgency of many of the issues singled out by the latter, agreed that it was imperative that those issues be dealt with through an adequate network of bilateral tax treaties. According to the Group of Experts, it would therefore seem appropriate for the competent United Nations bodies to urge Member States to embark as soon as possible on a policy of entering into such treaties. In that connexion the Group of Experts expressed readiness to consider a draft model bilateral convention between a developed and a developing country based on the guidelines already developed by the Group, which the United Nations Secretariat might wish to prepare as a follow-up to the work of the Group at its first seven meetings.

In his report to the first regular session of 1978 of the Economic

---

[3] United Nations publication, Sales No. E.79.XVI.3.

[4] *The Impact of Multinational Corporations on Development and on International Relations* (United Nations publication, Sales No. E.74.II.A.5), p. 92.

and Social Council on the work of the Group of Experts at its Seventh Meeting, the Secretary-General expressed the view that "the completion of a model bilateral convention for possible use by developed and developing countries constitutes a logical follow-up to the work done by the Group of Experts relating to the formulation of guidelines and would moreover be consonant with the recommendation of the Group of Eminent Persons that "bilateral tax treaties should be as uniform as possible so as to prepare the way for an international tax agreement" (see E/1978/36, para. 15). At that session, the Economic and Social Council adopted decision 1978/14, in which it welcomed the position of the Secretary-General as set forth above and requested the Group of Experts "to complete its consideration of a draft model bilateral convention at its Eighth Meeting in 1979".

The Fiscal and Financial Branch of the Department of International Economic and Social Affairs of the United Nations Secretariat therefore prepared a draft model convention (ST/SG/AC.8/L.29) consisting of articles reproducing the guidelines formulated by the Group of Experts, together with commentaries thereon incorporating the views of the members of the Group as expressed at its various meetings and also reproducing, where appropriate, the commentaries on the articles of the 1977 Model Double Taxation Convention on Income and on Capital of the Organisation for Economic Co-operation and Development, hereafter referred to as the OECD Model Convention. It may be recalled that in preparing the aforementioned guidelines the Group of Experts had decided to use the OECD Model Convention as its main reference text in order to take advantage of the accumulated technical expertise embodied in that Convention and the commentary thereon, and also for reasons of practical convenience stemming from the fact that the Convention was being used by OECD member countries in the negotiation of tax treaties not only with each other but also with developing countries. However, it was fully understood that there was no presumption of correctness to be accorded to the OECD Model Convention, and that the decisions of the Group were in no way required to be governed by the OECD text.

The Group of Experts reviewed the draft United Nations Model Convention at its Eighth Meeting, held at Geneva from 10 to 21 December 1979, and adopted the final text of the Convention and of the commentary thereon.[5]

The Meeting was attended by the following members: A. N. E. Amissah (Ghana); W. H. van den Berge (Netherlands); Maurice Hugh Collins (United Kingdom of Great Britain and Northern Ireland) accompanied by B. D. Kent; Jean-François Court (France); José Daniel Diniz (Brazil) accompanied by Maria Christina Albernaz de Andrade;

[5] *Tax Treaties between Developed and Developing Countries, Eighth Report* (United Nations publication, Sales No. E.80.XVI.1).

Mordecai S. Feinberg (United States of America); J. A. R. Felix (Sri Lanka); Antonio H. Figueroa (Argentina); Simcha Gafny (Israel); Shigeyoshi Genjida (Japan); Thomas Menck (Federal Republic of Germany) accompanied by Florenz Hundt; Efren Plana (Philippines); N. M. Qureshi (Pakistan); Avtar Singh (India); Gilberto Urrutia Vistoso (Chile); Max Widmer (Switzerland); and Ahmed Zarrouk (Tunisia).

The Meeting was attended by the following observers:

(*a*) Helmut Berger (Austria); Jozef Coremans (Belgium); Chung Duck Koo (the Republic of Korea); M. L. Lindström (Finland); José M. de la Villa (Spain).

(*b*) A. G. Davies (International Chamber of Commerce); James Gilmer (Organisation for Economic Co-operation and Development) accompanied by J. L. Lienard; Johan C. L. Huiskamp (International Fiscal Association) and Olav Snellingen (International Monetary Fund).

The Group unanimously re-elected A. N. E. Amissah and W. H. van den Berge as Chairman and Vice-Chairman. Jean Causse, Senior Economic Affairs Officer in the Fiscal and Financial Branch of the Department of International Economic and Social Affairs, served as Secretary of the Group and Ms. Toni Robinson, a member of the United States of America branch of the International Fiscal Association, served as Deputy Secretary of the Group. Stanley Surrey, Professor at Harvard University (United States of America) served as Special Adviser.

The Group set up a seven-member Drafting Committee composed of six members of the Group and one member of the United Nations Secretariat. The members of the Drafting Committee were: Maurice Hugh Collins (United Kingdom of Great Britain and Northern Ireland); Jean-François Court (France); José Daniel Diniz (Brazil); N. M. Qureshi (Pakistan); Avtar Singh (India); Max Widmer (Switzerland) and J. Pierre V. Benoit, Head, Fiscal and Financial Branch, Department of International Economic and Social Affairs, United Nations Secretariat.

J. Pierre Benoit conveyed to the members of the Group the appreciation of the Secretary-General for their very valuable contribution to the formulation of the United Nations Model Convention.

The United Nations Model Convention represents a compromise between the source principle and the residence principle, although it gives more weight to the source principle than does the OECD Model Convention. As a correlative to the principle of taxation at source the articles of the Model Convention are predicated on the premise of the recognition by the source country that (*a*) taxation of income from foreign capital would take into account expenses allocable to the earning of the income so that such income would be taxed on a net basis, that (*b*) taxation would not be so high as to discourage investment and that (*c*) it would take into account the appropriateness of the sharing of revenue with the country providing the capital. In addition, the United Nations Model Convention embodies the idea that it would be appropriate for the residence country to extend a measure of relief from double taxation through either foreign tax credit or exemption as in the OECD Model Convention.

In using the United Nations Model Convention, a country should bear in mind the fact that the relationship between treaties and domestic law may vary from country to country and that it is important to take into account the relationship between tax treaties and domestic law. Tax treaties affect the tax rules prevailing under the domestic tax laws of the Contracting States by establishing which Contracting State shall have jurisdiction to subject a given income item to its national tax laws and under what conditions and with what limitations it may do so. Consequently, countries wishing to enter into bilateral tax treaty negotiations should analyse carefully the applicable provisions of their domestic tax laws in order to assess the modifications that might be required if the treaty were applied.

It may also be noted that domestic tax laws in their turn exert an influence on the content of bilateral tax treaties. Thus, although there was general agreement in OECD about the principles embodied in the OECD Model Convention and although most existing bilateral tax treaties conform by and large to the latter, there are often substantial variations from one treaty to another, due to differences in the domestic laws of the various Contracting States.

B. Historical setting of the United Nations Model Convention

The United Nations Model Convention on Tax Treaties between Developed and Developing Countries forms part of the continuing international efforts aimed at eliminating double taxation. These efforts begun by the League of Nations and pursued in the Organisation for European Economic Co-operation (now known as the Organisation for Economic Co-operation and Development (OECD)) and in regional forums, as well as in the United Nations, have in general found concrete expression in a series of model or draft model bilateral tax conventions.

In 1921, the League of Nations, acting through its Financial Committee in response to an appeal by the 1920 Brussels International Financial Conference for action aimed at eliminating double taxation, entrusted a team of four economists (from Italy, the Netherlands, the United Kingdom and the United States of America) with the task of preparing a study on the economic aspects of international double taxation.

In 1922, the Financial Committee of the League invited a group of seven high-level tax officials (from Belgium, Czechoslovakia, France, Italy, the Netherlands, Switzerland and the United Kingdom) to study the administrative and practical aspects of international double taxation and international tax evasion. In 1925, the group was enlarged to include officials from Argentina, Germany, Japan, Poland and Venezuela. In 1927, an official from the United States of America joined the group. In the course of sessions held from 1923 to 1927, the group drafted Bilateral Conventions for the Prevention of Double Taxation in the Special Matter of Direct Taxes dealing with income and property taxes, a Bilateral Convention for the Prevention of Double Taxation in the Special Matter of Succession Duties, a Bilateral Convention on Administrative Assistance in Matters of Taxation and a Bilateral Convention on [Judicial] Assistance in the Collection of Taxes. The conventions, with their commentaries, were sent to the various Governments, Members and non-members of the League, which were invited to send representatives to discuss them at a General Meeting of Government Experts. The latter meeting, held at Geneva in October 1928, included representatives of 27 countries.

In 1929, pursuant to a recommendation of the General Meeting of Government Experts, the Council of the League of Nations appointed a permanent Fiscal Committee. The latter devoted considerable attention to the question of formulating, for tax purposes, rules for allocation of the business income of undertakings operating in several countries. Within the framework of those activities, a Draft Convention for the Allocation of Business Income between States for the Purposes of Taxation was formulated, first at meetings of a subcommittee held in New York and Washington under the auspices of the American Section of the International Chamber of Commerce, and then at the full meeting of the Fiscal Committee in June 1933. The Draft Convention was revised by the Fiscal Committee in June 1935.[6]

In 1940, the Fiscal Committee held a subcommittee meeting in the Netherlands to review the progress made with regard to tax treaties since the 1928 General Meeting of Government Experts. Soon afterwards, it began consolidating the 1928 Model Conventions and the 1935 Draft Convention. The results of its work were reviewed at a Regional Tax Conference convened in June 1940 at Mexico City, reconvened in July 1943, likewise at Mexico City, and attended by representatives from Argentina, Bolivia, Canada, Chile, Colombia, Ecuador, Mexico, Peru, the United States of America, Uruguay and Venezuela. The Second Regional Conference adopted a Model Bilateral Convention for the Prevention of the Double Taxation of Income

[6] For further details, see Mitchell B. Carroll, *Global Perspectives of an International Tax Lawyer* (Hicksville, New York, Exposition Press, 1978). Mr. Carroll is a former President of the Fiscal Committee of the League of Nations and the International Fiscal Association. He is currently Honorary President of the latter.

and a Protocol thereto, a Model Bilateral Convention for the Prevention of Double Taxation of Successions and a Protocol thereto, and a Model Bilateral Convention for the Establishment of Reciprocal Administrative Assistance for the Assessment and Collection of Direct Taxes and a Protocol thereto.

In March 1946, the Fiscal Committee of the League of Nations convened in London for its tenth session, at which it reviewed and redrafted the Mexico model bilateral tax conventions. The Fiscal Committee was of the opinion that the latter represented "a definite improvement on the 1928 Model Conventions" but that "nevertheless, since the membership of the Mexico City and London meetings differed considerably, it (was) natural that the participants in the London meeting held, on various points, different views from those which inspired the model conventions prepared in Mexico". The Committee stated that the general structure of the model conventions drafted at the tenth session was similar to that of the Mexico models; a number of changes had been made in the wording, and some articles had been suppressed because they contained provisions already contained in other clauses. The Committee observed that virtually the only clauses where there was an effective divergence between the views of the 1943 Mexico meeting and those of the London meeting were those "relating to the taxation of interest, dividends, royalties, annuities and pensions". The Committee added that it was aware of the fact that the provisions contained in the 1943 model conventions might appear more attractive to some States—in Latin America for instance—than those which it had agreed during its current sessions and that it thought "that the work done both in Mexico and in London could be usefully reviewed and developed by a balanced group of tax administrators and experts from both capital-importing and capital-exporting countries and from economically-advanced and less-advanced countries, when the League work on international tax problems is taken over by the United Nations".[7]

It was against that background that the Economic and Social Council of the United Nations, in its resolution 2 (III) of 1 October 1946, set up a Fiscal Commission which was requested to "Study and advise the Council in the field of public finance, particularly in its legal, administrative and technical aspects". After the Fiscal Commission and its Committee on International Tax Relations stopped functioning in 1954 the focus of action in the field of international taxation shifted to OEEC.

The Council of OEEC adopted its first recommendation concerning double taxation on 25 February 1955; that recommendation subsequently resulted in the establishment of the OECC Fiscal Com-

[7] League of Nations, *Fiscal Committee: Report on the Work of the Tenth Session of the Committee, held in London from March 20th to 26th, 1946* (C.37.M.37.1946.II.A), p. 8.

mittee in March 1956. In July 1958, the Fiscal Committee was instructed to prepare a draft convention for the avoidance of double taxation with respect to taxes on income and capital as well as concrete proposals for the implementation of such a convention. In the words of the Fiscal Committee: "Since the work of the League of Nations, the value of a Model Convention has been universally recognized not only by the national authorities but also by the taxpayers themselves."[8]

From 1958 to 1961, the Fiscal Committee prepared four reports, published under the title "The elimination of double taxation", in which the Committee proposed a total of 25 articles. After OEEC became the Organisation for Economic Co-operation and Development (OECD) in September 1961, the mandate of the Fiscal Committee was confirmed; the Committee subsequently agreed on a number of new articles and all the articles were embodied in a report entitled Draft Double Taxation Convention on Income and on Capital, published in 1963.

In July 1963, OECD, recognizing that the effort to eliminate double taxation between member countries needed to go beyond the field of periodic taxes on income and capital, instructed the Fiscal Committee to work out a draft convention which would provide a means of settling on a uniform basis the most common problems of double taxation of estates and inheritances. The Draft Convention for the Avoidance of Double Taxation with Respect to Taxes on Estates and Inheritances was published in 1966.

In 1967 the Fiscal Committee—renamed in 1971 "Committee on Fiscal Affairs"—began revising the 1963 Draft Double Taxation Convention. That revision was considered necessary in order to take account of "experience gained by Member countries in negotiating new conventions or in their practical working" and also of "the changes in systems of taxation and the increase in international fiscal relations on the one hand and, on the other, the development of new sectors of business activity and the increasingly complex forms of organisation adopted by enterprises for their international activities".[9] The revision of the 1963 Draft Convention ultimately led to the publication of the 1977 Model Double Taxation Convention on Income and on Capital.

As it had done for the 1963 Draft Convention, the Council of OECD, in a recommendation based on a suggestion by the Committee on Fiscal Affairs and adopted on 11 April 1977, recommended to the

---

[8] Organisation for Economic Co-operation and Development, *Draft Double Taxation Convention on Income and Capital: Report of the OECD Fiscal Committee* (Paris, 1963), p. 25, para. 49.

[9] Organisation for Economic Co-operation and Development, *Model Double Taxation Convention on Income and on Capital: Report of the OECD Committee on Fiscal Affairs* (Paris, 1977), p. 8, para. 10.

Governments of member countries "to pursue their efforts to conclude bilateral conventions for the avoidance of double taxation with respect to taxes on income and on capital with those member countries with which they have not yet entered into such conventions and to revise those of the existing conventions between them which may no longer be in keeping with present-day needs and when concluding new bilateral conventions or revising existing conventions between them, to conform to the Model Convention". The Council also recommended "that the Governments of member countries which consider it appropriate examine the feasibility of concluding among themselves multilateral conventions based upon the Model Convention." The Council instructed the Committee on Fiscal Affairs "to proceed to periodic reviews of situations where double taxation may occur, in the light of experience gained by member countries and to make appropriate proposals for its removal."

Meanwhile, in the mid 1960s, the United Nations began to take a renewed interest in the problem of double taxation, as a result of the continued increase in the number of developing Member States and as part of its action aimed at promoting the flow of foreign investment to developing countries. That renewed interest led to the activities described in section 1 above, which have culminated in the preparation of the United Nations Model Convention.

Action relating to double taxation has also been taken at the regional and subregional levels. At the regional level, a Group of Experts of the Latin American Free Trade Association (LAFTA) adopted in 1976 criteria for the avoidance of double taxation between LAFTA member countries and countries outside the region. At the subregional level, the Commission of the Cartagena Agreement adopted in November 1971 the Model Convention for the Avoidance of Double Taxation between Member Countries and Other Countries outside the Andean Subregion and also the Convention for the Avoidance of Double Taxation within the Andean Group. Furthermore, in November 1972, a Convention on Administrative Assistance in Tax Matters was concluded by Denmark, Finland, Iceland, Norway and Sweden; the Convention was amended in 1973 and again in 1976.

C. Rationale and significance of the United Nations Model Convention

The rationale of the preparation of bilateral tax conventions was cogently expressed by the Fiscal Committee of the League of Nations in the following terms:

> "The existence of model draft treaties . . . has proved of real use . . . in helping to solve many of the technical difficulties which arise in [the negotiation of tax treaties]. This procedure has

the dual merit that, on the one hand, in so far as the model constitutes the basis of bilateral agreements, it creates automatically a uniformity of practice and legislation, while, on the other hand, inasmuch as it may be modified in any bilateral agreement reached, it is sufficiently elastic to be adapted to the different conditions obtaining in different countries or pairs of countries."[10]

Like all model conventions, the United Nations Model Convention is not enforceable. Its provisions are not binding and furthermore should not be construed as formal recommendations of the United Nations. The United Nations Model Convention is intended primarily to point the way towards feasible approaches to the resolution of the issues involved that both potential contracting parties are likely to find acceptable. Its aim is to facilitate the negotiation of tax treaties by eliminating the need for elaborate analysis and protracted discussion of every issue *ab origine* in the case of each treaty. Indeed, in preparing for negotiations a participating country may wish to review the provisions of bilateral double taxation treaties entered into by the other country in order to survey the latter's treaty practice and in particular the concessions it has granted in the past. In bilateral negotiations, room of course should be left to insert in the treaty provisions adapted to special situations.

If the negotiating parties decide to use in a treaty wording suggested in the United Nations Model Convention, it is to be presumed that they would also expect to derive assistance in the interpretation of that wording from the relevant commentary. The commentaries, which may prove to be very useful in the implementation of a treaty concluded by the negotiating parties and in the settlement of any dispute relating thereto, are not intended to be annexed to such a treaty, the text of which in itself would constitute the legally binding agreement.

Since the United Nations Model Convention reproduces many articles of the OECD Model Convention (see Part One below) together with the commentaries thereon (see Part Two below), and as these commentaries include certain observations on the commentary, special derogations and reservations by the OECD member countries on certain provisions of the OECD Model Convention, such observations on the commentary, special derogations and reservations are quoted for information in the commentaries on the United Nations Model Convention.

With regard to the observations on the commentaries, the OECD Committee on Fiscal Affairs has noted that they "have sometimes

---

[10] League of Nations, *Fiscal Committee: Report to the Council on the Fifth Session of the Committee, held at Geneva from June 12th to 17th, 1935* (C.252.M.124.1935.II.A), chap. II., sect. B, para. 4.

been inserted at the request of some member countries who were unable to concur in the interpretation given in the commentary on the article concerned. These observations thus do not express any disagreement with the text of the Convention, but furnish a useful indication of the way in which those countries will apply the provisions of the article in question."[11]

With regard to the reservations, the Committee on Fiscal Affairs considers that they "must be viewed against the background of the global results which have been obtained. It is understood that in so far as certain member countries have entered reservations the other member countries, in negotiating bilateral conventions with the former, will retain their freedom of action in accordance with the principle of reciprocity."[12]

It is hoped that the United Nations Model Convention will contribute to the conclusion of an increasing number of bilateral tax treaties, not only between developed and developing countries but also between developing countries. It is also hoped that the Model Convention will contribute to the standardization of the provisions of such treaties. The creation of a network of bilateral tax treaties based on a common model will be an important step on the way leading to the eventual conclusion of a world-wide multilateral tax convention for the avoidance of double taxation. In the meantime, as an intermediate step, groups of countries might consider the possibility of negotiating regional or subregional multilateral tax conventions based on the United Nations Model Convention but adjusted to their requirements and the characteristics of their region or subregion.

The conclusion of regional or subregional conventions for the avoidance of double taxation would not only increase the number of countries which are parties to a double taxation convention but would also promote the co-ordination of tax policies and practices at the international level. The conclusion of such conventions would accelerate the harmonization of tax rules and practices concerning basic definitions, procedures for identifying the source of taxable items, methods for the elimination of double taxation and so on. It would also make it possible for tax administrations to resort to a broader gamut of co-operation measures while enabling taxpayers in any State party to a multilateral convention to make wider use of the recourse procedures open to them by invoking the relevant provisions of the convention in other Contracting States.

---

[11] Organisation for Economic Co-operation and Development, *Model Double Taxation Convention on Income and on Capital: Report of the Fiscal Committee* (Paris, 1977), para. 27.

[12] *Ibid.*, para. 29.

Part One

ARTICLES OF THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

SUMMARY OF THE CONVENTION

Title and Preamble

CHAPTER I
Scope of the Convention

Article 1 Personal scope
Article 2 Taxes covered

CHAPTER II
Definitions

Article 3 General definitions
Article 4 Resident
Article 5 Permanent establishment

CHAPTER III
Taxation of income

Article 6 Income from immovable property
Article 7 Business profits
Article 8 A Shipping, inland waterways transport and air transport (alternative A)
Article 8 B Shipping, inland waterways transport and air transport (alternative B)
Article 9 Associated enterprises
Article 10 Dividends
Article 11 Interest
Article 12 Royalties
Article 13 Capital gains
Article 14 Independent personal services
Article 15 Dependent personal services
Article 16 Directors' fees and remuneration of top-level managerial officials
Article 17 Income earned by entertainers and athletes
Article 18 A Pensions and social security payments (alternative A)
Article 18 B Pensions and social security payments (alternative B)
Article 19 Remuneration and pensions in respect of government service
Article 20 Payments received by students and apprentices
Article 21 Other income

TITLE OF THE CONVENTION

Convention between (State A) and (State B) for avoidance of double taxation with respect to taxes on income [and on capital].[1]

PREAMBLE OF THE CONVENTION

[1] Throughout the Convention, the words in square brackets are to be deleted if it is not intended to include in the Convention an article on the taxation of capital (see also article 22).

The Preamble of the Convention shall be drafted in accordance with the constitutional procedures of both Contracting States.

Chapter I

SCOPE OF THE CONVENTION

Article 1

PERSONAL SCOPE

This Convention shall apply to persons who are residents of one or both of the Contracting States.

Article 2

TAXES COVERED

1. This Convention shall apply to taxes on income [and on capital] imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.

2. There shall be regarded as taxes on income [and on capital] all taxes imposed on total income, [on total capital,] or on elements of income [or of capital,] including taxes on gains from the alienation of movable or immovable property, taxes on the total amounts of wages or salaries paid by enterprises, as well as taxes on capital appreciation.

3. The existing taxes to which the Convention shall apply are in particular:

   (*a*) (in State A): ....

   (*b*) (in State B): ....

4. The Convention shall apply also to any identical or substantially similar taxes which are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. At the end of each year, the competent authorities of the Contracting States shall notify each other of changes which have been made in their respective taxation laws.

Chapter II

DEFINITIONS

Article 3

GENERAL DEFINITIONS

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

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

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

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

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

(*e*) The term "competent authority" means:

(i) (In State A): ....

(ii) (In State B): ....

2. As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning which it has under the law of that State concerning the taxes to which the Convention applies.

Article 4

RESIDENT

1. For the purposes of this Convention, the term "resident of a Contracting State" means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management or any other criterion of a similar nature.

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

(*a*) He shall be deemed to be a resident of the State in which he has a permanent home available to him; if he has a permanent home available to him in both States, he shall be deemed to be a resident of the State with which his personal and economic relations are closer (centre of vital interests);

(*b*) If the State in which he has his centre of vital interests cannot be determined, or if he has not a permanent home available to him in either State, he shall be deemed to be a resident of the State in which he has an habitual abode;

(*c*) If he has an habitual abode in both States or in neither of them, he shall be deemed to be a resident of the State of which he is a national;

(*d*) If he is a national of both States or of neither of them, the competent authorities of the Contracting States shall settle the question by mutual agreement.

3. Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, then it shall be deemed to be a resident of the State in which its place of effective management is situated.

Article 5

PERMANENT ESTABLISHMENT

1. For the purposes of this Convention, the term "permanent establishment" means a fixed place of business through which the business of an enterprise is wholly or partly carried on.

2. The term "permanent establishment" includes especially:

(*a*) A place of management;

(*b*) A branch;

(*c*) An office;

(*d*) A factory;

(*e*) A workshop;

(*f*) A mine, an oil or gas well, a quarry or any other place of extraction of natural resources.

3. The term "permanent establishment" likewise encompasses:

(*a*) A building site, a construction, assembly or installation project or supervisory activities in connexion therewith, but only where such site, project or activities continue for a period of more than six months;

(*b*) The furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period.

4. Notwithstanding the preceding provisions of this article, the term "permanent establishment" shall be deemed not to include:

(*a*) The use of facilities solely for the purpose of storage or display of goods or merchandise belonging to the enterprise;

(*b*) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage or display;

(*c*) The maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise;

(*d*) The maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise or of collecting information, for the enterprise;

(*e*) The maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character.

5. Notwithstanding the provisions of paragraphs 1 and 2, where a person—other than an agent of an independent status to whom paragraph 7 applies—is acting in a Contracting State on behalf of an enterprise of the other Contracting State, that enterprise shall be deemed to have a permanent establishment in the first-mentioned Contracting State in respect of any activities which that person undertakes for the enterprise, if such a person:

(*a*) Has and habitually exercises in that State an authority to conclude contracts in the name of the enterprise, unless the activities of such person are limited to those mentioned in paragraph 4 which, if exercised through a fixed place of business, would not make this fixed place of business a permanent establishment under the provisions of that paragraph; or

(*b*) Has no such authority, but habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise.

6. Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other State or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 7 applies.

7. An enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business. However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, he will

not be considered an agent of an independent status within the meaning of this paragraph.

8. The fact that a company which is a resident of a Contracting State controls or is controlled by a company which is a resident of the other Contracting State, or which carries on business in that other State (whether through a permanent establishment or otherwise) shall not of itself constitute either company a permanent establishment of the other.

Chapter III

TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

1. Income derived by a resident of a Contracting State from immovable property (including income from agriculture or forestry) situated in the other Contracting State may be taxed in that other State.

2. The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in question is situated. The term shall in any case include property accessory to immovable property, livestock and equipment used in agriculture and forestry, rights to which the provisions of general law respecting landed property apply, usufruct of immovable property and rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources; ships, boats and aircraft shall not be regarded as immovable property.

3. The provisions of paragraph 1 shall also apply to income derived from the direct use, letting or use in any other form of immovable property.

4. The provisions of paragraphs 1 and 3 shall also apply to the income from immovable property of an enterprise and to income from immovable property used for the performance of independent personal services.

Article 7

BUSINESS PROFITS

1. The profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits of the enterprise may be taxed in the other State but only so much of them as is attributable to (*a*) that permanent establishment; (*b*) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (*c*) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

2. Subject to the provisions of paragraph 3, where an enterprise of a Contracting State carries on business in the other Contracting State through a permanent establishment situated therein, there shall in each Contracting State be attributed to that permanent establishment the profits which it might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment.

3. In the determination of the profits of a permanent establishment, there shall be allowed as deductions expenses which are incurred for the purposes of the business of the permanent establishment including executive and general administrative expenses so incurred, whether in the State in which the permanent establishment is situated or elsewhere. However, no such deduction shall be allowed in respect of amounts, if any, paid (otherwise than towards reimbursement of actual expenses) by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission, for specific services performed or for management, or, except in the case of a banking enterprise, by way of interest on moneys lent to the permanent establishment. Likewise, no account shall be taken, in the determination of the profits of a permanent establishment, for amounts charged (otherwise than towards reimbursement of actual expenses), by the permanent establishment to the head office of the enterprise or any of its other offices, by way of royalties, fees or other similar payments in return for the use of patents or other rights, or by way of commission for specific services performed or for management, or, except in the case of a banking enterprise by way of interest on moneys lent to the head office of the enterprise or any of its other offices.

4. In so far as it has been customary in a Contracting State to determine the profits to be attributed to a permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing in paragraph 2 shall preclude that Contracting State from determining the profits to be taxed by such an apportionment as may be customary; the method of apportionment adopted shall, however, be such that the result shall be in accordance with the principles contained in this article.

5. For the purposes of the preceding paragraphs, the profits to be attributed to the permanent establishment shall be determined by the same method year by year unless there is good and sufficient reason to the contrary.

6. Where profits include items of income which are dealt with separately in other articles of this Convention, then the provisions of those articles shall not be affected by the provisions of this article.

(NOTE: the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods and merchandise for the enterprise was not resolved. It should therefore be settled in bilateral negotiations.)

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Article 8 A (alternative A)

1. Profits from the operation of ships or aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

3. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or, if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.

4. The provisions of paragraph 1 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 8 B (alternative B)

1. Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

2. Profits from the operation of ships in international traffic shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated unless the shipping activities arising from such operation in the other Contracting State are more than casual. If such activities are more than casual, such profits may be taxed in that other State. The profits to be taxed in that other State shall be determined on the basis of an appropriate allocation of the over-all net profits derived by the enterprise from its shipping operations. The tax computed in accordance with such allocation shall then be reduced by . . . per cent. (The percentage is to be established through bilateral negotiations.)

3. Profits from the operation of boats engaged in inland waterways transport shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. If the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat,

then it shall be deemed to be situated in the Contracting State in which the home harbour of the ship or boat is situated, or if there is no such home harbour, in the Contracting State of which the operator of the ship or boat is a resident.

5. The provisions of paragraphs 1 and 2 shall also apply to profits from the participation in a pool, a joint business or an international operating agency.

Article 9

ASSOCIATED ENTERPRISES

1. Where:

(*a*) An enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or

(*b*) The same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State,

and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

2. Where a Contracting State includes in the profits of an enterprise of that State—and taxes accordingly—profits on which an enterprise of the other Contracting State has been charged to tax in that other State and the profits so included are profits which would have accrued to the enterprise of the first-mentioned State if the conditions made between the two enterprises had been those which would have been made between independent enterprises, then that other State shall make an appropriate adjustment to the amount of the tax charged therein on those profits. In determining such adjustment, due regard shall be had to the other provisions of the Convention and the competent authorities of the Contracting States shall, if necessary, consult each other.

Article 10

DIVIDENDS

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

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

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

(*b*) . . . per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the dividends in all other cases.

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

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

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

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

5. Where a company which is a resident of a Contracting State derives profits or income from the other Contracting State, that other State may not impose any tax on the dividends paid by the company, except in so far as such dividends are paid to a resident of that other State or in so far as the holding in respect of which the dividends are paid is effectively connected with a permanent establishment or a fixed base situated in that other State, nor subject the company's undistributed profits to a tax on the company's undistributed profits, even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in such other State.

Article 11

INTEREST

1. Interest arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such interest may also be taxed in the Contracting State in which it arises and according to the laws of that State, but if

the recipient is the beneficial owner of the interest the tax so charged shall not exceed . . . per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the interest. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

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

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

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

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

Article 12

ROYALTIES

1. Royalties arising in a Contracting State and paid to a resident of the other Contracting State may be taxed in that other State.

2. However, such royalties may also be taxed in the Contracting State in which they arise and according to the laws of that State, but if the recipient is the beneficial owner of the royalties, the tax so charged shall not exceed . . . per cent (the percentage is to be established through bilateral negotiations) of the gross amount of the royalties. The competent authorities of the Contracting States shall by mutual agreement settle the mode of application of this limitation.

3. The term "royalties" as used in this article means payments of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trade mark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial, or scientific equipment, or for information concerning industrial, commercial or scientific experience.

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

5. Royalties shall be deemed to arise in a Contracting State when the payer is that State itself, a political subdivision, a local authority or a resident of that State. Where, however, the person paying the royalties, whether he is a resident of a Contracting State or not, has in a Contracting State a permanent establishment or a fixed base in connexion with which the liability to pay the royalties was incurred, and such royalties are borne by such permanent establishment or fixed base, then such royalties shall be deemed to arise in the State in which the permanent establishment or fixed base is situated.

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

Article 13

CAPITAL GAINS

1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.

2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

4. Gains from the alienation of shares of the capital stock of a company the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State.

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

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

Article 14

INDEPENDENT PERSONAL SERVICES

1. Income derived by a resident of a Contracting State in respect of professional services or other activities of an independent character shall be taxable only in that State except in the following circumstances, when such income may also be taxed in the other Contracting State:

(*a*) If he has a fixed base regularly available to him in the other Contracting State for the purpose of performing his activities; in that case, only so much of the income as is attributable to that fixed base may be taxed in that other Contracting State; or (*b*) If his stay in the other Contracting State is for a period or periods amounting to or exceeding in the aggregate 183 days in the fiscal year concerned; in that case, only so much of the income as is derived from his activities performed in that other State may be taxed in that other State; or

(*c*) If the remuneration for his activities in the other Contracting State is paid by a resident of that Contracting State or is borne by a permanent establishment or a fixed base situated in that Contracting State and exceeds in the fiscal year . . . (the amount is to be established through bilateral negotiations).

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

Article 15

DEPENDENT PERSONAL SERVICES

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

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

(*a*) The recipient is present in the other State for a period or periods not exceeding in the aggregate 183 days in the fiscal year concerned; and

(*b*) The remuneration is paid by, or on behalf of, an employer who is not a resident of the other State; and

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

3. Notwithstanding the preceding provisions of this article, remuneration derived in respect of an employment exercised aboard a ship or aircraft operated in international traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

1. Directors' fees and other similar payments derived by a resident of a Contracting State in his capacity as a member of the Board of

Directors of a company which is a resident of the other Contracting State may be taxed in that other State.

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

Article 17

INCOME EARNED BY ENTERTAINERS AND ATHLETES

1. Notwithstanding the provisions of articles 14 and 15, income derived by a resident of a Contracting State as an entertainer, such as a theatre, motion picture, radio or television artiste, or a musician, or as an athlete, from his personal activities as such exercised in the other Contracting State, may be taxed in that other State.

2. Where income in respect of personal activities exercised by an entertainer or an athlete in his capacity as such accrues not to the entertainer or athlete himself but to another person, that income may, notwithstanding the provisions of articles 7, 14 and 15, be taxed in the Contracting State in which the activities of the entertainer or athlete are exercised.

Article 18

PENSIONS AND SOCIAL SECURITY PAYMENTS

Article 18 A (alternative A)

1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment shall be taxable only in that State.

2. Notwithstanding the provisions of paragraph 1, pensions paid and other payments made under a public scheme which is part of the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 18 B (alternative B)

1. Subject to the provisions of paragraph 2 of article 19, pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment may be taxed in that State.

2. However, such pensions and other similar remuneration may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein.

3. Notwithstanding the provisions of paragraphs 1 and 2, pensions paid and other payments made under a public scheme which is part of

the social security system of a Contracting State or a political subdivision or a local authority thereof shall be taxable only in that State.

Article 19

REMUNERATION AND PENSIONS IN RESPECT OF GOVERNMENT SERVICE

1. (*a*) Remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(*b*) However, such remuneration shall be taxable only in the other Contracting State if the services are rendered in that other State and the individual is a resident of that State who:

(i) Is a national of that State; or

(ii) Did not become a resident of that State solely for the purpose of rendering the services.

2. (*a*) Any pension paid by, or out of funds created by, a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

(*b*) However, such pension shall be taxable only in the other Contracting State if the individual is a resident of, and a national of, that other State.

3. The provisions of articles 15, 16 and 18 shall apply to remuneration and pensions in respect of services rendered in connexion with a business carried on by a Contracting State or a political subdivision or a local authority thereof.

Article 20

PAYMENTS RECEIVED BY STUDENTS AND APPRENTICES

1. Payments which a student or business apprentice who is or was immediately before visiting a Contracting State a resident of the other Contracting State and who is present in the first-mentioned State solely for the purpose of his education or training receives for the purpose of his maintenance, education or training shall not be taxed in that State, provided that such payments arise from sources outside that State.

2. In respect of grants, scholarships and remuneration from employment not covered by paragraph 1, a student or business apprentice described in paragraph 1 shall, in addition, be entitled during such education or training to the same exemptions, reliefs or reductions in respect of taxes available to residents of the State which he is visiting.

Article 21

OTHER INCOME

1. Items of income of a resident of a Contracting State, wherever arising, not dealt with in the foregoing articles of this Convention shall be taxable only in that State.

2. The provisions of paragraph 1 shall not apply to income, other than income from immovable property as defined in paragraph 2 of article 6, if the recipient of such income, being a resident of a Contracting State, carries on business in the other Contracting State through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the income is paid is effectively connected with such permanent establishment or fixed base. In such case the provisions of article 7 or article 14, as the case may be, shall apply.

3. Notwithstanding the provisions of paragraphs 1 and 2, items of income of a resident of a Contracting State not dealt with in the foregoing articles of this Convention and arising in the other Contracting State may also be taxed in that other State.

Chapter IV

TAXATION OF CAPITAL

Article 22

CAPITAL

1. [Capital represented by immovable property referred to in article 6, owned by a resident of a Contracting State and situated in the other Contracting State, may be taxed in that other State.]

2. [Capital represented by movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or by movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, may be taxed in that other State.]

3. [Capital represented by ships and aircraft operated in international traffic and by boats engaged in inland waterways transport, and by movable property pertaining to the operation of such ships, aircraft and boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.]

4. [All other elements of capital of a resident of a Contracting State shall be taxable only in that State.]

(The Group decided to leave to bilateral negotiations the question of the taxation of the capital represented by immovable property and movable property and of all other elements of capital of a resident of a Contracting State. Should the negotiating parties decide to include in the Convention an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located.)

Chapter V

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

Article 23 A

EXEMPTION METHOD

1. Where a resident of a Contracting State derives income [or owns capital] which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall, subject to the provisions of paragraphs 2 and 3, exempt such income [or capital] from tax.

2. Where a resident of a Contracting State derives items of income which, in accordance with the provisions of articles 10, 11 and 12, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the tax paid in that other State. Such deduction shall not, however, exceed that part of the tax, as computed before the deduction is given, which is attributable to such items of income derived from that other State.

3. Where in accordance with any provision of this Convention income derived [or capital owned] by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income [or capital] of such resident, take into account the exempted income [or capital].

Article 23 B

CREDIT METHOD

1. Where a resident of a Contracting State derives income [or owns capital] which, in accordance with the provisions of this Convention, may be taxed in the other Contracting State, the first-mentioned State shall allow as a deduction from the tax on the income of that resident an amount equal to the income tax paid in that other State [; and as a deduction from the tax on the capital of that resident, an amount equal to the capital tax paid in that other State]. Such deduction [in either case] shall not, however, exceed that part of the income tax [or capital tax,] as computed before the deduction is given, which is attributable, as the case may be, to the income [or the capital] which may be taxed in that other State.

2. Where, in accordance with any provision of this Convention, income derived [or capital owned] by a resident of a Contracting State is exempt from tax in that State, such State may nevertheless, in calculating the amount of tax on the remaining income [or capital] of such resident, take into account the exempted income [or capital].

Chapter VI

SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

1. Nationals of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected. This provision shall, notwithstanding the provisions of article 1, also apply to persons who are not residents of one or both of the Contracting States.

2. The term "nationals" means:

(*a*) All individuals possessing the nationality of a Contracting State;

(*b*) All legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State.

3. Stateless persons who are residents of a Contracting State shall not be subjected in either Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the State concerned in the same circumstances are or may be subjected.

4. The taxation on a permanent establishment which an enterprise of a Contracting State has in the other Contracting State shall not be less favourably levied in that other State than the taxation levied on enterprises of that other State carrying on the same activities. This provision shall not be construed as obliging a Contracting State to grant to residents of the other Contracting State any personal allowances, reliefs and reductions for taxation purposes on account of civil status or family responsibilities which it grants to its own residents.

5. Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of article 12 apply, interest, royalties and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable profits of such enterprise, be deductible under the same conditions as if they had been paid to a resident of the first-mentioned State. [Similarly, any debts of an enterprise of a Contracting State to a resident of the other Contracting State shall, for the purpose of determining the taxable capital of such

enterprise, be deductible under the same conditions as if they had been contracted to a resident of the first-mentioned State.]

6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.

7. The provisions of this article shall, notwithstanding the provisions of article 2, apply to taxes of every kind and description.

Article 25

MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of the Contracting State of which he is a resident or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.

2. The competent authority shall endeavour, if the objection appears to it to be justified and if it is not itself able to arrive at a satisfactory solution, to resolve the case by mutual agreement with the competent authority of the other Contracting State, with a view to the avoidance of taxation which is not in accordance with this Convention. Any agreement reached shall be implemented notwithstanding any time-limits in the domestic law of the Contracting States.

3. The competent authorities of the Contracting States shall endeavour to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention. They may also consult together for the elimination of double taxation in cases not provided for in the Convention.

4. The competent authorities of the Contracting States may communicate with each other directly for the purpose of reaching an agreement in the sense of the preceding paragraphs. The competent authorities, through consultations, shall develop appropriate bilateral procedures, conditions, methods and techniques for the implementation of the mutual agreement procedure provided for in this article. In addition, a competent authority may devise appropriate unilateral procedures, conditions, methods and techniques to facilitate the above-mentioned bilateral actions and the implementation of the mutual agreement procedure.

Article 26

EXCHANGE OF INFORMATION

1. The competent authorities of the Contracting States shall exchange such information as is necessary for carrying out the provisions of this Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention, in so far as the taxation thereunder is not contrary to the Convention, in particular for the prevention of fraud or evasion of such taxes. The exchange of information is not restricted by article 1. Any information received by a Contracting State shall be treated as secret in the same manner as information obtained under the domestic laws of that State. However, if the information is originally regarded as secret in the transmitting State it shall be disclosed only to persons or authorities (including courts and administrative bodies) involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes which are the subject of the Convention. Such persons or authorities shall use the information only for such purposes but may disclose the information in public court proceedings or in judicial decisions. The competent authorities shall, through consultation, develop appropriate conditions, methods and techniques concerning the matters in respect of which such exchanges of information shall be made, including, where appropriate, exchanges of information regarding tax avoidance.

2. In no case shall the provisions of paragraph 1 be construed so as to impose on a Contracting State the obligation:

(*a*) To carry out administrative measures at variance with the laws and administrative practice of that or of the other Contracting State;

(*b*) To supply information which is not obtainable under the laws or in the normal course of the administration of that or of the other Contracting State;

(*c*) To supply information which would disclose any trade, business, industrial, commerical or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (*ordre public*).

Article 27

DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Nothing in this Convention shall affect the fiscal privileges of diplomatic agents or consular officers under the general rules of international law or under the provisions of special agreements.

Chapter VII

FINAL PROVISIONS

Article 28

ENTRY INTO FORCE

1. This Convention shall be ratified and the instruments of ratification shall be exchanged at .... as soon as possible.
2. The Convention shall enter into force upon the exchange of instruments of ratification and its provisions shall have effect:

(*a*) (In State A): ....
(*b*) (In State B): ....

Article 29

TERMINATION

This Convention shall remain in force until terminated by a Contracting State. Either Contracting State may terminate the Convention, through diplomatic channels, by giving notice of termination at least six months before the end of any calendar year after the year .... In such event, the Convention shall cease to have effect:

(*a*) (In State A): ....
(*b*) (In State B): ....

TERMINAL CLAUSE

NOTE: The provisions relating to the entry into force and termination and the terminal clause concerning the signing of the Convention shall be drafted in accordance with the constitutional procedure of both Contracting States.

Part Two

COMMENTARIES ON THE ARTICLES OF THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

Commentaries on chapter I

SCOPE OF THE CONVENTION

Article 1

PERSONAL SCOPE

A. GENERAL CONSIDERATIONS

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

Like the OECD Model Convention, the United Nations Model Convention is applicable to persons who are "residents of one or both of the Contracting States". The personal scope of most of the earliest conventions was more restrictive, in that it encompassed "citizens" of the Contracting States. However, in some early conventions that scope was wider, covering "taxpayers" of the Contracting States, that is persons who, although not residing in either State are nevertheless liable to tax on part of their income or capital in each of them. In some articles there are exceptions to this rule, for example in articles 24, paragraph 1, 25, paragraph 1, and 26, paragraph 1.

To limit the possible use of artificial legal manoeuvres designed to obtain the benefit of tax advantages which may be available under domestic laws and the tax reliefs provided for in bilateral double taxation conventions, the United Nations Model Convention follows the same course as the OECD Model Convention. It introduces in its articles certain concepts such as that of "beneficial owner" (in Articles 10, 11 and 12) and special provisions, such as those for so-called artiste-companies (article 17, paragraph 2), which are also mentioned in the commentaries. It may be appropriate for potential Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention.

Like the OECD Model Convention, the United Nations Model Convention does not contain any special provisions relating to partnerships. The Contracting States are therefore left free to examine the problems concerning partnerships in their bilateral negotiations and to agree upon such special provisions as they may find necessary and appropriate. With regard to the application of the OECD Model Convention to partnerships, the OECD Committee on Fiscal Affairs found it very difficult to devise a uniform solution that would be acceptable to all or even to the great majority of OECD member countries. The wide differences in the views of those countries stemmed from the fact that their domestic laws treat partnerships in different ways. In some OECD countries, partnerships are treated as taxable units and sometimes even as companies, while other OECD countries do not tax the partnership as such and tax only the individual partners on their share of the partnership income. Similar differences in the tax treatment of partnerships exist in the developing countries.

Such differences exert various effects on the application of the Convention to partnerships, especially when one or more partners are not resident of the State in which the partnership was created or organized. According to the commentary on article 1 of the OECD Model Convention, "the question arises, whether a partnership as such may invoke the provisions of the Convention. Where a partnership is treated as a company or taxed in the same way, it may reasonably be argued that the partnership is a resident of the Contracting State taxing the partnership on the grounds mentioned in paragraph 1 of Article 4 and therefore, falling under the scope of the Convention, is entitled to the benefits of the Convention." The OECD commentary goes on to observe that in other instances "the application of the Convention to the partnership as such might be refused, at least if no special rule is provided for in the Convention covering partnerships". The OECD commentary adds:

> ". . . different rules of the Convention may be applied in the Contracting States to income derived by a partner from the partnership, depending on the approach of such States. In States where partnerships are treated as companies, distributions of profits to the partners may be considered to be dividends (paragraph 3 of Article 10) whilst for other States all profits of a partnership, whether distributed or not, are considered as business profits of the partners (Article 7). In many States, business profits of partnerships include, for tax purposes, all or some special remuneration paid by a partnership to its partners (such as rents, interest, royalties, remuneration for services), whilst in other States such payments are not dealt with as business profits (Article 7) but under other headings."

Lastly the OECD commentary notes: "the capital invested in a partnership or the alienation of a participation in a partnership may be treated, depending on the approach, under paragraph 2 of Articles 22 and 13 (permanent establishment) or paragraph 4 of Articles 22 and 13 (other movable property)."

B. RESERVATIONS ON ARTICLE 1 OF THE OECD MODEL CONVENTION

"The *United States* reserves the right to tax its citizens and residents (with certain exceptions) without regard to the Convention."

Article 2

TAXES COVERED BY THE CONVENTION

A. GENERAL CONSIDERATIONS

Article 2 of the United Nations Model Convention reproduces article 2 of the OECD Model Convention.

This article is designed to clarify and render more precise the terminology and nomenclature concerning the taxes to be covered by the convention. In this connexion, it may be observed that the same income or capital may be subject in the same country to various taxes—either taxes which differ in nature or taxes of the same nature levied by different political subdivisions or local authorities. Hence double taxation cannot be wholly avoided unless the methods for the relief of double taxation applied in each Contracting State take into account all the taxes to which such income or capital is subject. Consequently, the terminology and nomenclature relating to the taxes covered by a treaty must be clear, precise and as comprehensive as possible. As noted in the OECD commentary on article 2 of the OECD Model Convention, this is necessary:

> "to ensure identification of the Contracting States' taxes covered by the Convention, to widen as much as possible the field of application of the Convention by including, as far as possible, and in harmony with the domestic laws of the Contracting States, the taxes imposed by their political subdivisions or local authorities, and to avoid the necessity of concluding a new convention whenever the Contracting States' domestic laws are modified, by means of the periodical exchange of lists and through a procedure for mutual consultation".

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 2

Paragraph 1

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

Paragraph 2

This paragraph contains a definition of taxes on income and on capital, which include all taxes on total income, on total capital or on elements of income or of capital, including taxes on gains from the alienation of movable or immovable property, taxes on capital appreciation and taxes on the total amounts of wages or salaries paid by enterprises. According to the commentary on article 2, paragraph 2, of the OECD Model Convention, the last-named taxes do not include "social security charges or any other charges paid where there is a direct connexion between the levy and the individual benefits to be received". The OECD commentary further observes:

> "Clearly a State possessing taxing powers—and it alone—may levy the taxes imposed by its legislation together with any duties or charges accessory to them: increases, costs, interest, etc. It has not been considered necessary to specify this in the Article, as it is obvious that in the levying of the tax the accessory duties or charges depend on the same rule as the principal duty.
>
> "The Article does not mention 'ordinary taxes' or 'extraordinary taxes'. Normally, it might be considered justifiable to include extraordinary taxes in a Model Convention, but experience has shown that such taxes are generally imposed in very special circumstances. In addition, it would be difficult to define them. These may be extraordinary for various reasons; their imposition, the manner in which they are levied, their rates, their objects, etc. This being so, it seems preferable not to include extraordinary taxes in the Article. But as it is not intended to exclude extraordinary taxes from all conventions, ordinary taxes have not been mentioned either. The Contracting States are thus free to restrict the convention's field of application to ordinary taxes, to extend it to extraordinary taxes, or even to establish special provisions."

Paragraph 3

This paragraph provides the Contracting States with an opportunity to enumerate the taxes to which the convention is to apply. According to the commentary on article 2, paragraph 3, of the OECD Model Convention, the list "is not exhaustive", for "it serves to illustrate the preceding paragraphs of the article". In principle, however, it is expected to be "a complete list of taxes imposed in each State at the time of signature and covered by the convention".

Paragraph 4

This paragraph supplements paragraph 3 by stating that the Convention is to apply also to any identical or substantially similar taxes which are imposed after the date of signature of the convention in addition to, or in place of, the existing taxes. According to the commentary on article 2, paragraph 4, of the OECD Model Convention, "this provision is necessary to prevent the Convention from becoming inoperative in the event of one of the States modifying its taxation laws". The commentary also notes that "each State undertakes to notify the other of any amendments made to its taxation laws by communicating to it at the end of each year, when necessary, a list of new or substituted taxes, imposed during that year". However, the competent authorities will have to work out the methods for applying paragraph 4. In some cases countries may choose not to notify each other each year but only when substantive changes are made.

C. OBSERVATION ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 2 OF THE OECD MODEL CONVENTION

Observation on the commentary

"In contexts such as limitations on the rate of tax or the granting of credits for foreign tax, *New Zealand* would wish to make it clear that the term 'tax' does not include penalties."

Reservations on the article

"*Australia, Canada* and the *United States* reserve their positions on that part of paragraph 1 which states that the Convention should apply to taxes of political subdivisions or local authorities.

"*Japan* reserves its position on that part of paragraph 1 which states that the Convention shall apply to taxes on capital."

Commentaries on chapter II

DEFINITIONS

Article 3

General definitions

A. General considerations

Article 3 of the United Nations Model Convention reproduces article 3 of the OECD Model Convention. A number of general definitions are normally necessary for the understanding and application of a bilateral tax convention, although terms relating to more specialized concepts are usually defined or interpreted in special provisions. On the other hand, there are terms whose definitions are not included in the convention but are left to bilateral negotiations.

Article 3 of the United Nations Model Convention, like article 3 of the OECD Model Convention, sets forth a number of general definitions required for the interpretation of the terms used in the Convention. These terms are "person", "company", "enterprise of a Contracting State" and "international traffic". Article 3 leaves space for the designation of the "competent authority" of each Contracting State. The terms "resident" and "permanent establishment" are defined in articles 4 and 5 respectively, while the interpretation of certain terms used in the articles on special categories of income (e.g., immovable property, dividends) is clarified in the articles concerned. The parties to a convention are left free to agree bilaterally on a definition of the terms "a Contracting State" and "the other Contracting State". They are also free to include in the possible definition of a Contracting State a reference to continental shelves.

B. Commentary on the paragraphs of article 3

Paragraph 1

(a) *Definition of the term "person"*

The term "person", which is defined in subparagraph (*a*) as including specifically an individual, a company and any other body of persons, should be interpreted by reference to articles 1 and 4 and thus be viewed as being used in a very broad sense. According to the commentary on article 3 of the OECD Model Convention, the term "person" also includes "any entity which, although itself not a body of persons, is treated as a body corporate for tax purposes [e.g., a foundation].

(b) *Definition of the term "company"*

The definition of the term "company", like the corresponding definition in the OECD Model Convention, is formulated with special reference to article 10 on dividends. The definition is relevant to that article and to article 5, paragraph 8, and article 16, corresponding respectively to article 5, paragraph 7, and article 16 of the OECD Model Convention.

(c) *Definition of the term "enterprise of a Contracting State"*

Subparagraph (*c*) defines the terms "enterprise of a Contracting State" and "enterprise of the other Contracting State". However, it does not define the term "enterprise" *per se*, because, as noted in the commentary on article 3, paragraph 1, subparagraph (*c*), of the OECD Model Convention, "the question whether an activity is performed within the framework of an enterprise or is deemed to constitute in itself an enterprise has always been interpreted according to the provisions of the domestic laws of the Contracting States".

(d) *Definition of the term "international traffic"*

The definition of the term "international traffic" is based on the principle that the right to tax profits arising from the operation of ships or aircraft in international traffic resides only in the Contracting State in which the place of effective management is situated. This principle is set forth in article 8 A, paragraph 1 (corresponding to article 8, paragraph 1, of the OECD Model Convention), and in article 8 B, paragraph 1, and the first sentence of paragraph 2 (provided in the latter case that the shipping activities concerned are not more than casual). However, since in certain instances the Contracting State in which the place of effective management is situated may not be the State of which the enterprise operating the ships or aircraft is a resident, the Contracting States may agree on a bilateral basis to include a reference to residence in subparagraph (*d*) in order that the definition may conform to the general tenor of the other articles relating to international traffic. In such cases, as noted in the commentary on article 3, paragraph 1, subparagraph (*d*), of the OECD Model Convention, "the words 'an enterprise which has its place of effective management in a Contracting State' should be replaced by 'an enterprise of a Contracting State' or 'a resident of a Contracting State' ". Moreover, as also noted in the OECD commentary, the definition of the term "international traffic" is "broader than the term normally signifies. However, this has been deliberate in order to preserve for the State of the place of effective management the right to tax purely domestic traffic as well as international traffic between third States, and to allow the other Contracting State to tax traffic solely within its borders".

(e) *Definition of the term "competent authority"*

As in the OECD Model Convention, the definition of the term "competent authority" is left to the Contracting States, which are free to designate one or more authorities as being competent for the purpose of applying the convention. This approach is necessary because in some countries the implementation of double taxation conventions may not lie solely within the jurisdiction of the highest tax authorities in so far as some matters may be reserved to, or may fall within the competence of, other authorities.

Paragraph 2

Like article 3, paragraph 2, of the OECD Model Convention, this paragraph contains a general rule concerning the definition of terms used but not defined in the Convention.

C. OBSERVATION ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 3 OF THE OECD MODEL CONVENTION

Observation on the commentary

"For the purposes of Articles 10, 11 and 12, *New Zealand* would wish to treat dividends, interest and royalties in respect of which a trustee is subject to tax in the State of which he is a resident as being beneficially owned by that trustee."

Reservation on the article

"*Belgium* reserves the right to vary, in its conventions, subparagraph (*b*) of paragraph 1 of article 3, and paragraph 1 of article 4, so as to make it clear that partnerships constituted under Belgian law must be treated as residents of Belgium, in view of the twofold fact that they are legal persons and that their world income is in all cases subject to tax in Belgium."

Article 4

RESIDENT

A. GENERAL CONSIDERATIONS

Article 4 of the United Nations Model Convention reproduces article 4 of the OECD Model Convention with one substantive change, namely the deletion of the second sentence of paragraph 1. According to the commentary on article 4 of the OECD Model Convention,

"The concept of 'resident of a Contracting State' has various functions and is of importance in three cases:

"(*a*) in determining a convention's personal scope of application;

"(*b*) in solving cases where double taxation arises in consequence of double residence;

"(*c*) in solving cases where double taxation arises as a consequence of taxation in the State of residence and in the State of source or situs."

Like article 4 of the OECD Model Convention, article 4 of the United Nations Model Convention is intended to define the meaning of the expression "resident of a Contracting State" and to establish rules for resolving cases of double residence. In the two typical cases of conflict between two residences and between residence and source or situs, the conflict arises because, under their domestic laws, one or both Contracting States claim that the person concerned is resident in their territory. In this connexion the OECD commentary provides the following clarification:

"Generally the domestic laws of the various States impose a comprehensive liability to tax—"full tax liability"—based on the taxpayers' personal attachment to the State concerned (the 'State of residence'). This liability to tax is not imposed only on persons who are 'domiciled' in a State in the sense in which 'domicile' is usually taken in the legislations (private law). The cases of full liability to tax are extended to comprise also, for instance, persons who stay continually, or maybe only for a certain period, in the territory of the State. Some legislations impose full liability to tax on individuals who perform services on board ships which have their home harbour in the State.

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

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

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 4

Paragraph 1

The Group decided to adopt as paragraph 1 of article 4 the first of the two sentences of paragraph 1 of article 4 of the OECD Model

Convention, and not to adopt the second sentence which reads: "But this term [resident of a Contracting State] does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein." It was pointed out that the second sentence had been included in the OECD Convention to deal, for example, with the special situation of foreign diplomats and consular staffs serving in a country which taxed residents on the basis of their world-wide income, who might be considered (under the domestic law of the country in which they are serving) as residents but, because of their special status, might nevertheless be taxable only on income from sources in that State. It was noted, however, that the sentence could have a considerably broader impact. If one of the Contracting States taxed income solely when it arose from domestic sources, and did not tax income from foreign sources, the inclusion of the second sentence in any convention to which it was a party might result in all residents of that country being characterized as non-residents for the purposes of the convention and as a result being deprived of its benefits. The sentence was consequently omitted from the United Nations Model. Nevertheless it may be appropriate for use in treaties between countries which tax the income of residents on a world-wide basis.

Paragraph 1, like article 4, paragraph 1, of the OECD Model Convention, makes reference to the concept of residence contained in the domestic laws of the Contracting States and lists as follows the criteria for taxation as a resident: domicile, residence, place of management or any other criterion of a similar nature. Thus formulated, the definition of the term "resident of a Contracting State" is, according to the commentary on article 4, paragraph 1, of the OECD Model Convention, aimed at covering, as far as individuals are concerned, "the various forms of personal attachment to a State which, in the domestic taxation laws, form the basis of a comprehensive taxation (full liability to tax). . . ."

Paragraph 2

This paragraph, which reproduces article 4, paragraph 2, of the OECD Model Convention, lists in decreasing order of relevance a number of subsidiary criteria to be applied when an individual is a resident of both Contracting States and the preceding criteria do not provide a clear-cut determination of his status as regards residence. The commentary on article 4, paragraph 2, of the OECD Model Convention stresses that "as far as possible, the preference criterion must be of such a nature that there can be no question but that the person concerned will satisfy it in one State only, and at the same time it must reflect such an attachment that it is felt to be natural that the right to tax devolves upon that particular State". Concerning the importance to be attached to the various criteria, the OECD commentary states:

> "The Article gives preference to the Contracting State in which the individual has a permanent home available to him. This criterion will frequently be sufficient to solve the conflict, e.g. where the individual has a permanent home in one Contracting State and has only made a stay of some length in the other Contracting State.
>
> "Subparagraph (*a*) means, therefore, that in the application of the convention (that is, where there is a conflict between the laws of the two States) it is considered that the residence is that place where the individual owns or possesses a home; this home must be permanent, that is to say, the individual must have arranged and retained it for his permanent use as opposed to staying at a particular place under such conditions that it is evident that the stay is intended to be of short duration.
>
> "As regards the concept of home, it should be observed that any form of home may be taken into account (house or apartment belonging to or rented by the individual, rented furnished room). But the permanence of the home is essential; this means that the individual has arranged to have the dwelling available to him at all times continuously, and not occasionally for the purpose of a stay which, owing to the reasons for it, is necessarily of short duration (travel for pleasure, business travel, educational travel, attending a course at a school, etc.).
>
> " If the individual has a permanent home in both Contracting States, paragraph 2 gives preference to the State with which the personal and economic relations of the individual are closer, this being understood as the centre of vital interests. In the cases where the residence cannot be determined by reference to this rule, paragraph 2 provides as subsidiary criteria, first, habitual abode, and then nationality. If the individual is a national of both States or of neither of them, the question shall be solved by mutual agreement between the States concerned according to the procedure laid down in Article 25.
>
> "If the individual has a permanent home in both Contracting States, it is necessary to look at the facts in order to ascertain with which of the two States his personal and economic relations are closer. Thus, regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the

first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

"Subparagraph (*b*) establishes a secondary criterion for two quite distinct and different situations:

"(*a*) the case where the individual has a permanent home available to him in both Contracting States and it is not possible to determine in which one he has his centre of vital interests;

"(*b*) the case where the individual has a permanent home available to him in neither Contracting State.

Preference is given to the Contracting State where the individual has an habitual abode.

"In the first situation, the case where the individual has a permanent home available to him in both States, the fact of having an habitual abode in one State rather than in the other appears therefore as the circumstance which, in case of doubt as to where the individual has his centre of vital interests, tips the balance towards the State where he stays more frequently. For this purpose regard must be had to stays made by the individual not only at the permanent home in the State in question but also at any other place in the same State.

"The second situation is the case of an individual who has a permanent home available to him in neither Contracting State, as for example, a person going from one hotel to another. In this case also all stays made in a State must be considered without it being necessary to ascertain the reasons for them.

"In stipulating that in the two situations which it contemplates preference is given to the Contracting State where the individual has an habitual abode, subparagraph (*b*) does not specify over what length of time the comparison must be made. The comparison must cover a sufficient length of time for it to be possible to determine whether the residence in each of the two States is habitual and to determine also the intervals at which the stays take place.

"Where, in the two situations referred to in subparagraph (*b*) the individual has an habitual abode in both Contracting States or in neither, preference is given to the State of which he is a national. If, in these cases still, the individual is a national of both Contracting States or of neither of them the subparagraph (*d*) assigns to the competent authorities the duty of resolving the difficulty by mutual agreement according to the procedure established in Article 25."

Paragraph 3

Paragraph 3, which reproduces article 4, paragraph 3, of the OECD Model Convention, deals with companies and other bodies of persons, irrespective of whether they are legal persons or not. The OECD commentary indicates that "It may be rare in practice for a company, etc. to be subject to tax as a resident in more than one State, but it is, of course, possible if, for instance, one State attaches importance to the registration and the other State to the place of effective management. So, in the case of companies etc., also, special rules as to the preference must be established". According to the OECD commentary,

> "It would not be an adequate solution to attach importance to a purely formal criterion like registration. Therefore paragraph 3 attaches importance to the place where the company, etc. is actually managed".

The OECD commentary goes on to state:

> "The formulation of the preference criterion in the case of persons other than individuals was considered in particular in connection with the taxation of income from shipping, inland waterways transport and air transport. A number of conventions for the avoidance of double taxation on such income accord the taxing power to the State in which the 'place of management' of the enterprise is situated; other conventions attach importance to its 'place of effective management', others again to the 'fiscal domicile of the operator'. Concerning conventions concluded by the United Kingdom which provide that a company shall be regarded as resident in the State in which 'its business is managed and controlled', it has been made clear, on the United Kingdom side, that this expression means the 'effective management' of the enterprise.
>
> "As a result of these considerations, the 'place of effective management' has been adopted as the preference criterion for persons other than individuals."

C. OBSERVATION ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 4 OF THE OECD MODEL CONVENTION

Observation on the commentary

"*New Zealand's* interpretation of the term 'effective management' is practical day to day management, irrespective of where the overriding control is exercised."

Reservations on the article

"*Canada* and the *United States* reserve the right to use as the test for paragraph 3 the place of incorporation or organization with respect to a company.

"*Japan* wishes to be free to conclude a bilateral convention which provides that the fiscal domicile of a resident of both Contracting States is to be determined through consultation between competent authorities. When entering into such consultation, Japan is prepared to take into consideration the rules set out in paragraph 2 of this Article as far as practicable.

"*Japan* also reserves its position on the provisions in this and other Articles in the Model Convention which refer directly or indirectly to the place of effective management."

Article 5

PERMANENT ESTABLISHMENT

A. GENERAL CONSIDERATIONS

Article 5 of the United Nations Model Convention incorporates a number of provisions of article 5 of the OECD Model Convention (either unchanged or substantially amended) and some new provisions (details on the amendments and new provisions are provided below in the commentary on the paragraphs of the article).

The concept of permanent establishment is used in bilateral tax treaties principally for the purpose of determining the right of a Contracting State to tax the profits of an enterprise of the other Contracting State. According to that concept, an enterprise of one Contracting State is taxable in the other only if it maintains a permanent establishment in the latter State and only to the extent that the profits earned by the enterprise in that State are attributable to the permanent establishment. The concept of permanent establishment is to be found in the early model conventions including the 1928 model Conventions of the League of Nations. The OECD Model Convention reaffirms the concept and supplements it by introducing the new concept of a "fixed base", to be used in the case of professional services or other activities of an independent character.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 5

Paragraph 1

This paragraph, which reproduces article 5, paragraph 1, of the OECD Model Convention, provides a definition of the term "permanent establishment" which emphasizes its essential nature as a "fixed place of business" with a specific "situs". According to the commentary on article 5, paragraph 1, of the OECD Model Convention, this definition contains the following conditions:

"—the existence of a 'place of business', i.e. a facility such as premises or, in certain instances, machinery or equipment;

"—this place of business must be 'fixed', i.e. it must be established at a distinct place with a certain degree of permanence;

"—the carrying on of the business of the enterprise through this fixed place of business. This means usually that persons who, in one way or another, are dependent on the enterprise (personnel) conduct the business of the enterprise in the State in which the fixed place is situated."

The OECD commentary goes on to observe:

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

"The term 'place of business' covers any premises, facilities or installations used for carrying on the business of the enterprise whether or not they are used exclusively for that purpose. A place of business may also exist where no premises are available or required for carrying on the business of the enterprise and it simply has a certain amount of space at its disposal. It is immaterial whether the premises, facilities or installations are owned or rented by or are otherwise at the disposal of the enterprise. A place of business may thus be constituted by a pitch in a market place, or by a certain permanently used area in a Customs depot (e.g. for the storage of dutiable goods). Again the place of business may be situated in the business facilities of another enterprise. This may be the case, for instance where the foreign enterprise has at its constant disposal certain premises or a part thereof owned by the other enterprise.

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

"Since the place of business must be fixed, it also follows that a permanent establishment can be deemed to exist only if the place of business has a certain degree of permanency, i.e. if it is not of a purely temporary nature. If the place of business was not set up merely for a temporary purpose, it can constitute a permanent establishment, even though it existed, in practice, only for a very short period of time because of the special nature of the activity of the enterprise or because, as a consequence of special circumstances (e.g. death of the taxpayer, investment failure), it was prematurely liquidated. Where a place of business which was, at the outset, designed for a short temporary purpose only, is maintained for such a period that it cannot be considered as a temporary one, it becomes a fixed place of business and thus—retrospectively—a permanent establishment.

"For a place of business to constitute a permanent establishment the enterprise using it must carry on its business wholly or partly through it. As stated in . . . above, the activity need not be of a productive character. Furthermore, the activity need not be permanent in the sense that there is no interruption of operation, but operations must be carried out on a regular basis.

"Where tangible property such as facilities, equipment, buildings, or intangible property such as patents, procedures and similar property, are let or leased to third parties through a fixed place of business maintained by an enterprise of a Contracting State in the other State, this activity will, in general, render the place of business a permanent establishment. The same applies if capital is made available through a fixed place of business. If an enterprise of a State lets or leases facilities, equipment, buildings or intangible property to an enterprise of the other State without maintaining for such letting or leasing activity a fixed place of business in the other State, the leased facility, equipment, building or intangible property, as such, will not constitute a permanent establishment of the lessor provided the contract is limited to the mere leasing of the equipment, etc. This remains the case even when, for example, the lessor supplies personnel after installation to operate the equipment provided that their responsibility is limited solely to the operation or maintenance of the equipment under the direction, responsibility and control of the lessee. If the personnel have wider responsibilities, for example participation in the decisions regarding the work for which the equipment is used, the activity of the lessor may go beyond the mere leasing of equipment and may constitute an entrepreneurial activity. In such a case a permanent establishment could be deemed to exist if the criterion of permanency is met. When such activity is connected with, or is similar in character to, those mentioned in paragraph 3, the time limit of twelve months[1] applies. Other cases have to be determined according to the circumstances.

"The business of an enterprise is carried on mainly by the entrepreneur or persons who are in a paid-employment relationship with the enterprise (personnel). This personnel includes employees and other persons receiving instructions from the enterprise (e.g. dependent agents). The powers of such personnel in its relationship with third parties are irrelevant. It makes no difference whether or not the dependent agent is authorised to conclude contracts if he works at the fixed place of business. But a permanent establishment may nevertheless exist if the business of the enterprise is carried on mainly through automatic equipment, the activities of the personnel being restricted to setting up, operating, controlling and maintaining such equipment. Whether or not gaming and vending machines and the like set up by an enterprise of a State in the other State constitute a permanent establishment thus depends on whether or not the enterprise carries on a business activity besides the initial setting up of the machines. A permanent establishment does not exist if the enterprise merely sets up the machines and then leases the machines to other enterprises. A permanent establishment may exist, however, if the enterprise which sets up the machines also operates and maintains them for its own account. This also applies if the machines are operated and maintained by an agent dependent on the enterprise.

"A permanent establishment begins to exist as soon as the enterprise commences to carry on its business through a fixed place of business. This is the case once the enterprise prepares, at the place of business, the activity for which the place of business is to serve permanently. The period of time during which the fixed place of business itself is being set up by the enterprise should not be counted, provided that this activity differs substantially from the activity for which the place of business is to serve permanently. The permanent establishment ceases to exist with the disposal of the fixed place of business or with the cessation of any activity through it, that is when all acts and measures connected with the former activities of the permanent establishment are terminated (winding up current business transactions, maintenance and repair of facilities). A temporary

[1] Six months in the United Nations Model Convention.

interruption of operations, however, cannot be regarded as closure. If the fixed place of business is leased to another enterprise, it will normally only serve the activities of that enterprise instead of the lessor's; in general, the lessor's permanent establishment ceases to exist, except where he continues carrying on a business activity of his own through the fixed place of business."

Paragraph 2

Paragraph 2, which reproduces article 5, paragraph 2, of the OECD Model Convention, singles out a number of examples of what can be regarded, *prima facie*, as constituting a permanent establishment. During the discussion, a member from a developing country emphasized the need to broaden as much as possible the scope of the term "permanent establishment" and suggested that a warehouse should be included among the specific examples. However, it was agreed not to expand the list of examples in view of the fact that the deletion of the word "delivery" in subparagraphs (*a*) and (*b*) of paragraph 4 meant that a "warehouse" used for that purpose would constitute a permanent establishment. It was also noted that a "commercial warehouse", where for example space was being rented to other concerns, was covered as a permanent establishment. According to the commentary on article 5, paragraph 2, of the OECD Model Convention, it is assumed that the Contracting States interpret the terms listed "in such a way that such places of business constitute permanent establishments only if they meet the requirements of paragraph 1". With regard to the term "place of management", the OECD commentary points out that it has been mentioned separately because it is not necessarily an "office" and that "where the laws of the two Contracting States do not contain the concept of a 'place of management' as distinct from an office, there will be no need to refer to the former term in their bilateral convention".

In connexion with subparagraph (*f*), which provides that the term "permanent establishment" includes mines, oil or gas wells, quarries or any other place of extraction of natural resources, the OECD commentary states that "the term 'any other place of extraction of natural resources' should be interpreted broadly" and that it includes, for example, all places of extraction of hydrocarbons whether on or off-shore. The OECD commentary further observes:

> "Subparagraph (*f*) refers to the extraction of natural resources, but does not mention the exploration of such resources, whether on or off-shore. Therefore, whenever income from such activities is considered to be business profits, the question whether these activities are carried on through a permanent establishment is governed by paragraph 1. Since, however, it has not been possible to arrive at a common view on the basic questions of the attribution of taxation rights and of the qualifica-

tion of the income from exploration activities, the Contracting States may agree upon the insertion of specific provisions. They may agree, for instance, that an enterprise of a Contracting State, as regards its activities of exploration of natural resources in a place or area in the other Contracting State:

"(*a*) shall be deemed not to have a permanent establishment in that other State; or

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

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

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

Paragraph 3

This paragraph covers a broader range of activities than article 5, paragraph 3 of the OECD Model Convention. In subparagraph 3 (*a*), in addition to the term "installation project" used in the OECD Model Convention, there is included the term "assembly project" as well as "supervisory activities" in connection with "a building site, a construction, installation or assembly project". In the guidelines the term "assembly project" had been substituted for "installation project" but the group felt on reflection that it would best clarify the status of an installation project in this context if it was specifically mentioned in the paragraph. Another difference from the OECD Model Convention in this paragraph is that while the OECD Model Convention, in article 5, states that a "building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months", article 5, paragraph 3, of the United Nations Model Convention reduces the duration of the relevant site or project to six months. In special cases the six-month period in paragraph 3, subparagraphs (*a*) and (*b*), of the latter article could be reduced in bilateral negotiations to a period of not less than three months.

It may be noted that there was substantial support within the group, especially among members from developing countries, for a more elaborate version of subparagraph 3 (*a*), which would have provided that the term "permanent establishment" should likewise encompass a situation:

"Where such project or activity, being incidental to the sale of machinery or equipment, continues for a period not exceeding six months and the charges payable for the project or activities exceed 10 per cent of the sale price of the machinery or equipment".

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

Concerning the time-limit established in paragraph 3, subparagraphs (*a*) and (*b*), of article 5 of the United Nations Model Convention, some members of the Group from developing countries said that they would have preferred to remove the time-limit altogether for two main reasons: first, because construction, assembly and similar activities could as a result of modern technology be of very short duration and still result in a considerable profit for the enterprise carrying on those activities; and secondly, because the period during which the foreign personnel involved in the activities remained in the source country was irrelevant to the definition of the right of developing countries to tax the corresponding income. Other members from developing countries felt that any time-limit should have been removed because such a limitation was apt to be used by enterprises of capital-exporting countries to evade taxation in the source country. The view was expressed that there was no reason why a construction project should not be treated in the same manner as artistes, athletes and public entertainers covered by article 17 of the OECD Model Convention, who are taxed at the place where their activities are performed irrespective of the duration of those activities. Members from developed countries observed that the Group's task was to work out guidelines for treaty provisions that would promote international trade and development, and that the idea behind the time-limit was that business enterprises of one Contracting State should be encouraged to initiate preparatory or ancillary operations in the other Contracting State without becoming immediately subject to the tax of the latter State, so as to facilitate a more permanent and larger commitment at a later stage.

Article 5, paragraph 3, of the United Nations Model Convention contains a new subparagraph (*b*) dealing with the furnishing of services, including consultancy services which are not covered specifically in the OECD Model Convention in connexion with the concept of permanent establishment. The Group felt that management and consultancy services should be covered because the provision of such services in developing countries by corporations of industrialized countries often involved very large sums of money. The Group was of the opinion that profits from such services should be taxed by developing countries in certain circumstances. However, some members from developing countries proposed the inclusion in that paragraph of another criterion based on the amount of remuneration for the furnishing of services. Such criterion would constitute the subject of an additional sub-paragraph, namely subparagraph 3 (*c*), which would be worded as follows:

"(*c*) The furnishing of services including consultancy services by an enterprise, but only where the remuneration for activities of that nature (for the same or a connected project) derived from a resident of a Contracting State or a permanent establishment or a fixed base situated therein exceeds in the fiscal year an amount of . . . (an amount to be established through bilateral negotiations)".

Most members agreed that monetary limitations, if set by analogy with those applied to services of individuals in a number of tax treaties, would be meaningless in the area of the corporate services here discussed, while other members were opposed to any monetary limitations. On the other hand, some members felt that the physical presence of representatives of a foreign corporation in the source country for a minimum period, such as six months, would be a reasonable limitation which would, as a practical matter, cover most of the important situations and would preclude administrative difficulties in the case of merely sporadic activities. Some members preferred this paragraph without any limit on the amount of remuneration.

One member from a developed country expressed the view that the above provision might in certain cases have undesirable effects on international trade and on the transfer of technology.

Some members from developed countries thought that the time-limit approach would be an acceptable solution if the words "for the same or a connected project" were inserted after the word "continue", since they thought it desirable to add together unrelated projects in view of the uncertainty which that step involved and the undesirable distinction it created between an enterprise with, for example, one project of three months' duration and another with two projects, each of three months' duration, one following the other. In that respect, other members found that the injection of a "project" limitation would be either too easy to manipulate or too narrow in that it might preclude taxation in the case of a continuous number of separate projects, each of four or five months' duration.

Some members from developing countries expressed the view that in bilateral negotiations a clause could be inserted in paragraph 3 which would stipulate that fishing ships pertaining to an enterprise of the Contracting State that operated in the territorial waters of the other Contracting State could be considered as permanent establishments in the latter State. In that sense they pointed out as an example that the establishment of a temporary limit on the amount of fish caught etc. would constitute an adequate means of solving the problem.

There was general agreement that only profits from service attributable to a permanent establishment in the source country should be taxable by it. In the context of this paragraph, the following passages of the commentary on article 5, paragraph 3, of the OECD Model Convention are relevant:

"This paragraph provides expressly that a building site or construction or installation project constitutes a permanent establishment only if it lasts more than twelve months. Any of those items which does not meet this condition does not of itself constitute a permanent establishment, even if there is within it an installation, for instance an office or a workshop within the meaning of paragraph 2, associated with the construction activity.

"The term 'building site or construction or installation project' includes not only the construction of buildings but also the construction of roads, bridges or canals, the laying of pipe-lines and excavating and dredging. Planning and supervision of the erection of a building are covered by this term, if carried out by the building contractor. However, planning and supervision is not included if carried out by another enterprise whose activities in connection with the construction concerned are restricted to planning and supervising the work. If that other enterprise has an office which it uses only for planning or supervision activities relating to a site or project which does not constitute a permanent establishment, such office does not constitute a fixed place of business within the meaning of paragraph 1, because its existence has not a certain degree of permanence.

"The twelve month test applies to each individual site or project. In determining how long the site or project has existed, no account should be taken of the time previously spent by the contractor concerned on other sites or projects which are totally unconnected with it. A building site should be regarded as a single unit, even if it is based on several contracts, provided that it forms a coherent whole commercially and geographically. Subject to this proviso, a building site forms a single unit even if the orders have been placed by several persons (e.g. for a row of houses).

"A site exists from the date on which the contractor begins his work, including any preparatory work, in the country where the construction is to be established, e.g. if he installs a planning office for the construction. In general, it continues to exist until the work is completed or permanently abandoned. A site should not be regarded as ceasing to exist when work is temporarily discontinued. Seasonal or other temporary interruptions should be included in determining the life of a site. Seasonal interruptions include interruptions due to bad weather. Temporary interruption could be caused, for example, by shortage of material or labour difficulties. Thus, for example, if a contractor started work on a road on 1st May, stopped on 1st November because of bad weather conditions or a lack of materials but resumed work on 1st February the following year, completing the road on 1st June, his construction project should be regarded as a permanent establishment because thirteen months elapsed between the date he first commenced work (1st May) and the date he finally finished (1st June of the following year). If an enterprise (general contractor) which has undertaken the performance of a comprehensive project sub-contracts parts of such a project to other enterprises (sub-contractors), the period spent by a sub-contractor working on the building site must be considered as being time spent by the general contractor on the building project. The sub-contractor himself has a permanent establishment at the site if his activities there last more than twelve months.

"The very nature of a construction or installation project may be such that the contractor's activity has to be relocated continuously or at least from time to time, as the project progresses. This would be the case for instance where roads or canals were being constructed, waterways dredged, or pipe-lines laid. In such a case, the fact that the work force is not present for twelve months in one particular place is immaterial. The activities performed at each particular spot are part of a single project, and that project must be regarded as a permanent establishment if, as a whole, it lasts more than twelve months."

Paragraph 4

This paragraph reproduces article 5, paragraph 4 of the OECD Model Convention with three substantive amendments, namely the deletion of the term "delivery" in subparagraphs (*a*) and (*b*) and the deletion of subparagraph (*f*). The deletion of the word "delivery" means that a "warehouse" used for that purpose will constitute a permanent establishment. Furthermore, a "commercial warehouse", where space is rented to other concerns, is also a permanent establishment under paragraph 2.

The deletion of the term "delivery" was agreed on after members from developing countries pointed out that the presence of a stock of goods for prompt delivery facilitated the sales of the product and thereby the earning of profit in the host country by the enterprise having the facility. There was a continuous connexion and hence the existence of such a supply of goods, they argued, should constitute a permanent establishment, leaving as a separate matter the determination of the proper amount of income attributable to the permanent establishment. The Group felt that it would be preferable to leave open for bilateral negotiations the question of whether cases involving deliveries made from stocks of goods should be included in or excluded from the definition of permanent establishment. Some members from developed countries pointed out that since in the normal case only a small amount of income would be allocated if the only activity were that described in the proposed clause, it would not serve any purpose to make the change.

Concerning paragraph 4, subparagraph (*f*), of the OECD Model Convention, although there was a general consensus not to include it in the United Nations Model Convention, some members of the Group indicated that the desirability of including it in a treaty could be left to bilateral negotiation. Subparagraph (*f*) of the OECD Model provides for: "the maintenance of a fixed place of business solely for any combination of activities mentioned in sub-paragraphs (*a*) to (*e*), provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".

Concerning the business activities listed in paragraph 4, the commentary on article 5, paragraph 4, of the OECD Model Convention states that they are "treated as exceptions to the general definition laid down in paragraph 1" and that they "are not permanent establishments, even if the activity is carried on through a fixed place of business". The OECD commentary stresses that "the common feature of these activities is that they are in general preparatory or auxiliary activities" and that "the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State, if it carries on in that other State activities of a purely preparatory or auxiliary character". The following passages of the OECD commentary are likewise relevant to article 5, paragraph 4, of the United Nations Model Convention:

> "Subparagraph (*a*) relates only to the case in which an enterprise acquires the use of facilities for storing [or] displaying ..... its own goods or merchandise. Subparagraph (*b*) relates to the stock of merchandise itself and provides that the stock, as such, shall not be treated as a permanent establishment if it is maintained for the purpose of storage [or] display. Subparagraph (*c*) covers the case in which a stock of goods or merchandise belonging to one enterprise is processed by a second enterprise, on behalf of, or for the account of, the first-mentioned enterprise. The reference to the collection of information in subparagraph (*d*) is intended to include the case of the newspaper bureau which has no purpose other than to act as one of many 'tentacles' of the parent body; to exempt such a bureau is to do no more than to extend the concept of 'mere purchase'.
>
> "Subparagraph (*e*) provides that a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a permanent establishment. The wording of this subparagraph makes it unnecessary to produce an exhaustive list

of exceptions. Furthermore, this sub-paragraph provides a generalized exception to the general definition in paragraph 1 and, when read with that paragraph, provides a more selective test, by which to determine what constitutes a permanent establishment. To a considerable degree it limits that definition and excludes from its rather wide scope a number of forms of business organizations which, although they are carried on through a fixed place of business, should not be treated as permanent establishments. It is recognized that such a place of business may well contribute to the productivity of the enterprise, but the services it performs are so remote from the actual realization of profits that it is difficult to allocate any profit to the fixed place of business in question. Examples are fixed places of business solely for the purpose of advertising or for the supply of information or for scientific research or for the servicing of a patent or a know-how contract, if such activities have a preparatory or auxiliary character.

"It is often difficult to distinguish between activities which have a preparatory or auxiliary character and those which have not. The decisive criterion is whether or not the activity of the fixed place of business in itself forms an essential and significant part of the activity of the enterprise as a whole. Each individual case will have to be examined on its own merits. In any case, a fixed place of business whose general purpose is one which is identical to the general purpose of the whole enterprise, does not exercise a preparatory or auxiliary activity. Where, for example, the servicing of patents and know-how is the purpose of an enterprise, a fixed place of business of such enterprise exercising such an activity cannot get the benefits of subparagraph (*e*). A fixed place of business which has the function of managing an enterprise or even only a part of an enterprise or of a group of the concern cannot be regarded as doing a preparatory or auxiliary activity, for such a managerial activity exceeds this level. If enterprises with international ramifications establish a so-called 'management office' in States in which they maintain subsidiaries, permanent establishments, agents or licensees, such office having supervisory and co-ordinating functions for all departments of the enterprise located within the region concerned, a permanent establishment will normally be deemed to exist, because the management office may be regarded as an office within the meaning of paragraph 2. Where a big international concern has delegated all management functions to its regional management offices so that the functions of the head office of the concern are restricted to general supervision (so-called polycentric enterprises), the regional management offices even have to be regarded as a 'place of management' within the meaning of subparagraph (*a*) of paragraph 2. The function of managing an enterprise, even if it only covers a certain area of the operations of the concern, constitutes an essential part of the business operations of the enterprise and therefore can in no way be regarded as an activity which has a preparatory or auxiliary character within the meaning of subparagraph (*e*) of paragraph 4.

"A permanent establishment could also be constituted if an enterprise maintains a fixed place of business in order to supply spare parts to customers for the machinery supplied to such customers, and to maintain and repair such machinery. Since these after-sale organisations perform an essential and significant part of the services of an enterprise vis-à-vis its customers, their activities are not merely auxiliary ones. Subparagraph (*e*) applies only if the activity of the fixed place of business is limited to a preparatory or auxiliary one. This would not be the case where, for example, the fixed place of business does not only give information but also furnishes plans etc. specially developed for the purposes of the individual customer. Nor would it be the case if a research establishment were to concern itself with manufacture.

"Moreover, subparagraph (*e*) makes it clear that the activities of the fixed place of business must be carried on for the enterprise. A fixed place of business which renders services not only to its enterprise but also directly to the other enterprises, for example to other companies of a group to which the company owning the fixed place belongs, would not fall within the scope of subparagraph (*e*).

". . .

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

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

"A fixed place of business used both for activities which rank as exceptions (paragraph 4) and for other activities would be regarded as a single permanent establishment and taxable as regards both types of activities. This would be the case, for instance, where a store maintained for the delivery of goods also engaged in sales."

Paragraph 5

Since neither paragraph 4 nor paragraph 5 deals with the treatment of a combination of the activities specified in subparagraph 4 (*a*) to subparagraph 4 (*e*), whatever interpretation is given to the omission in paragraph 4 should also apply to paragraph 5. With the addition of subparagraph 5 (*b*), this paragraph departs substantially from and is considerably broader in scope than article 5, paragraph 5, of the OECD Model Convention, which the Group considered to be too narrow in scope because it restricted the type of agent who would be deemed to create a permanent establishment of a non-resident enterprise, exposing it to taxation in the source country.

Some members from developing countries pointed out that a narrow formula might encourage tax evasion by permitting an agent who was in fact dependent to represent himself as acting on his own behalf. It was the understanding of the Group that the phrase "authority to conclude contracts on behalf of" in subparagraph 5 (*a*) of article 5 meant that the agent had legal authority to bind the enterprise for business purposes and not only for administrative purposes (e.g., conclusion of lease or electricity and manpower contracts).

Paragraph 6

This paragraph does not correspond to any provision of the OECD Model Convention. It was included because it was the common feeling of the Group that the OECD definition of permanent establishment was not adequate to deal with certain aspects of the insurance business. Members from developing countries pointed out that if an insurance agent was independent, the profits would not be taxable in accordance with the provisions suggested in article 5, paragraph 7, of the United Nations Model Convention (based on article 5, paragraph 6, of the OECD Model Convention); and if the agent was dependent, no tax could be imposed because insurance agents normally had no authority to conclude contracts as would be required under the provisions suggested in subparagraph 5 (*a*) (based on article 5, paragraph 5, of the OECD Model Convention). Those members expressed the view that taxation of insurance profits in the country where the premiums were being paid was desirable and should take place independently of the status of the agent. They therefore suggested that the United Nations Model Convention should include a special provision relating to insurance business. However, such taxation is based on the assumption that the person (employee or representative) through whom premiums are collected and risk insured, is present in the country where the risk is located.

Once agreement had been reached on the principle of including a special provision on insurance, the discussion in the Group focused mainly on cases involving representation through "an independent agent". Members from developing countries felt it would be desirable to provide that a permanent establishment existed in such cases because of the nature of the insurance business, the fact that the risks were situated within the country claiming tax jurisdiction, and the facility with which persons could, on a part-time basis, represent insurance companies on the basis of an "independent status", making it difficult to distinguish between dependent and independent insurance agents. Members from developed countries, on the other hand, stressed that in cases involving independent agents, insurance business should not be treated differently from such activities as the sale of tangible commodities. Those members also drew attention to the difficulties involved in ascertaining the total amount of business done when the insurance was handled by a number of independent agents within the same country. In view of the difference in approach, the Group agreed that the case of representation through independent agents should be left to bilateral negotiations, which could take account of the methods used to sell insurance and other features of the insurance business in the countries concerned.

Paragraph 7

The first sentence of this paragraph reproduces article 5, paragraph 6, of the OECD Model Convention in its entirety, with a few minor drafting changes. The commentary on the OECD text reads as follows:

"Where an enterprise of a Contracting State carries on business dealings through a broker, general commission agent or any other agent of an independent status, it cannot be taxed in the other Contracting State in respect of those dealings if the agent is acting in the ordinary course of his business . . . Although it stands to reason that such an agent, representing a separate enterprise, cannot constitute a permanent establishment of the foreign enterprise, paragraph 6 has been inserted in the article for the sake of clarity and emphasis.

"A person will come within the scope of paragraph 6—i.e. he will not constitute a permanent establishment of the enterprise on whose behalf he acts—only if

"(*a*) he is independent of the enterprise both legally and economically,

"(*b*) he acts in the ordinary course of his business when acting on behalf of the enterprise.

"Whether a person is independent of the enterprise represented depends on the extent of the obligations which this person has vis-à-vis the enterprise. Where the person's commercial activities for the enterprise are subject to detailed instructions or to comprehensive control by it, such person cannot be regarded as independent of the enterprise. Another important criterion will be whether the entrepreneurial risk has to be borne by the person or by the enterprise the person represents. A subsidiary is not to be considered dependent on its parent company solely because of the parent's ownership of the share capital. Persons cannot be said to act in the ordinary course of their own business if, in place of the enterprise, such persons perform activities which, economically, belong to the sphere of the enterprise rather than to that of their own business operations. Where, for example, a commission agent not only sells the goods or merchandise of the enterprise in his own name but also habitually acts, in relation to that enterprise, as a permanent agent having an authority to conclude contracts, he would be deemed in respect of this particular activity to be a permanent establishment, since he is thus acting outside the ordinary course of his own trade or business (namely that of a commission agent), unless his activities are limited to those mentioned at the end of paragraph 5.

". . . ."

The second sentence of article 5, paragraph 7, of the United Nations Model Convention constitutes a new provision, whose inclusion stemmed from a proposal by members from developing countries to broaden the scope of the definition of a permanent establishment by treating as a dependent agent an agent who habitually secures orders exclusively or almost exclusively for an enterprise of the other Contracting State or a group of centrally controlled affiliated enterprises. In that situation, the agent shall constitute a permanent establishment for the particular members of the group for whom he is acting at a given time. In support of this proposal it was argued that when an agent, although acting in an independent capacity, acted for only one enterprise and devoted his time and activity wholly or almost wholly to that enterprise, he lost his independent status.

It was stated that the confinement of the activities of an agent wholly or almost wholly to those undertaken on behalf of one enterprise must be pursuant to an agreement with that enterprise. Some members from developing countries felt that the existence of such an agreement should not be a requirement for the application of the United Nations amendment replacing article 5, paragraph 5, of the OECD Model Convention, for in practice it would annul it.

Paragraph 8

This paragraph reproduces article 5, paragraph 7, of the OECD Model Convention. The commentary on the OECD text reads as follows:

> "It is generally accepted that the existence of a subsidiary company does not, of itself, constitute that subsidiary company a permanent establishment of its parent company. This follows from the principle that, for the purpose of taxation, such a subsidiary company constitutes an independent legal entity. Even the fact that the trade or business carried on by the subsidiary company is managed by the parent company does not constitute the subsidiary company a permanent establishment of the parent company.
>
> "However, a subsidiary company will constitute a permanent establishment for its parent company under the same conditions stipulated in paragraph 5 as are valid for any other unrelated company, i.e. if it cannot be regarded as an independent agent in the meaning of paragraph 6, and if it has and habitually exercises an authority to conclude contracts in the name of the parent company. And the effects would be the same as for any other unrelated company to which paragraph 5 applies.
>
> "The same rules should apply to activities which one subsidiary carries on for any other subsidiary of the same company."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 5 OF THE OECD MODEL CONVENTION

Observations on the commentary

"Treatment in Irish tax law of non-resident operators in *Ireland* and in the Irish continental shelf area. Profits arising to a person not resident in Ireland from exploration or exploitation activities in Ireland or in the Irish continental shelf area as well as profits from exploration or exploitation rights are treated as the profits of a trade carried on in Ireland through a branch or agency and are, in consequence, taxable in Ireland. This includes non-resident contractors who supply well-drilling, pipe-laying and similar services in Ireland or in the Irish continental shelf area. In addition, capital gains accruing on the disposal of exploration or exploitation rights in Ireland or in the Irish continental shelf area are treated as gains accruing on the disposal of assets situated in Ireland. When negotiating conventions with other Member countries, Ireland would wish subparagraph (*f*) of paragraph 2 to be so drafted and interpreted as to reflect the Irish position.

"*Italy* does not adhere to the interpretation given in paragraph 11 above concerning the list of examples of paragraph 2. In its opinion, these examples can always be regarded as constituting *a priori* permanent establishments.

"While, subject to its reservations in relation to this Article, *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article, it would wish to be free to negotiate for the addition of specific provisions deeming an enterprise in some particular situations to have a permanent establishment in New Zealand."

Reservations on the article

"*Australia* reserves the right to treat an enterprise as having a permanent establishment in a State if the enterprise carries on designated supervisory activities in that State for more than twelve months, if substantial equipment is used in that State for more than twelve months by, for or under contract with the enterprise in the exploration for or exploitation of natural resources, or if a person acting in that State on behalf of the enterprise—manufactures or processes there goods or merchandise belonging to the enterprise.

"*Greece, New Zealand, Portugal* and *Turkey* reserve their positions on paragraph 3, and consider that any building site or construction or installation project which lasts more than six months should be regarded as a permanent establishment.

"*New Zealand* also reserves its position so as to be able to tax an enterprise which carries on supervisory activities for more than six months in connection with a building site or construction or installation project lasting more than six months, and also an enterprise where substantial equipment or machinery is for more than six months being used by, for or under contract with the enterprise.

"*Spain* reserves its position on paragraph 3 so as to be able to tax an enterprise having a permanent establishment in Spain, even if the site of the construction or installation project does not last for more than twelve months, where the activity of this enterprise in Spain presents a certain degree of permanency within the meaning of paragraphs 1 and 2."

Commentaries on chapter III

TAXATION OF INCOME

Article 6

INCOME FROM IMMOVABLE PROPERTY

A. GENERAL CONSIDERATIONS

Article 6 of the United Nations Model Convention reproduces article 6 of the OECD Model Convention.

In taxing income from immovable property, the object should be the taxation of profits rather than of gross income; the expenses incurred in earning income from real property or from agriculture or forestry should therefore be taken into account. This objective should not, however, preclude the use of a withholding tax on rents from real property, based on gross income; in such cases the rate should take into account the fact that expenses have been incurred. On the other hand, if a withholding tax on gross rents is used, it will be just as satisfactory if the owner of the real property can elect to have the income from the property taxed on a net basis under the regular income tax. Article 6 is not intended to prevent a country which taxes income from agriculture or other immovable property on an estimated or similar basis from continuing to use that method.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 6

Paragraph 1

This paragraph grants the right to tax income from immovable property (including income from agriculture or forestry) to the State of source, that is, the State where the property in question is situated. In the words of the commentary on article 6, paragraph 1, of the OECD Model Convention, this provision is based on "the fact that there is always a very close economic connexion between the source of this income and the State of source".

Although income from agriculture and forestry is included in article 6, Contracting States are free to agree in their bilateral conventions to treat such income under article 7. Article 6 deals only with income which a resident of a Contracting State derives from immovable property situated in the other Contracting States. It does not, therefore, apply to income from immovable property situated in the Contracting State of which the recipient is a resident within the meaning of article 4 or situated in a third State; the provisions of paragraph 1 of article 21 shall apply to such income.

Paragraph 2

The definition of immovable property contained in this paragraph, according to which the term has the meaning which it has under the law of the Contracting State in which the property in question is situated, is intended to help prevent difficulties of interpretation with regard to whether an asset or a right is to be regarded as immovable property or not. In addition the paragraph lists a number of assets and rights which are in any case to be regarded as covered by the term. On the other hand, the paragraph provides that ships, boats and aircraft shall not be regarded as immovable property. Like the OECD Model Convention, the United Nations Model Convention contains no special provision concerning income from indebtedness secured by immovable property, a matter which is dealt with under the article relating to interest.

Paragraph 3

This paragraph provides that the general rule set forth in paragraph 1 shall apply regardless of the form in which immovable property is used.

Paragraph 4

The commentary on article 6, paragraph 4, of the OECD Model Convention observes that this paragraph "makes it clear that the provisions of paragraphs 1 and 3 apply also to income from immovable property, of industrial, commercial and other enterprises and to income from immovable property used for the performance of independent personal services". The OECD commentary also observes:

> "It should be noted in this connexion that the right to tax of the State of source has priority over the right to tax of the other State and applies also where in the case of an enterprise or of non-industrial and non-commercial activities, income is only indirectly derived from immovable property. This does not prevent income from immovable property, when derived through a permanent establishment, from being treated as income of an enterprise, but secures that income from immovable property will be taxed in the State in which the property is situated also in the case where such property is not part of a permanent establishment situated in that State. It should further be noted that the provisions of the article do not prejudge the application of domestic law as regards the manner in which income from immovable property is to be taxed".

C. RESERVATIONS ON ARTICLE 6 OF THE OECD MODEL CONVENTION

"*Finland* reserves the right to tax income of shareholders in Finnish companies from the direct use, letting, or use in any other form of the right to enjoyment of immovable property situated in Finland and owned by the company, where such right is based on the ownership of shares or other corporate rights in the company.

"*France* wishes to retain the possibility of applying the provisions in its domestic laws relative to the taxation of income from shares or rights, which are treated therein as income from immovable property."

Article 7

BUSINESS PROFITS

A. GENERAL CONSIDERATIONS

Article 7 of the United Nations Model Convention consists of a number of provisions of article 7 of the OECD Model Convention, either unchanged or substantially amended, and some new provisions. In particular paragraph 5 of article 7 of the OECD text has not been included. The Group of Experts could not reach a consensus on provisions relating to the matters covered by that paragraph and therefore decided to include in article 7 a note indicating that the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise should be settled in bilateral negotiations. The members from developing countries considered that that paragraph should not be reproduced in the article, or, if it was included, it should be amended to include a statement to the effect that in the case of a permanent establishment engaged in purchasing and other activities, profits derived from purchasing activities should be attributed to the permanent establishment. Furthermore, some members from developing countries felt that where purchasing constituted the sole activity of an enterprise in the source country, a permanent establishment would exist in that country, and that since the purchasing activity contributed to the generation of the over-all profit of the enterprise, there should be an allocation of the portion of the over-all profit attributable to the permanent establishment. The members from developed countries believed that it would be desirable to incorporate the provisions of article 7, paragraph 5, in the text of article 7. Details concerning the other amendments to the OECD text and the new provisions are provided below in the commentary on the paragraphs of the article.

The most relevant question in international tax practice concerning business profits relates to the facts which make an enterprise liable to taxation on its profits in a foreign country. There is general acceptance of the so-called "arm's-length" rule embodied in the

OECD Draft Model Convention. According to this rule, the profits attributable to a permanent establishment are those which would be earned by the establishment if it were a wholly independent entity dealing with its head office as if it were a distinct and separate enterprise operating under conditions and selling at prices prevailing in the regular market. The profits so attributable are normally the profits shown on the books of the establishment. Nevertheless, this rule permits the authorities of the country in which the permanent establishment is located to rectify the accounts of the enterprise, so as to reflect properly income which the establishment would have earned if it were an independent enterprise dealing with its head office at arms's length. The application of the arm's-length rule to the allocation of profits between the home office and its permanent establishment presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's-length principle.

The application of the arm's-length rule is particularly important in connexion with the difficult and complex problem of the deductions to be allowed to the permanent establishment. It is also generally accepted that in calculating the profits of a permanent establishment, allowance should be made for expenses, wherever incurred, for the purposes of the business of the permanent establishment, including executive and general administrative expenses. Apart from what may be regarded as ordinary expenses, there are some classes of expenditure that give rise to special problems. These include interest and royalties etc. paid by the permanent establishment to its head office in return for money lent or patent rights licensed by the latter to the permanent establishment. They further include commissions (except for the reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the establishment. In these cases, it is considered that the payments should not be allowed as deductions in computing the profits of the permanent establishment. Conversely, such payments made to a permanent establishment by the head office should be excluded from the profits of the permanent establishment. On the other hand, an allocable share of such payments, e.g., interest and royalties, paid by the enterprise to third parties should be allowed.

Although according to the OECD Model Convention only profits attributable to the permanent establishment should be taxable in the source country, in some cases the "attribution principle" has been amplified by the so-called "force of attraction" rule, which permits the enterprise, once it carries out business through a permanent establishment in the source country, to be taxed on business profits in that country arising from transactions outside the permanent establishment. Furthermore, non-business income of the enterprise may likewise be attracted into the taxable income of the permanent establishment. Where, owing to the principle of the "force of attraction", the profits of an enterprise other than those attributable directly to the permanent establishment may be taxed in the State where the permanent establishment is situated, such profits should be determined in the same way as if they were attributable directly to the permanent establishment.

It may be recalled that the OECD Model Convention contains the following preliminary remarks on article 7:

> "This Article is in many respects a continuation of, and a corollary to, Article 5 on the definition of the concept of permanent establishment. The permanent establishment criterion is commonly used in international double taxation conventions to determine whether a particular kind of income shall or shall not be taxed in the country from which it originates but the criterion does not of itself provide a complete solution to the problem of the double taxation of business profits; in order to prevent such double taxation it is necessary to supplement the definition of permanent establishment by adding to it an agreed set of rules of reference to which the profits made by the permanent establishment, or by an enterprise trading with a foreign member of the same group of enterprises, are to be calculated. To put the matter in a slightly different way, when an enterprise of a Contracting State carries on business in the other Contracting State the authorities of that second State have to ask themselves two questions before they levy tax on the profits of the enterprise: the first question is whether the enterprise has a permanent establishment in their country; if the answer is in the affirmative the second question is what, if any, are the profits on which that permanent establishment should pay tax. It is with the rules to be used in determining the answer to this second question that Article 7 is concerned. Rules for ascertaining the profits of an enterprise of a Contracting State which is trading with an enterprise of the other Contracting State when both enterprises are members of the same group of enterprises or are under the same effective control are dealt with in Article 9.
>
> "It should perhaps be said at this point that neither Article is strikingly novel or particularly detailed. The question of what criteria should be used in attributing profits to a permanent establishment, and of how to allocate profits from transactions between enterprises under common control, has had to be dealt with in a large number of double taxation conventions and it is fair to say that the solutions adopted have generally conformed to a standard pattern. It is generally recognized that the essential principles on which this standard pattern is based are well founded, and it has been thought sufficient to restate them with some slight amendments and modifications primarily aimed at producing greater clarity. The two Articles incorporate a number

of directives. They do not, nor in the nature of things could they be expected to, lay down a series of precise rules for dealing with every kind of problem that may arise when an enterprise of one State makes profits in another. Modern commerce organizes itself in an infinite variety of ways, and it would be quite impossible within the fairly narrow limits of an article in a double taxation convention to specify an exhaustive set of rules for dealing with every kind of problem that may arise. This, however, is a matter of relatively minor importance, if there is agreement on general lines. Special cases may require special consideration, but it should not be difficult to find an appropriate solution if the problem is approached within the framework of satisfactory rules based on agreed principles."

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 7

Paragraph 1

This paragraph reproduces article 7, paragraph 1, of the OECD Model Convention, with the addition of the provisions contained in clauses (*b*) and (*c*). In the discussion preceding the adoption by the Group of Experts of this paragraph, several members from developing countries expressed support for the "force of attraction" rule, although they would limit the application of that rule to business profits covered by article 7 of the OECD Model Convention and not extend it to income from capital (dividends, interest and royalties) covered by other treaty provisions. The members supporting the application of the "force of attraction" rule also indicated that neither sales through independent commission agents nor purchase activities would become taxable to the principal under that rule. Some members from developed countries pointed out that the "force of attraction" rule had been found unsatisfactory and abandoned in recent tax treaties concluded by them because of the undesirability of taxing income from an activity that was totally unrelated to the establishment and that was in itself not extensive enough to constitute a permanent establishment. They also stressed the uncertainty that such an approach would create for taxpayers. Members from developing countries pointed out that the proposed "force of attraction" approach did remove some administrative problems in that it made it unnecessary to determine whether particular activities were or were not related to the permanent establishment or the income involved attributable to it. That was the case especially with respect to transactions conducted directly by the home office within the country, but similar in nature to those conducted by the permanent establishment. However, after discussion, it was proposed that the "force of attraction" rule, should be limited so that it would apply to sales of goods or merchandise and other business activities in the following manner: if an enterprise has a permanent establishment in the other Contracting State for the purpose of selling goods or merchandise, sales of the same or a similar kind may be taxed in that State even if they are not conducted through the permanent establishment; a similar rule will apply if the permanent establishment is used for other business activities and the same or similar activities are performed without any connexion with the permanent establishment.

Clauses (*b*) and (*c*) were deemed entirely acceptable by the members from developing countries and a few members from developed countries. Other members from developed countries said that they could accept clauses (*b*) and (*c*) if those clauses were understood not to extend to sales effected by agents of an independent status. Others believed that such an exception would be less acceptable than either the original OECD provision or that provision amended by clauses (*b*) and (*c*). In effect, if that exception were admitted, taxation in the host country would depend upon whether an independent commission agent or broker was involved, which they felt would not be a logical distinction and would, moreover, lend itself to artificial sales arrangements. A few members from developed countries thought that the addition of clauses (*b*) and (*c*) was undesirable and preferred the OECD text.

It may be recalled that the OECD Model Convention contains the following commentary on the provisions of paragraph 1 of article 7 of that Convention.

> "This paragraph is concerned with two questions. First, it restates the generally accepted principle of double taxation conventions that an enterprise of one State shall not be taxed in the other State unless it carries on business in that other State through a permanent establishment situated therein. It is hardly necessary to argue here the merits of this principle. It is perhaps sufficient to say that it has come to be accepted in international fiscal matters that until an enterprise of one State sets up a permanent establishment in another State it should not properly be regarded as participating in the economic life of that other State to such an extent that it comes within the jurisdiction of that other State's taxing rights.
>
> "The second and more important point is that it is laid down—in the second sentence—that when an enterprise carries on business through a permanent establishment in another State that State may tax the profits of the enterprise but only so much of them as is attributable to the permanent establishment; in other words that the right to tax does not extend to profits that the enterprise may derive from that State otherwise than through the permanent establishment. This is a question on which there may be differences of view. Some countries have taken the view that when a foreign enterprise has set up a permanent establish-

ment within their territory it has brought itself within their fiscal jurisdiction to such a degree that they can properly tax all profits that the enterprise derives from their territory, whether the profits come from the permanent establishment or from other activities in that territory. But it is thought that it is preferable to adopt the principle contained in the second sentence of paragraph 1, namely that the test that business profits should not be taxed unless there is a permanent establishment is one that should properly be applied not to the enterprise itself but to its profits. To put the matter another way, the principle laid down in the second sentence of paragraph 1 is based on the view that in taxing the profits that a foreign enterprise derives from a particular country, the fiscal authorities of that country should look at the separate sources of profit that the enterprise derives from their country and should apply to each the permanent establishment test. This is of course without prejudice to other articles.

"On this matter, naturally, there is room for differences of view, and since it is an important question it may be useful to set out the arguments for each point of view.

"Apart from the background question of fiscal jurisdiction, the main argument commonly put forward against the solution advocated above is that there is a risk that it might facilitate avoidance of tax. This solution, the argument runs, might leave it open to an enterprise to set up in a particular country a permanent establishment which made no profits, was never intended to make profits, but existed solely to supervise a trade, perhaps of an extensive nature, that the enterprise carried on in that country through independent agents and the like. Moreover, the argument goes, although the whole of this trade might be directed and arranged by the permanent establishment, it might be difficult in practice to prove that that was the case. If the rates of tax are higher in that country than they are in the country in which the head office is situated, then the enterprise has a strong incentive to see that it pays as little tax as possible in the other territory; the main criticism of the solution advocated above is that it might conceivably provide the enterprise with a means of ensuring that result.

"Apart again from the question of the proper extent of fiscal jurisdiction, the main argument in favour of the proposed solution is that it is conducive to simple and efficient administration, and that it is more closely adapted to the way in which business is commonly transacted. The organisation of modern business is highly complex. In OECD Member countries, there are a considerable number of companies each of which is engaged in a wide diversity of activities and is carrying on business extensively in many countries. It may be that such a company may have set up a permanent establishment in a second country and may be transacting a considerable amount of business through that permanent establishment in one particular kind of manufacture; that a different part of the same company may be selling quite different goods or manufactures in that second country through independent agents; and that the company may have perfectly genuine reasons for taking this course—reasons based on, for example, either on the historical pattern of its business or on commercial convenience. Is it desirable that the fiscal authorities should go so far as to insist on trying to search out the profit element of each of the transactions carried on through independent agents, with a view to aggregating that profit with the profits of the permanent establishment? Such an article might interfere seriously with ordinary commercial processes, and so be out of keeping with the aims of the Convention.

"It is no doubt true that evasion of tax could be practised by undisclosed channelling of profits away from a permanent establishment and that this may sometimes need to be watched, but it is necessary in considering this point to preserve a sense of proportion and to bear in mind what is said above. It is not, of course, sought in any way to sanction any such malpractice, or to shelter any concern thus evading tax from the consequences that would follow from detection by the fiscal authorities concerned. It is fully recognised that Contracting States should be free to use all methods at their disposal to fight fiscal evasion.

"For the reasons given above, it is thought that the argument that the solution advocated might lead to increased avoidance of tax by foreign enterprises should not be given undue weight. Much more importance is attached to the desirability of interfering as little as possible with existing business organisation and of refraining from inflicting demands for information on foreign enterprises which are unnecessarily onerous."

Paragraph 2

This paragraph reproduces article 7, paragraph 2, of the OECD Model Convention. In the discussion relating to that paragraph, a member from a developed country pointed out that his country was having some problems with inconsistent determination of the profits properly attributable to a permanent establishment, especially with regard to "turn-key" contracts. It was recalled that under a turn-key contract a contractor agreed to construct a factory or similar facility and make it ready for operation. When the facility was ready for operation, it was handed over to the purchaser, who could then begin operations. The international tax problems occurred when the facility was to be constructed in one country by a contractor resident in another country. The actual construction activities carried on in one country clearly constituted a permanent establishment within that country if of sufficiently long duration. Turn-key contracts, however, were often concluded before the creation of the permanent establishment and involved many components other than normal construction activities. They also included the purchase of capital goods, the performance of architectural and engineering services and the provision of technical assistance. Those latter items, it was explained, were sometimes completed before construction activities actually started (and hence, before the creation of a permanent establishment at the construction site) and often outside the country in which the construction site/permanent establishment was situated.

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

The Group recognized that that problem was a complex and potentially controversial one involving many interrelated issues, such as source of income rules and the definitions of permanent establishment and profits of an enterprise. The Group acknowledged that the problem might be considered in the course of bilateral negotiations. Since the discussion resulted in no change in article 7, paragraph 2, of the OECD Model Convention, the whole of the OECD commentary on that paragraph, which reads as follows, is relevant to the United Nations text:

> "This paragraph contains the central directive on which the allocation of profits to a permanent establishment is intended to be based. The paragraph incorporates the view, which is generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment are those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market. Normally, these would be the same profits that one would expect to be determined by the ordinary processes of good business accountancy. This principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise and with associated companies and their permanent

establishments; but Contracting States which consider that the existing paragraph does not in fact cover these more general transactions may, in their bilateral negotiations, agree upon more detailed provisions.

"In the great majority of cases, trading accounts of the permanent establishment—which are commonly available if only because a well-run business organisation is normally concerned to know what is the profitability of its various branches—will be used by the taxation authorities concerned to ascertain the profit properly attributable to that establishment. Exceptionally there may be no separate accounts. . . . But where there are such accounts they will naturally form the starting point for any processes of adjustment in case adjustment is required to produce the amount of properly attributable profits. It should perhaps be emphasized that the directive contained in paragraph 2 is no justification for tax administrations to construct hypothetical profit figures in vacuo; it is always necessary to start with the real facts of the situation as they appear from the business records of the permanent establishment and to adjust as may be shown to be necessary the profit figures which those facts produce. It should also be noted that the principle set out in paragraph 2 is subject to the provisions contained in paragraph 3, especially as regards the treatment of payments which, under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded by the latter to the permanent establishment.

"Even where a permanent establishment is able to produce proper accounts which purport to show the profits arising from its activities, it may still be necessary for the taxation authorities of the country concerned to rectify those accounts in accordance with the general directive laid down in paragraph 2. Adjustment of this kind may be necessary, for example, because goods have been invoiced from the head office to the permanent establishment at prices which are not consistent with this directive, and profits have thus been diverted from the permanent establishment to the head office, or vice versa.

"In such cases, it will usually be appropriate to substitute for the prices used ordinary market prices for the same or similar goods supplied on the same or similar conditions. Clearly the price at which goods can be bought on open market terms varies with the quantity required and the period over which they will be supplied; such factors would have to be taken into account in deciding the open market price to be used. It is perhaps only necessary to mention at this point that there may sometimes be perfectly good commercial reasons for an enterprise invoicing its goods at prices less than those prevailing in the ordinary market;

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

"Some States consider that there is a realisation of a taxable profit when an asset, other than trading stock, forming part of the business property of a permanent establishment situated within their territory is transferred to a permanent establishment or the head office of the same enterprise situated in another State. Article 7 allows such States to tax profits deemed to arise in connexion with such a transfer. Such profits may be determined as indicated in [the preceding four paragraphs]."

Paragraph 3

The first sentence of paragraph 3 of article 7 reproduces the entire text of article 7, paragraph 3, of the OECD Model Convention. The rest of the paragraph consists of new provisions formulated by the Group of Experts. These provisions stem from a proposal by members from developing countries, who felt that it would be helpful to include all the necessary definitions and clarifications in the text, with a view, in particular, to assisting developing countries not represented in the Group. Some of those members also felt that provisions prohibiting the deduction of certain expenses should be included in the text of a bilateral tax treaty to make it clear that taxpayers were fully informed about their fiscal obligations. In the course of the discussion it was pointed out that the additions to the OECD text would ensure that the permanent establishment would be able to deduct interest, royalties and other expenses incurred by the head office on behalf of the establishment. The Group agreed that if billings by the head office included the full costs, both direct and indirect, then there should not be a further allocation of the executive and administrative expenses of the head office, since that would produce a duplication of such charges on the transfer between the head office and the permanent establishment. It was pointed out that it was important to determine how the price was fixed and what elements of cost it included. Where an international wholesale price was used, it would normally include indirect costs. There was general agreement within the Group that any duplication of costs and expenses should be prevented.

Since the first sentence of article 7, paragraph 3, of the United Nations Model Convention reproduces the whole of article 7, paragraph 3, of the OECD Model Convention, the OECD commentary on the latter paragraph, which reads as follows, is relevant to the United Nations text:

"This paragraph clarifies, in relation to the expenses of a permanent establishment, the general directive laid down in paragraph 2. The paragraph specifically recognises that in calculating the profits of a permanent establishment allowance is to be made for expenses, wherever incurred, that were incurred for the purposes of the permanent establishment. Clearly in some cases it will be necessary to estimate or to calculate by conventional means the amount of expenses to be taken into account. In the case, for example, of general administrative expenses incurred at the head office of the enterprise, it may be appropriate to take into account a proportionate part based on the ratio that the permanent establishment's turnover (or perhaps gross profits) bears to that of the enterprise as a whole. Subject to this, it is considered that the amount of expenses to be taken into account as incurred for the purposes of the permanent establishment should be the actual amount so incurred. The deduction allowable to the permanent establishment for any of the expenses of the enterprise attributed to it does not depend upon the actual reimbursement of such expenses by the permanent establishment.

"Apart from what may be regarded as ordinary expenses, there are some classes of payments between permanent establishments and head offices which give rise to special problems, and it is convenient to deal with them at this point. The next paragraphs discuss three specific cases of this kind and give solutions for them. It should not, of course, be inferred that it is only in relation to the three classes of payments mentioned in these paragraphs that problems may arise; there may well be payments of other kinds to which similar considerations apply.

"The first of these cases relates to payments which under the name of interest, royalties, etc. are made by a permanent establishment to its head office in return for money loaned, or patent rights conceded, by the latter to the permanent establishment. In such a case, it is considered that the payments should not be allowed as deductions in computing the permanent establishment's taxable profits. Equally, such payments made to a permanent establishment by the head office should be excluded from the computation of the permanent establishment's taxable profits. It is, however, recognised that special considerations apply to payments of interest made by different parts of a financial enterprise (e.g. a bank) to each other on advances etc. (as distinct from capital allotted to them), in view of the fact that making and receiving advances is narrowly related to the ordinary business of such enterprises. Furthermore, if an enterprise makes payments of interest, etc. to a third party and these payments in part relate to the activities of the permanent establishment, then a proportionate part of them should naturally be taken into account in calculating the permanent establishment's profits insofar as they can properly be regarded as expenses incurred for the purposes of the permanent establishment.

"The second case relates to the performance of ancillary services by a permanent establishment on behalf of its head office or vice versa. Consider, for example, the case of a large company with a varied business, part of which it carries on in another country through a permanent establishment. In addition, that permanent establishment advertises on behalf of its head office goods which that enterprise produces but which the permanent establishment itself does not handle. Clearly, in calculating for tax purposes the profits of the permanent establishment, the profits should be increased by the amount of the expense it has incurred on behalf of the head office (unless, of course, such an adjustment has already been made in drawing up the accounts of the permanent establishment). In fact if the permanent establishment and its head office were entirely separate and independent, the permanent establishment would ordinarily carry out services for the head office only if it were paid a commission as well as reimbursed the actual expenses incurred. It is, therefore, necessary to decide whether the calculation should be made on the basis of account being taken not only of any expenses borne by a permanent establishment by reason of services performed for the head office but also of a notional commission increasing the profits of the permanent establishment.

"After consideration of this question, it is thought that in such circumstances the profits of the permanent establishment should not be increased by the addition of a 'commission' figure. While, on one view, to include a 'commission' figure in the profits of every permanent establishment that has performed services otherwise than for its own purposes could be looked at in theory as a consequential application of the fiction of separate enterprise, it would inevitably be found exceedingly cumbersome in practice. There would be scope for lengthy argument about, and usually no concrete basis for determining, the percentage to be used in calculating the amount of notional 'commission'. In the great majority of cases the accounts of the permanent establishment would doubtless take into consideration actual expenses incurred; in other words they would not normally include any credit for 'commission'. If as a general rule the 'separate enterprise' test were to be applied to services performed by a permanent establishment on behalf of its head office and a notional 'commission' profit were to be included in the profits of the permanent establishment, it would, therefore, be necessary in the great majority of cases first to settle how the 'commission' element was to be calculated and then re-write the accounts of the permanent establishment. Considerations of practical administration weigh heavily against such a course. Therefore no 'commission' element should in such cases be included in the profits of the permanent establishment. Similarly, in the converse case where the head office undertakes services on behalf of the permanent establishment, no 'commission' element should be deducted in determining the profits of the permanent establishment.

"The third case is related to the question whether any part of the total profits of an enterprise should be deemed to arise from the exercise of good management. Consider the case of a company that has its head office in one country but carries on all its business through a permanent establishment situated in another country. In the extreme case it might well be that only the directors' meetings were held at the head office and that all other activities of the company, apart from purely formal legal activities, were carried on in the permanent establishment. In such a case there is something to be said for the view that at least part of the profits of the whole enterprise arose from the skilful management and business acumen of the directors and that part of the profits of the enterprise ought, therefore, to be attributed to the country in which the head office was situated. If the company has been managed by a managing agency, then that agency would doubtless have charged a fee for its services and the fee might well have been a simple percentage participation in the profits of the enterprise. But, once again, whatever the theoretical merits of such a course, practical considerations weigh heavily against it. In the kind of case quoted the expenses of management would, of course, be set against the profits of the permanent establishment in accordance with the provisions of paragraph 3, but when the matter is looked at as a whole, it is thought that it would not be right to go further by deducting and taking into account some notional figure for 'profits of management'. In cases identical to the extreme case mentioned above, no account should therefore be taken in determining taxable profits of the permanent establishment of any notional figure such as profits of management.

"It may be, of course, that countries where it has been customary to allocate some proportion of the total profits of an enterprise to the head office of the enterprise to represent the profits of good management will wish to continue to make such an allocation. Nothing in the article is designed to prevent this. Nevertheless it follows from what is said in the above paragraph that a country in which a permanent establishment is situated is in no way required to deduct when calculating the profits attributable to that permanent establishment an amount intended to represent a proportionate part of the profits of management attributable to the head office.

"It might well be that if the country in which the head office of an enterprise is situated allocates to the head office some percentage of the profits of the enterprise only in respect of good management, while the country in which the permanent establishment is situated does not, the resulting total of the amounts charged to tax in the two countries would be greater than it should be. In any such case the country in which the head office of the enterprise is situated should take the initiative in arranging for such adjustments to be made in computing the taxation liability in that country as may be necessary to ensure that any double taxation is eliminated.

"It is usually found that there are, or there can be constructed, adequate accounts for each part or section of an enterprise so that profits and expenses, adjusted as may be necessary, can be allocated to a particular part of the enterprise with a considerable degree of precision. This method of allocation is, it is thought, to be preferred in general wherever it is reasonably practicable to adopt it. There are, however, circumstances in which this may not be the case and paragraphs 2 and 3 are in no way intended to imply that other methods cannot properly be adopted where appropriate in order to arrive at the profits of a permanent establishment on a 'separate enterprise' footing. It may well be, for example, that profits of insurance enterprises can most conveniently be ascertained by special methods of computation, e.g. by applying appropriate co-efficients to gross premiums received from policy holders in the country concerned. Again, in the case of a relatively small enterprise operating on both sides of the border between two countries, there may be no proper accounts for the permanent establishment nor means of constructing them. There may, too, be other cases where the affairs of the permanent establishment are so closely bound up with those of the head office that it would be impossible to disentangle them on any strict basis of branch accounts. Where it has been customary in such cases to estimate the arm's length profit of a permanent establishment by reference to suitable criteria, it may well be reasonable that that method should continue to be followed notwithstanding that the estimate thus made may not achieve as high a degree of accurate measurement of the profit as adequate accounts. Even where such a course has not been customary, it may, exceptionally, be necessary for practical reasons to estimate the arm's length profits."

Some countries wished to point out that they allowed only those deductions that were permitted by their domestic laws.

Paragraph 4

This paragraph reproduces article 7, paragraph 4, of the OECD Model Convention. The OECD commentary on the latter paragraph, which reads as follows, is therefore relevant to the United Nations text:

"It has in some cases been the practice to determine the profits to be attributed to a permanent establishment not on the basis of separate accounts or by making an estimate of arm's length profit, but simply by apportioning the total profits of the enterprise by reference to various formulae. Such a method differs from those envisaged in paragraph 2, since it contemplates not an attribution of profits on a separate enterprise footing, but an apportionment of total profits; and indeed it might produce a result in figures which would differ from that which would be arrived at by a computation based on separate accounts. Paragraph 4 makes it clear that such a method may continue to be employed by a Contracting State if it has been customary in that State to adopt it, even though the figure arrived at may at times differ to some extent from that which would be obtained from separate accounts, provided that the result can fairly be said to be in accordance with the principles contained in the article. It is emphasized, however, that in general the profits to be attributed. to a permanent establishment should be determined by reference to the establishment's accounts if these reflect the real facts. It is considered that a method of allocation which is based on apportioning total profits is generally not as appropriate as a method which has regard only to the activities of the permanent establishment and should be used only where exceptionally it has as a matter of history been customary in the past and is accepted in the country concerned both by the taxation authorities and taxpayers generally there as being satisfactory. It is understood that paragraph 4 may be deleted where neither State uses such a method. Where, however, Contracting States wish to be able to use a method which has not been customary in the past the paragraph should be amended during the bilateral negotiations to make this clear.

"It would not, it is thought, be appropriate within the framework of this Commentary to attempt to discuss at length the many various methods involving apportionment of total profits that have been adopted in particular fields for allocating profits. These methods have been well documented in treaties on international taxation. It may, however, not be out of place to summarise briefly some of the main types and to lay down some very general directives for their use.

"The essential character of a method involving apportionment of total profits is that a proportionate part of the profits of the whole enterprise is allocated to a part thereof, all parts of the enterprise being assumed to have contributed on the basis of the criterion or criteria adopted to the profitability of the whole. The difference between one such method and another arises for the most part from the varying criteria used to determine what is the correct proportion of the total profits. It is fair to say that the criteria commonly used can be grouped into three main categories, namely those which are based on the receipts of the enterprise, its expenses or its capital structure. The first category covers allocation methods based on turnover or on commission, the second on wages and the third on the proportion of the total working capital of the enterprise allocated to each branch or part. It is not, of course, possible to say in vacuo that any of these methods is intrinsically more accurate than the others; the appropriateness of any particular method will depend on the circumstances to which it is applied. In some enterprises, such as those providing services or producing proprietary articles with a high profit margin, net profits will depend very much on turnover. For insurance enterprises it may be appropriate to make an apportionment of total profits by reference to premiums received from policy holders in each of the countries concerned. In the case of an enterprise manufacturing goods with a high cost raw material or labour content, profits may be found to be related more closely to expenses. In the case of banking and financial concerns the proportion of total working capital may be the most relevant criterion. It is considered that the general aim of any method involving apportionment of total profits ought to be to produce figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis, and that it would not be desirable to attempt in this connection to lay down any specific directive other than that it should be the responsibility of the taxation authority, in consultation with the authorities of other countries concerned, to use the method which in the light of all the known facts seems most likely to produce that result.

"The use of any method which allocates to a part of an enterprise a proportion of the total profits of the whole does, of course, raise the question of the method to be used in computing the total profits of the enterprise. This may well be a matter which will be treated differently under the laws of different countries. This is not a problem which it would seem practicable to attempt to resolve by laying down any rigid rule. It is scarcely to be expected that it would be accepted that the profits to be apportioned should be the profits as they are computed under the laws of one particular country; each country concerned would have to be given the right to compute the profits according to the provisions of its own laws."

Paragraph 5

This paragraph reproduces article 7, paragraph 6, of the OECD Model Convention. In the words of the OECD commentary, the paragraph "is intended to lay down clearly that a method of allocation once used should not be changed merely because in a particular year some other method produces more favourable results. One of the purposes of a double taxation convention is to give an enterprise of a Contracting State some degree of certainty about the tax treatment that will be accorded to its permanent establishment in the other Contracting State as well as to the part of it in its home State which is dealing with the permanent establishment; for this reason, paragraph 6 gives an assurance of continuous and consistent tax treatment."

Paragraph 6

This paragraph reproduces article 7, paragraph 7, of the OECD Model Convention. The commentary on that paragraph is therefore relevant to article 7, paragraph 6, of the United Nations Model Convention. The commentary reads as follows:

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

"This interpretation of the term profits, however, may give rise to some uncertainty as to the application of the Convention. If the profits of an enterprise include categories of income which are treated separately in other articles of the Convention, e.g.

dividends, it may be asked whether the taxation of those profits is governed by the special Article on dividends etc., or by the provisions of this Article.

"To the extent that an application of this Article and the special Article concerned would result in the same tax treatment, there is little practical significance to this question. Further, it should be noticed that some of the special Articles contain specific provisions giving priority to a specific article (cf. paragraph 4 of Article 6, paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21.

"It has seemed desirable, however, to lay down a rule of interpretation in order to clarify the field of application of the present Article in relation to the other Articles dealing with a specific category of income. In conformity with the practice generally adhered to in existing bilateral conventions, paragraph 7 gives first preference to the special Articles on dividends, interest etc. It follows from the rule that this article will be applicable to industrial and commercial income which does not belong to categories of income covered by the special articles, and, in addition, to dividends, interest etc. which under paragraph 4 of Articles 10 and 11, paragraph 3 of Article 12 and paragraph 2 of Article 21 fall within this article. It is understood that the items of income covered by the special Articles may, subject to the provisions of the Convention, be taxed either separately, or as industrial and commercial profits, in conformity with the tax laws of the Contracting States.

"It is open to Contracting States to agree bilaterally upon special explanations or definitions concerning the term 'profits' with a view to clarifying the distinction between this term and e.g. the concept of dividends. It may in particular be found appropriate to do so where in a convention under negotiation a deviation has been made from the definitions in the special Articles on dividends, interest and royalties. It may also be deemed desirable if the Contracting States wish to place on notice, that, in agreement with the domestic tax laws of one or both of the States, the term 'profits' includes special classes of receipts such as income from the alienation or the letting of a business or of movable property used in a business. In this connexion it may have to be considered whether it would be useful to include also additional rules for the allocation of such special profits."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 7 OF THE OECD MODEL CONVENTION

Observations on the commentary

"*Australia* and *New Zealand* would wish to be free to propose in bilateral negotiations a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

"*Australia* would wish that in this Article there be provision that will permit resort to domestic law in relation to the taxation of the profit of an insurance enterprise.

"While *New Zealand*, for the purpose of negotiating conventions with other Member countries, accepts, in general, the principles of this Article relating to the attribution of profits to a permanent establishment, it would wish to be free to negotiate for the inclusion of specific provision governing the basis of attribution in some particular situations."

Reservations on the article

"*New Zealand* reserves the right to exclude from the scope of this Article income from the business of any form of insurance.

"The *United States* believes it appropriate to provide in paragraph 2 for arm's length treatment not only with the head office of the enterprise, but also with any person controlling, controlled by, or subject to the same common control as, the enterprise. This can be accomplished by changing the phrase 'separate enterprise' to 'independent enterprise' and by deleting the last fourteen words."

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

A. GENERAL CONSIDERATIONS

Two alternative versions are given for article 8 of the United Nations Model Convention, namely article 8 A and article 8 B. Article 8 A reproduces article 8 of the OECD Model Convention. Article 8 B contains major substantive changes in relation to article 8 of the OECD Model Convention in that it deals separately with profits from the operation of aircraft and profits from the operation of ships which are covered in paragraphs 1 and 2 respectively. The remaining paragraphs (3, 4 and 5) reproduce paragraphs 2, 3 and 4 of article 8 of the OECD Model Convention with one minor adjustment in paragraph 5.

With regard to the taxation of profits from the operation of ships in international traffic several members from developed countries supported the position taken in article 8 of the OECD Model Convention. In their view, shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extended; taxation at the place of effective management was also preferable from the viewpoint of the various tax administrations. They argued that if every country taxed a portion of the profits of a shipping line, computed according to its own rules, the sum of those portions might well exceed the total income of the enterprise. According to them, that would constitute a serious problem, especially because taxes in the developing countries were often excessively high, and the total profits of shipping enterprises were frequently quite modest. However, certain members from developed countries said they found taxation of shipping profits at the source acceptable.

Most members from developing countries asserted that those countries were not in a position to forgo even the limited revenue to be derived from taxing foreign shipping enterprises as long as their own shipping industries were not more fully developed. They recognized, however, that considerable difficulties were involved in determining a taxable profit in such a situation and allocating the profit to the various countries concerned.

While certain members from developed countries expressed no serious objection to the proposal for source taxation of shipping profits, a large number of members from developed countries said they still preferred the principle of exclusive taxation by the State in which the place of effective management of the enterprise was situated. Since no consensus could be reached on a provision concerning the taxation of shipping profits that could be included in the article, the Group agreed that the question of such taxation should be left to bilateral negotiations.

It should be noted that while the texts of both articles 8 A and 8 B refer to the "place of effective management of the enterprise", some countries may wish to refer instead to the "country of residence of the enterprise".

There was a consensus within the group to recommend articles 8 A or 8 B as alternatives. However some members could not agree to article 8 A but also could not agree to article 8 B because of the phrase "more than casual". They argued that some countries might wish to tax either all shipping profits or all airlines profits and acceptance might thus lead to revenue losses, considering the limited number of shipping companies or airlines whose effective management was situated in those countries. The group agreed that in such cases taxation should be left to bilateral negotiations.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLES 8 A AND 8 B

Paragraph 1 of article 8 A

This paragraph, which reproduces article 8, paragraph 1, of the OECD Model Convention, has the same object as the latter paragraph, namely, to ensure that profits from the operation of ships or aircraft in international traffic will be taxed in one State alone. The paragraph is based on the principle that the profits concerned are wholly exempt from tax at source and are taxed exclusively in the State in which the place of effective management of the enterprise engaged in international traffic is situated. The exemption from tax in the source country of foreign enterprises engaged in international shipping traffic is predicated largely on the premise that the income of these enterprises is earned on the high seas, that exposure to the tax laws of numerous countries is likely to result in double taxation or at best in difficult allocation problems, and that exemption in places other than the home country ensures that the enterprises will not be taxed in foreign countries if their over-all operations turn out to be unprofitable. Considerations relating to international air traffic are similar. Since many developing countries with water boundaries do not have resident shipping companies but do have ports used to a significant extent by ships from other countries, they have traditionally disagreed with the principle of such an exemption of shipping profits.

The commentary on article 8, paragraph 1, of the OECD Model Convention notes that:

"In certain circumstances the Contracting State in which the place of effective management is situated may not be the State of which an enterprise operating ships or aircraft is a resident, and some States therefore prefer to confer the exclusive taxing right on the State of residence."

The commentary suggests that "such States are free to substitute a rule on the following lines:

"Profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic shall be taxable only in that State."

The commentary then adds the following:

"Some other States, on the other hand, prefer to use a combination of the residence criterion and the place of effective management criterion by giving the primary right to tax to the State in which the place of effective management is situated while the State of residence eliminates double taxation in accordance with Article 23, so long as the former State is able to tax the total profits of the enterprise, and by giving the primary right to tax to the State of residence when the State of effective management is not able to tax total profits. States wishing to follow that principle are free to substitute a rule on the following lines:

" 'Profits of an enterprise of a Contracting State from the operation of ships or aircraft, other than those from transport by ships or aircraft, operated solely between places in the other Contracting State, shall be taxable only in the first-mentioned

State. However, where the place of effective management of the enterprise is situated in the other State and that other State imposes tax on the whole of the profits of the enterprise from the operation of ships or aircraft, the profits from the operation of ships or aircraft, other than those from transport by ships or aircraft operated solely between places in the first-mentioned State, may be taxed in that other State.'

"The profits covered consist in the first place of the profits obtained by the enterprise from the carriage of passengers or cargo. With this definition, however, the provision would be unduly restrictive, in view of the development of shipping and air transport, and for practical considerations also. The provision therefore covers other classes of profits as well, i.e. those which by reason of their nature or their close relationship with the profits directly obtained from transport may all be placed in a single category. Some of these classes of profits are mentioned in the following paragraphs.

"Profits obtained by leasing a ship or aircraft on charter fully equipped, manned and supplied must be treated like the profits from the carriage of passengers or cargo. Otherwise, a great deal of business of shipping or air transport would not come within the scope of the provision. The Article does not apply to profits from leasing a ship or aircraft on a bare boat charter basis except when it is an occasional source of income for an enterprise engaged in the international operation of ships or aircraft.

"The principle that the taxing right should be left to one Contracting State alone makes it unnecessary to devise detailed rules e.g. for defining the profits covered, this being rather a question of applying general principles of interpretation.

"Shipping and air transport enterprises—particularly the latter—often engage in additional activities more or less closely connected with the direct operation of ships and aircraft. Although it would be out of the question to list here all the auxiliary activities which could properly be brought under the provision, nevertheless a few examples may usefully be given.

"The provision applies, inter alia, to the following activities:

"(*a*) the sale of passage tickets on behalf of other enterprises;

"(*b*) the operation of a bus service connecting a town with its airport;

"(*c*) advertising and commercial propaganda;

"(*d*) transportation of goods by truck connecting a depot with a port or airport.

"If an enterprise engaged in international transport undertakes to see to it that, in connexion with such transport, goods are delivered directly to the consignee in the other Contracting State, such inland transportation is considered to fall within the scope of the international operation of ships or aircraft and, therefore, is covered by the provisions of this article.

"Recently, 'containerisation' has come to play an increasing role in the field of international transport. Such containers frequently are also used in inland transport. Profits derived by an enterprise engaged in international transport from the lease of containers which is supplementary or incidental to its international operation of ships or aircraft fall within the scope of this article.

"On the other hand, the provision does not cover a clearly separate activity, such as the keeping of a hotel as a separate business; the profits from such an establishment are in any case easily determinable. In certain cases, however, circumstances are such that the provision must apply even to a hotel business, e.g. the keeping of a hotel for no other purpose than to provide transit passengers with night accommodation, the cost of such a service being included in the price of the passage ticket. In such a case, the hotel can be regarded as a kind of waiting room.

"There is another activity which is excluded from the field of application of the provision, namely a shipbuilding yard operated in one country by a shipping enterprise having its place of effective management in another country.

"It may be agreed bilaterally that profits from the operation of a vessel engaged in fishing, dredging or hauling activities on the high seas be treated as income falling under this article.

"Investment income of shipping, inland waterways or air transport enterprises (e.g. income from stocks, bonds, shares or loans) is to be subjected to the treatment ordinarily applied to this class of income."

Paragraph 1 of article 8 B

This paragraph reproduces article 8, paragraph 1, of the OECD Model Convention, with the deletion of the words "ships or". Thus the paragraph does not apply to the taxation of profits from the operation of ships in international traffic but does apply to the taxation of profits from the operation of aircraft in international traffic. Hence the commentary on article 8 A, paragraph 1, is relevant in so far as aircraft are concerned.

However, during the discussion by the Group of Experts, several members from developing countries, although agreeing to the consensus, pointed out, in connexion with the taxation of profits from the operation of aircraft in international traffic, that no consideration had been given to the very substantial expenditure that developing countries incurred in the construction of airports. They considered that it would appear more reasonable to situate the geographical source of profits from international transportation at the place where passengers or freight were booked.

Paragraph 2 of article 8 B

The Group observed that countries wishing to adopt the approach embodied in the aforementioned alternative proposal might note that the taxation of shipping profits in the country in which those profits originated (source country) was based on an operative rule for the shipping business and was not qualified by the provisions of articles 5 and 7 relating to business profits governed by the permanent establishment rule. Such taxation thus covered both regular or frequent shipping visits and irregular or isolated visits, provided the latter were planned and not merely fortuitous. The phrase "more than casual" meant a scheduled or planned visit of a ship to a particular country to pick up freight or passengers. The over-all net profits should, in general, be determined by the authorities of the country in which the place of effective management of the enterprise is situated (or country of residence). The final conditions of the determination might be decided in bilateral negotiations. In the course of such negotiations, it might be specified, for example, whether the net profits were to be determined before the deduction of special allowances or incentives which could not be assimilated to depreciation allowances but could be considered rather as subsidies to the enterprise. It might also be specified in the course of the bilateral negotiations that direct subsidies paid to the enterprise by a Government should be included in net profits. The method for the recognition of any losses incurred during prior years, for the purpose of the determination of net profits, might also be worked out in the negotiations. In order to implement that approach, the country of residence would furnish a certificate indicating the net shipping profits of the enterprise and the amounts of any special items, including prior-year losses, which in accordance with the decisions reached in the negotiations were to be included in, or excluded from, the determination of the net profits to be apportioned or otherwise specially treated in that determination. The allocation of profits to be taxed might be based on some proportional factor specified in the bilateral negotiations, preferably the factor of outgoing freight receipts (determined on a uniform basis with or without the deduction of commissions). The percentage reduction in the tax computed on the basis of the allocated profits was intended to achieve a sharing of revenues that would reflect the managerial and capital inputs originating in the country of residence.

Paragraph 2 of article 8 A and paragraph 3 of article 8 B

Each of these paragraphs reproduces article 8, paragraph 2, of the OECD Model Convention. The paragraphs are applicable not only to inland waterways transport between two or more countries but also to inland waterways transport effected by an enterprise of one country between two points in another country. They do not preclude the settlement through bilateral negotiations of any specific tax problem which may occur with regard to inland waterways transport, particularly between adjacent countries.

With regard to enterprises not exclusively engaged in shipping, inland waterways transport or air transport, the commentary on article 8, paragraph 2, of the OECD Model Convention observes:

> "If such an enterprise has in a foreign country permanent establishments exclusively concerned with the operation of its ships or aircraft, there is no reason to treat such establishments differently from the permanent establishments of enterprises engaged exclusively in shipping, inland waterways transport or air transport.
>
> "Nor does any difficulty arise in applying the provisions of paragraphs 1 and 2 if the enterprise has in another State a permanent establishment which is not exclusively engaged in shipping, inland waterways transport or air transport. If its goods are carried in its own ships to a permanent establishment belonging to it in a foreign country, it is right to say that none of the profit obtained by the enterprise through acting as its own carrier can properly be attributed to the permanent establishment. The same must be true even if the permanent establishment maintains installations for operating the ships or aircraft (e.g. consignment wharves) or incurs other costs in connection with the carriage of the enterprise's goods (e.g. staff costs). In this case, the permanent establishment's expenditure in respect of the operation of the ships, boats, or aircraft should be attributed not to the permanent establishment but to the enterprise itself, since none of the profit obtained through the carrying benefits the permanent establishment.
>
> "Where the enterprise's ships or aircraft are operated by a permanent establishment which is not the place of effective management of the whole enterprise (e.g. ships or aircraft put into service by the permanent establishment and figuring on its balance sheet), then the effective management for the purposes of paragraphs 1 and 2 must be considered, as regards the operation of the ships or aircraft as being in the Contracting State in which the permanent establishment is situated."

Paragraph 3 of article 8 A and paragraph 4 of article 8 B

Each of these paragraphs, which reproduces article 8, paragraph 3, of the OECD Model Convention, refers to the case in which the place of effective management of the enterprise concerned is aboard a ship or a boat. As noted in the commentary on article 8, paragraph 3, of the OECD Model Convention, "In this case tax will only be charged by the State where the home harbour of the ship or boat is situated. It is provided that if the home harbour cannot be determined, tax will be charged only in the Contracting State of which the operator of the ship or boat is a resident."

Paragraph 4 of article 8 A and paragraph 5 of article 8 B

Paragraph 4 of article 8 A reproduces article 8, paragraph 4, of the OECD Model Convention. Paragraph 5 of article 8 B likewise reproduces the latter paragraph, with one adjustment, namely, the replacement of the word "paragraph 1" by the words "paragraphs 1 and 2". As the commentary on article 8, paragraph 4, of the OECD Model Convention observes:

> "Various forms of international co-operation exist in shipping or air transport. In this field, international co-operation is secured through pooling agreements or other conventions of a similar kind which lay down certain rules for apportioning the receipts (or profits) from the joint business.
>
> "In order to clarify the taxation position of the participant in a pool, joint business or in an international operating agency and to cope with any difficulties which may arise the Contracting States may bilaterally add the following, if they find it necessary:
>
> " 'but only to so much of the profits so derived as is attributable to the participant in proportion to its share in the joint operation.' "

C. SPECIAL DEROGATION, OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 8 OF THE OECD MODEL CONVENTION

Special derogation

"In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic, to remuneration of crews of such ships, to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships, and to capital gains from the alienation of such ships and assets."

Observations on the commentary

"While agreeing in principle to abide by the provisions of Article 8 in bilateral conventions, *Turkey* intends in exceptional cases to apply the permanent establishment rule in taxing international transport profits.

"*Portugal, Spain* and *Turkey* reserve the right, in the course of negotiations for concluding conventions with other Member countries, to propose that the part of inland transport (cf. paragraph 9 above) carried out by means other than that employed for international transport be excluded from the scope of the Article, whether or not the means of transport belong to the transporting enterprise.

"These countries also reserve the right, in the course of such negotiations, to propose that the leasing of containers (cf. paragraph 10 above) even if supplementary or incidental be regarded as an activity separate from international shipping or aircraft operations, and consequently be excluded from the scope of the Article.

"*Germany* reserves its position as to the application of the Article to income from inland transportation and container services (cf. paragraphs 9 and 10 above)."

Reservations on the article

"*Australia* and *Canada* reserve the right to tax as profits from internal traffic profits from the carriage of passengers or cargo taken on board at one place in a respective country for discharge at another place in the same country. Australia also reserves the right to tax as profits from internal traffic profits from other coastal and continental shelf activities.

"*Canada, Turkey* and the *United States* reserve the right not to extend the scope of the Article to cover inland transportation in bilateral conventions (paragraph 2 of the Article)."

Article 9

ASSOCIATED ENTERPRISES

A. GENERAL CONSIDERATIONS

Article 9 of the United Nations Model Convention reproduces article 9 of the OECD Model Convention.

This article deals with associated enterprises, i.e., parent and subsidiary companies and companies under common control. It should be considered in conjunction with article 25 on mutual agreement procedure and article 26 on exchange of information, just as article 9 of the OECD Model Convention has to be considered with articles 25 and 26 of that Convention.

The application of the arm's-length rule to the allocation of profits between the home office and its permanent establishment presupposes for most countries that the domestic legislation authorizes a determination on the basis of the arm's-length principle.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 9

Paragraph 1

Under this paragraph, as under article 9, paragraph 1, of the OECD Model Convention, the tax authorities of a Contracting State may, for the purpose of calculating tax liabilities, in the words of the OECD commentary on that paragraph "re-write the accounts of the enterprises if as a result of the special relations between the enterprises the accounts do not show the true taxable profits arising in that State". After observing that "it is evidently appropriate that adjustment should be sanctioned in such circumstances", the commentary states: "It should perhaps be mentioned that the provisions of this paragraph apply only if special conditions have been made or imposed between the two enterprises. No re-writing of the accounts of associated enterprises is authorised if the transactions between such enterprises have taken place on normal open market commercial terms (on an arm's-length basis)."

Paragraph 2

In the words of the commentary on article 9, paragraph 2, of the OECD Model Convention, "The re-writing of transactions between associated enterprises in the situation envisaged in paragraph 1 may give rise to economic double taxation (taxation of the same income in the hands of different persons), in so far as an enterprise of State A whose profits are revised upwards will be liable to tax on an amount of profit which has already been taxed in the hands of its associated enterprise in State B." The OECD commentary observes that "paragraph 2 provides that in these circumstances, State B shall make an appropriate adjustment so as to relieve the double taxation". The remainder of the commentary on article 9, paragraph 2, of the OECD Model Convention reads as follows:

> "It should be noted, however, that an adjustment is not automatically to be made in State B simply because the profits in State A have been increased; the adjustment is due only if State B considers that the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm's length. In other words, the paragraph does not seek to avoid a double charge to tax which arises where the profits of one associated enterprise are increased to a level which exceeds what they would have been if they had been correctly computed on an arm's-length basis. State B is therefore committed to make an adjustment of the profits of the affiliated company only if it

considers that the adjustment made in State A is justified both in principle and as regards the amount.

"The paragraph does not specify the method by which an adjustment is to be made. OECD Member countries use different methods to provide relief in these circumstances and it is therefore left open for Contracting States to agree bilaterally on any specific rules which they wish to add to the Article. Some States, for example, would prefer the system under which, where the profits of enterprise X in State A are increased to what they would have been on an arm's-length basis, the adjustment would be made by re-opening the assessment on the associated enterprise Y in State B containing the doubly taxed profits in order to reduce the taxable profit by an appropriate amount. Some other States, on the other hand, would prefer to provide that, for the purposes of article 23, the doubly taxed profits should be treated in the hands of enterprise Y of State B as if they may be taxed in State A; accordingly, the enterprise of State B is entitled to relief in State B, under Article 23, in respect of tax paid by its associate enterprise in State A.

"It is not the purpose of the paragraph to deal with what might be called 'secondary adjustments'. Suppose that an upward revision of taxable profits of enterprise X in State A has been made in accordance with the principle laid down in paragraph 1; and suppose also that an adjustment is made to the profits of enterprise Y in State B in accordance with the principle laid down in paragraph 2. The position has still not been restored exactly to what it would have been had the transactions taken place at arm's-length prices because, as a matter of fact, the money representing the profits which are the subject of the adjustment is found in the hands of enterprise Y instead of in those of enterprise X. It can be argued that if arm's-length pricing had operated and enterprise X had subsequently wished to transfer these profits to enterprise Y, it would have done so in the form of, for example, a dividend or a royalty (if enterprise Y were the parent of enterprise X) or in the form of, for example, a loan (if enterprise X were the parent of enterprise Y); and that in those circumstances there could have been other tax consequences (e.g. the operation of a withholding tax) depending upon the type of income concerned and the provisions of the article dealing with such income.

"These secondary adjustments, which would be required to establish the situation exactly as it would have been if transactions had been at arm's length, depend on the facts of the individual case. It should be noted that nothing in paragraph 2 prevents such secondary adjustments from being made where they are permitted under the domestic laws of Contracting States.

"The paragraph also leaves open the question whether there should be a period of time after the expiration of which State B would not be obliged to make an appropriate adjustment to the profits of enterprise Y following an upward revision of the profits of enterprise X in State A. Some States consider that State B's commitment should be open-ended—in other words, that however many years State A goes back to revise assessments, enterprise Y should in equity be assured of an appropriate adjustment in State B. Other States consider that an open-ended commitment of this sort is unreasonable as a matter of practical administration. In the circumstances, therefore, this problem has not been dealt with in the text of the Article; but Contracting States are left free in bilateral conventions to include, if they wish, provisions dealing with the length of time during which State B is to be under obligation to make an appropriate adjustment.

"If there is a dispute between the interested parties over the character and amount of the appropriate adjustment, the matter will be dealt with in the same way as any other question of fact; if necessary the competent authorities may consult each other."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 9 OF THE OECD MODEL CONVENTION

Observations on the commentary

"In negotiating conventions with other Member countries, *Australia* and *New Zealand* would wish to be free to propose a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to an enterprise, the competent authority may apply to that enterprise for that purpose the provisions of the taxation law of that State, subject to the qualification that such law will be applied, as far as the information available to the competent authority permits, in accordance with the principles of this Article.

"*Australia* would wish that, in this Article, there be provision that will permit resort to domestic law in relation to the taxation of the profits of an insurance enterprise."

Reservations on the article

"*Belgium, Finland, Germany, Italy, Japan, Portugal* and *Switzerland* reserve the right not to insert paragraph 2 in their conventions.

"The *United States* believes that this Article should apply to all related persons, not just an enterprise of one Contracting State and a related enterprise of the other Contracting State, and that it should apply to 'income, deductions, credits or allowances', not just to 'profits'."

Article 10

DIVIDENDS

A. GENERAL CONSIDERATIONS

Article 10 of the United Nations Model Convention reproduces the provisions of article 10 of the OECD Model Convention with the exception of those of paragraph 2, in which substantive changes have been made.

According to the commentary on article 10 of the OECD Model Convention, the term "dividends" generally means the distribution of profits to the shareholders by companies limited by shares (*sociétés anonymes*), limited partnerships with share capital (*sociétés en commandite par actions*), limited liability companies (*sociétés à responsabilité limitée*) or other joint stock companies (*sociétés de capitaux*).

The OECD commentary also observes:

"The profits of a business carried on by a partnership are the partners' profits derived from their own exertions; for them they are industrial or commercial profits. So the partner is ordinarily taxed personally on his share of the partnership capital and partnership profits.

"The position is different for the shareholder; he is not a trader and the company's profits are not his; so they cannot be attributed to him. He is personally taxable only on those profits which are distributed by the company (apart from the provisions in certain countries' laws relating to the taxation of undistributed profits in special cases). From the shareholders' standpoint, dividends are income from the capital which they have made available to the company as its shareholders."

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 10

Paragraph 1

This paragraph reproduces article 10, paragraph 1, of the OECD Model Convention. By providing simply that dividends may be taxed in the State of the beneficiary's residence, the paragraph does not prescribe the taxation of dividends exclusively in that State and leaves open the possibility of taxation by the State of which the company paying the dividends is a resident, that is, the State in which the dividends originate (source country). Although agreeing to the consensus on paragraph 1 of article 10, many members from developing countries felt that as a matter of principle dividends should be taxed only by the source country. According to them, if both the country of residence and the source country were given the right to tax, the country of residence should grant a full tax credit regardless of the amount of foreign tax to be absorbed and, in appropriate cases, a tax-sparing credit. One of those members emphasized that there was no necessity for a developing country to waive or reduce its withholding tax on dividends, especially if it offered tax incentives and other concessions.

According to the commentary on article 10, paragraph 1, of the OECD Model Convention, this paragraph:

> "... does not prescribe the principle of taxation of dividends either exclusively in the State of the beneficiary's residence or exclusively in the State of which the company paying the dividends is a resident.
>
> "Taxation of dividends exclusively in the State of source is not acceptable as a general rule. Furthermore, there are some States which do not have taxation of dividends at the source, while as a general rule, all the States tax residents in respect of dividends they receive from non-resident companies.
>
> "On the other hand, taxation of dividends exclusively in the State of the beneficiary's residence is not feasible as a general rule. It would be more in keeping with the nature of dividends, which are investment income, but it would be unrealistic to suppose that there is any prospect of it being agreed that all taxation of dividends at the source should be relinquished.
>
> "For this reason, paragraph 1 states simply that dividends may be taxed in the State of the beneficiary's residence. The term 'paid' has a very wide meaning, since the concept of payment means the fulfilment of the obligation to put funds at the disposal of the shareholder in the manner required by contract or by custom.
>
> "The article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State. It does not, therefore, apply to dividends paid by a company which is a resident of a third State or to dividends paid by a company which is a resident of a Contracting State which are attributable to a permanent establishment which an enterprise of that State has in the other Contracting State."

Paragraph 2

This paragraph reproduces article 10, paragraph 2, of the OECD Model Convention with three substantive changes, namely, the deletion of "5 per cent" in subparagraph (*a*) and "15 per cent" in subparagraph (*b*) and their replacement by "a certain percentage (to be established through bilateral negotiations)", and the replacement of "25 per cent" in subparagraph (*a*) by "10 per cent". In subparagraphs (*a*) and (*b*) "a certain percentage (to be established through bilateral negotiations)" was used because the Group was unable to reach a consensus on the percentages of the gross amount of the dividends to be used. The members from developing countries, who basically preferred the principle of the taxation of dividends exclusively in the source country, considered that the adoption of the percentages of the gross amount of the dividends used in article 10, paragraph 2, of the OECD Model Convention would entail too large a loss of revenue for the source country. Nevertheless they were not opposed to taxation in the beneficiary's country of residence provided that any reduction in withholding taxes in the source country benefited the foreign investor rather than the Treasury of the Government of the beneficiary's country of residence, as was the case under the traditional tax-credit method whenever the reduction lowered the cumulative tax rate of the source country below the rate of the beneficiary's country of residence.

The replacement of "25 per cent" by "10 per cent" in subparagraph (*a*) takes account of the fact that in some developing countries non-residents are limited to a 50 per cent share ownership, so that 10 per cent represents a significant portion of such permitted ownership.

The Group of Experts felt that in the bilateral negotiations relating to the percentage of gross amount of the dividends if the beneficial owner directly held at least 10 per cent of the capital of the company paying the dividends, the negotiating countries might be guided by the following considerations:

First, if the developed (residence) country uses a credit system, the negotiations could appropriately seek a limitation on withholding tax rates at source that would, in combination with the basic corporate tax rate of the source country, produce a combined effective rate that does not exceed the tax in the residence country. In ascertaining the effective rate that exists in the absence of limitation, consideration might be given to the effect of tax incentives and other provisions in the source country affecting the rates of tax. Hence, a treaty could provide for different withholding rates at different stages of activity of an enterprise as incentive measures ceased to be operative. Distinctions might be drawn in the negotiations, if appropriate and feasible, between old and new investments. This over-all approach could result in varying reductions in the withholding rates of the same source country in various treaties, depending upon the relationship between the combined effective rate of the source country and the rates of the different residence countries. In other words, the treaties of a residence country may contain varying reductions in withholding rates among the developing countries with which it has treaties. Any limitation in withholding rates so negotiated would of necessity be a benefit to the investor, since it would be the purpose of the limitation to reduce the effective rate of the source country to the credit level of the residence country.

Secondly, if the developed country uses an exemption system for double-taxation relief, it may, in bilateral negotiations, seek a limitation on withholding rates on several grounds: (*a*) that the exemption itself stresses the concept of not taxing intercorporate dividends, and a limitation of the withholding rate at source would be in keeping with that concept; (*b*) that the exemption and resulting departure from tax neutrality with domestic investment are of benefit to the international investor, and hence a limitation of the withholding rate at source would be in keeping with this step, since that limitation would also benefit the investor.

Thirdly, with respect to portfolio investment, both the source country and the country of residence should be in a position to tax dividends paid on the shares involved, although the relatively small amount of portfolio investment and its distinctly lesser importance compared with direct investment might make the issues concerning its tax treatment less intense in some cases. However, some source countries may have varying views on the importance of portfolio investment and on the figures to be inserted.

It may be recalled that the OECD commentary on article 10, paragraph 2, of the OECD Model Convention contains the following passages:

> "If a partnership is treated as a body corporate under the domestic laws applying to it, the two Contracting States may agree to modify subparagraph (*a*) of paragraph 2 in a way to give the benefits of the reduced rate provided for parent companies also to such partnership.
>
> "Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. States which wish to make this more explicit are free to do so during bilateral negotiations.
>
> "The tax rates fixed by the article for the tax in the State of source are maximum rates. The States may agree, in bilateral negotiations, on lower rates or even on taxation exclusively in the State of the beneficiary's residence. The reduction of rates provided for in paragraph 2 refers solely to the taxation of dividends and not to the taxation of the profits of the company paying the dividends.
>
> "The two Contracting States may also, during bilateral negotiations, agree to a holding percentage lower than that fixed in the article. A lower percentage is, for instance, justified in cases where the state of residence of the parent company, in

accordance with its domestic law, grants exemption to such a company for dividends derived from a holding of less than 25 per cent in a non-resident subsidiary.

"In subparagraph (*a*) of paragraph 2, the term 'capital' is used in relation to the taxation treatment of dividends, i.e. distributions of profits to shareholders. The use of this term in this context implies that, for the purposes of subparagraph (*a*), it should be used in the sense in which it is used for the purposes of distribution to the shareholder (in the particular case, the parent company).

"(*a*) As a general rule, therefore, the term 'capital' in subparagraph (*a*) should be understood as it is understood in company law. Other elements, in particular the reserves, are not to be taken into account.

"(*b*) Capital, as understood in company law, should be indicated in terms of par value of all shares which in the majority of cases will be shown as capital in the company's balance sheet.

"(*c*) No account need be taken of differences due to the different classes of shares issued (ordinary shares, preference shares, plural voting shares, non-voting shares, bearer shares, registered shares, etc.), as such differences relate more to the nature of the shareholder's right than to the extent of his ownership of the capital.

"(*d*) When a loan or other contribution to the company does not, strictly speaking, come as capital under company law but when on the basis of internal law or practice ('thin capitalisation', or assimilation of a loan to share capital), the income derived in respect thereof is treated as dividend under Article 10, the value of such loan or contribution is also to be taken as 'capital' within the meaning of subparagraph (*a*).

"(*e*) In the case of bodies which do not have a capital within the meaning of company law, capital for the purpose of subparagraph (*a*) is to be taken as meaning the total of all contributions to the body which are taken into account for the purpose of distributing profits.

In bilateral negotiations, Contracting States may depart from the criterion of 'capital' used in subparagraph (*a*) of paragraph 2 and use instead the criterion of 'voting power'.

"Subparagraph (*a*) of paragraph 2 does not require that the company receiving the dividends must have owned at least 25 per cent of the capital for a relatively long time before the date of the distribution. This means that all that counts regarding the holding is the situation prevailing at the time material for the coming into existence of the liability to the tax to which paragraph 2 applies, i.e. in most cases the situation existing at the time when the dividends become legally available to the shareholders. The primary reason for this resides in the desire to have a provision which is applicable as broadly as possible. To require the parent company to have possessed the minimum holding for a certain time before the distribution of the profits could involve extensive inquiries. Internal laws of certain OECD Member countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received. In view of this, Contracting States may include a similar condition in their conventions.

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

" 'provided that this holding was not acquired primarily for the purpose of taking advantage of this provision';

"Paragraph 2 lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment.

"The paragraph does not settle procedural questions. Each State should be able to use the procedure provided in its own laws. It can either forthwith limit its tax to the rates given in the article or tax in full and make a refund.

"It does not specify whether or not the relief in the State of source should be conditional upon the dividends being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

"The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the dividends. This question is dealt with in articles 23 A and 23 B.

"Attention is drawn generally to the following case: the beneficial owner of the dividends arising in a Contracting State is a company resident of the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the dividends the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this article, in order to define the treatment applicable to such companies."

Paragraph 3

This paragraph reproduces article 10, paragraph 3, of the OECD Model Convention, the commentary on which reads as follows:

"In view of the great differences between the laws of OECD Member countries, it is impossible to define "dividends" fully and exhaustively. Consequently, the definition merely mentions examples which are to be found in the majority of the Member countries' laws and which, in any case, are not treated differently in them. The enumeration is followed up by a general formula. In the course of the revision of the 1963 Draft Convention, a thorough study has been undertaken to find a solution which does not refer to domestic laws. This study has led to the conclusion that, in view of the still remaining dissimilarities between Member countries in the field of company law and taxation law, it does not yet appear to be possible to work out a definition of the concept of dividends that would be independent of domestic laws. It is open to the Contracting States, through bilateral negotiations, to make allowance for peculiarities of their laws and to agree to bring under the definition of 'dividends' other payments by companies falling under the article.

"The notion of dividends basically concerns distributions by companies within the meaning of subparagraph (*b*) of paragraph 1 of Article 3. Therefore the definition relates, in the first instance, to distributions of profits the titles to which are constituted by shares, that is holdings in a company limited by shares (joint stock company). The definition assimilates to shares all securities issued by companies which carry a right to participate in the companies' profits without being debt-claims; such are, for example, 'jouissance' shares or 'jouissance' rights, founders' shares or other rights participating in profits. In bilateral conventions, of course, this enumeration may be adapted to the legal situation in the Contracting States concerned. This may be necessary in particular, as regards income from 'jouissance' shares and founders' shares. On the other hand, debt-claims participating in profits do not come into this category; likewise interest on convertible debentures is not a dividend.

"The laws of many of the States put participations in a "Société à responsabilité limitée" (limited liability company) on the same footing as shares. Likewise, distributions of profits by co-operative societies are generally regarded as dividends.

"Distributions of profits by partnerships are not dividends within the meaning of the definition, unless the partnerships are subject, in the State where their place of effective management is situated, to a fiscal treatment substantially similar to that applied to companies limited by shares (for instance, in Belgium, Portugal and Spain, also in France as regards distributions to "commanditaires" in the "sociétés en commandite simple"). On the other hand, clarification in bilateral conventions may be necessary in cases where the taxation law of a Contracting State gives the owner of holdings in a company a right to opt, and certain conditions, for being taxed as a partner of a partnership, or, vice versa, gives the partner of a partnership the right to opt for taxation as the owner of holdings in a company.

"Payments regarded as dividends may include not only distributions of profits decided by annual general meetings of shareholders, but also other benefits in money or money's worth, such as bonus shares, bonuses, profits on a liquidation and disguised distributions of profits. The reliefs provided in the article apply so long as the State of which the paying company is a resident taxes such benefits as dividends. It is immaterial whether any such benefits are paid out of current profits made by the company or are derived, for example, from reserves, i.e. profits of previous financial years. Normally, distributions by a company which have the effect of reducing the membership rights, for instance, payments constituting a reimbursement of capital in any form whatever, are not regarded as dividends.

"The benefits to which a holding in a company confer entitlement are, as a general rule, available solely to the shareholders themselves. Should, however, certain of such benefits be made available to persons who are not shareholders within the meaning of company law, they may constitute dividends if:

"—the legal relations between such persons and the company are assimilated to a holding in a company ('concealed holdings') and

"—the persons receiving such benefits are closely connected with a shareholder; this is the case, for example, where the recipient is a relative of the shareholder or is a company belonging to the same group as the company owning the shares.

"When the shareholder and the person receiving such benefits are residents of two different States with which the State of source has concluded conventions, differences of views may arise as to which of these conventions is applicable. A similar problem may arise when the State of source has concluded a convention with one of the States but not with the other. This, however, is a conflict which may affect other types of income, and the solution to it can be found only through an arrangement under the mutual agreement procedure."

Paragraph 4

This paragraph reproduces article 10, paragraph 4, of the OECD Model Convention, the commentary on which reads as follows:

"Certain States consider that dividends, interest and royalties arising from sources in their territory and payable to individuals or legal persons who are residents of other States fall outside the scope of the arrangement made to prevent them from being taxed both in the State of source and in the State of the beneficiary's residence when the beneficiary has a permanent establishment in the former State. Paragraph 4 is not based on such a conception which is sometimes referred to as 'the force of attraction of the permanent establishment'. It does not stipulate that dividends flowing to a resident of a Contracting State from a source situated in the other State must, by a kind of legal presumption, or fiction even, be related to a permanent establishment which that resident may have in the latter State, so that the said State would not be obliged to limit its taxation in such a case. The paragraph merely provides that in the State of source the dividends are taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident of the other State, if they are paid in respect of holdings forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 4 relieves the State of source of the dividends from any limitations under the Article. The foregoing explanations accord with those in the Commentary on Article 7.

"The rules set out above also apply where the beneficiary of the dividends has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in article 14, a fixed base with which the holding in respect of which the dividends are paid is effectively connected."

Paragraph 5

This paragraph reproduces article 10, paragraph 5, of the OECD Model Convention, the commentary on which reads as follows:

"The Article deals only with dividends paid by a company which is a resident of a Contracting State to a resident of the other State. Certain States, however, tax not only dividends paid by companies resident therein—but even distributions by non-resident companies of profits arising within their territory. Each

State, of course, is entitled to tax profits arising in its territory which are made by non-resident companies, to the extent provided in the Convention (in particular in Article 7). The shareholders of such companies should not be taxed as well at any rate, unless they are residents of the State and so naturally subject to its fiscal sovereignty.

"Paragraph 5 rules out the extra-territorial taxation of dividends, i.e. the practice by which States tax dividends distributed by a non-resident company solely because the corporate profits from which the distributions are made originated in their territory (for example, realised through a permanent establishment situated therein). There is, of course, no question of extra-territorial taxation when the country of source of the corporate profits taxes the dividends because they are paid to a shareholder who is a resident of that State or to a permanent establishment or fixed base situated in that State.

"Moreover, it can be argued that such a provision does not aim at, or cannot result in, preventing a State from subjecting the dividends to a withholding tax when distributed by foreign companies if they are cashed in its territory. Indeed, in such a case, the criterion for tax liability is the fact of the payment of the dividends, and not the origin of the corporate profits allotted for distribution. But if the person cashing the dividends in a Contracting State is a resident of the other Contracting State (of which the distributing company is a resident), he may under Article 21 obtain exemption from, or refund of, the withholding tax of the first-mentioned State. Similarly, if the beneficiary of the dividends is a resident of a third State which had concluded a double taxation convention with the State where the dividends are cashed, he may, under Article 21 of that convention, obtain exemption from, or refund of, the withholding tax of the last-mentioned State.

"Paragraph 5 further provides that non-resident companies are not to be subjected to special taxes on undistributed profits."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 10 OF THE OECD MODEL CONVENTION

Observations on the commentary

"*Portugal* makes the following observations as regards paragraph 27 above. Indeed gains from the increase in capital of companies with a head office or place of effective management in Portugal, when the increase results from the capitalisation of reserves or the issue of shares, are taxed under the Portuguese domestic law as capital gains. In bilateral conventions, Portugal usually inserts in Article 13 a provision allowing it to tax such gains.

"The *United Kingdom* does not adhere to paragraph 24 above. Under United Kingdom law, certain interest payments are treated as distributions, and are therefore included by the United Kingdom in the definition of dividends."

Reservations on the article

"*Paragraph 2*

"*Australia* reserves the right always to tax, at a rate of not less than 15 per cent, dividends paid by a company which is a resident of Australia for purposes of its tax.

"*Belgium, Japan* and *New Zealand* reserve their positions on sub-paragraph (*a*) because they wish to retain their freedom of action with regard to the treatment of holding (parent companies and subsidiaries).

"*Canada* reserves the right to apply a 15 per cent rate of tax at source on dividends paid to non-residents without regard to the relation between the company paying the dividends and the beneficial owner.

"*Germany* with a view to its system of company taxation, reserves its position on paragraph 2.

"*Italy* reserves its position concerning the percentage envisaged for the holding (25 per cent) and can only agree to a rate of tax of 5 per cent for a direct holding of more than 50 per cent.

"The *Netherlands* reserves its position on the rate of 5 per cent, since it considers that transfers of profits within a group of enterprises should be entirely exempted from tax at the source.

"*Portugal* reserves its position on the rates of tax in paragraph 2.

"*Spain* reserves its position on the rate of tax of 5 per cent and the determination of the minimum percentage for the holding.

"*Turkey* cannot accept a rate of tax which is lower than 20 per cent.

"*Paragraph 3*

"*Belgium* reserves the right to amplify the definition of dividends in paragraph 3 so as to cover expressly income—even when paid in the form of interest—which is taxable as income from capital invested by partners in Belgian partnerships which have not opted for their profits to be charged to personal income tax in the names of such partners individually.

"In view, moreover, of the fact that Belgian law excludes distributions of liquidation surpluses from the movable capital income category ('revenus mobiliers') and subjects them to a compositional charge to company tax which relieves the individual shareholders or partners from any liability to personal tax, *Belgium* reserves the right to levy, in accordance with its internal law, such "special contributions", either in the case of the redemption of its own shares or partnership shares by a company or partnership resident in Belgium or on the division of its assets by such a company or partnership among its shareholders or members. Such special contributions fall neither under the restrictions provided in paragraph 2, as regards distribution tax charged on dividends, nor under any other restrictive provision whatever of the Convention (paragraph 4 of Article 13; paragraph 1 of Article 21, etc.).

"*Paragraph 4*

"*Italy* reserves the right to subject dividends to the taxes imposed by its law whenever the recipient thereof has a permanent establishment in Italy, even if the holding on which the dividends are paid is not effectively connected with such permanent establishment.

"*Paragraph 5*

"*Australia* reserves the right to impose tax on the undistributed Australian income of a private (close) company which is a resident of the other State.

"*France* cannot adhere to the provisions of this paragraph. France wishes to retain the possibility of applying the provisions in its laws according to which profits made in France by foreign companies are deemed to be distributed to non-resident shareholders and are taxed accordingly. France is prepared, however, to reduce in bilateral conventions the rate provided for in its domestic laws.

"*Spain* cannot adhere without a reservation to the provisions of this paragraph owing to the structure of its fiscal law which provides that permanent establishments in Spain of foreign companies are to be taxed under the same conditions as Spanish companies.

"The *United States* believes that the text should clarify that the prohibition of paragraph 5 will apply regardless of whether the company derives profits or income from the other Contracting State.

"The *United States* reserves the right to impose its accumulated earnings tax and personal holding company tax, to prevent tax avoidance.

"The *United States* reserves the right to apply its dividend withholding tax to dividends paid by a company which is incorporated outside the United States, if at least one-half of the company's income consists of profits attributable to a permanent establishment in the United States."

Article 11

INTEREST

A. GENERAL CONSIDERATIONS

Article 11 of the United Nations Model Convention reproduces the provisions of article 11 of the OECD Model Convention with the exception of paragraphs 2 and 4, in which substantive changes have been made.

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

At the domestic level, interest is usually deductible from the figures used for calculating profits. In this context, any tax on interest is paid by the beneficiary unless a special contract provides that it should be paid by the payer of the interest. Contrary to what occurs in the case of dividends, it is not liable to double taxation, that is, taxation in the hands of both the beneficiary and the payer. If the latter is obliged to withhold a certain portion of the interest as a tax, the interest thus withheld represents an advance on the amount of tax to which the beneficiary will be liable on his aggregate income or profits at the end of the fiscal year. At that time, the beneficiary can deduct the amount withheld by the payer from the amount of tax due from him and obtain reimbursement of any sum by which the amount withheld exceeds the amount of the tax that is finally payable. This mechanism prevents the beneficiary from being taxed twice on the same interest.

At the international level, when the beneficiary of the interest is a resident of one country and the payer of the interest is a resident of another, the same interest is subject to taxation in both countries. This double taxation may considerably reduce the net amount of interest received by the beneficiary or, if the payer has agreed to bear the cost of the tax deductible at the source, will increase the financial burden on the payer.

It may be recalled that the commentary on the OECD Model Convention contains the following "preliminary remarks" concerning the taxation of interest.

" 'Interest' is generally taken to mean remuneration on money lent, being remuneration coming within the category of 'income from movable capital' (revenus de capitaux mobiliers). Unlike dividends, interest does not suffer economic double taxation, that is, it is not taxed both in the hands of the debtor and in the hands of the creditor. Unless it is provided to the contrary by the contract, payment of the tax charged on interest falls on the recipient. If it happens that the debtor undertakes to bear any tax chargeable at the source, this is as though he had agreed to pay his creditor additional interest corresponding to such tax.

"But like dividends, interest on bonds or debentures or loans usually attracts tax charged by deduction at the source when the interest is paid. This method is, in fact, commonly used for practical reasons, as the tax charged at the source can constitute an advance of the tax payable by the recipient in respect of his total income or profits. If in such a case the recipient is a resident of the country which practises deduction at the source, any double taxation he suffers is remedied by internal measures. But the position is different if he is a resident of another country: he is then liable to be taxed twice on the interest, first by the State of source and then by the State of which he is a resident. It is clear that his double charge of tax can reduce considerably the interest on the money lent and so hamper the movement of capital and the development of international investment.

"A formula reserving the exclusive taxation of interest to one State, whether the State of the beneficiary's residence or the State of source, could not be sure of receiving general approval. Therefore a compromise solution was adopted. It provides that interest may be taxed in the State of residence—but leaves to the State of source the right to impose a tax if its laws so provide, it being implicit in this right that the State of source is free to give up all taxation on interest paid to non-residents. Its exercise of this right will however be limited by a ceiling which its tax cannot exceed but, it goes without saying, the Contracting States can agree to adopt an even lower rate of taxation in the State of source. The sacrifice that the latter would accept in such conditions will be matched by a relief to be given by the State of residence, in order to take into account the tax levied in the State of source (cf. Article 23 A or 23 B).

"Certain countries do not allow interest paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise they forbid the deduction. The question whether the deduction should also be allowed in cases where the interest is paid by a resident of a Contracting State to a resident of the other State, is dealt with in paragraph 5 of Article 24."

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 11

Paragraph 1

This paragraph reproduces article 11, paragraph 1, of the OECD Model Convention, the commentary on which reads as follows:

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

"The Article deals only with interest arising in a Contracting State and paid to a resident of the other Contracting State. It does not, therefore, apply to interest arising in a third State or to interest arising in a Contracting State which is attributable to a permanent establishment which an enterprise of that State has in the other Contracting State".

Paragraph 2

This paragraph reproduces article 11, paragraph 2, of the OECD Model Convention with one substantive change, namely, the deletion of the phrase "shall not exceed 10 per cent of the gross amount of the interest" from the first sentence of paragraph 2 and its replacement by the phrase "shall not exceed a certain percentage of the gross amount of the interest (to be established through bilateral negotiations)".

In the Group of Experts, there was strong feeling on the part of members from developing countries that those countries should have the exclusive, or at least the primary, right to tax interest. According to that view, it was incumbent on the developed countries to prevent double taxation of that income through exemption, credit or other relief measures. These members reasoned that interest should be taxed where it was earned, that is, where the capital was put to use. The taxing of interest would also have a significant effect on the economies of developing countries because, apart from its contribution to revenues, it would reduce the outflow of foreign exchange. Some members from developed countries felt that the home country of the investor should have the exclusive right to tax interest, since in their view that would promote the mobility of capital and give the right to tax to the country which was best equipped to consider the characteristics of the taxpayer. Other members from developed countries felt that the developed countries should have the primary right to tax interest and that the country in which the investment was made should make the necessary accommodations to ensure that its tax would be fully offset against the tax of the investor's home country, thus providing tax neutrality as between domestic and foreign investment. They also pointed out that an exemption of foreign interest from the tax of the investor's home country might not be in the best interests of the developing countries because it could induce investors to place their capital in the developing country with the lowest tax rate. Members from developing countries contested that view and stated that tax rates were only one of the factors involved in investments. Members from developed countries also drew attention to the fact that under current conditions, the greater part of international loan capital was provided by banks, pension funds and other large financial institutions, and that the imposition of high withholding taxes on such loans would either make the investment unattractive to institutional lenders, which in any case preferred loans to domestic borrowers, or increase the cost of the loan to the borrower.

During the discussion, it was stressed that in order to take account of the fact that, in the international field, interest mainly related to payments to financial institutions and that the gross figure might not necessarily correspond to net income in certain developing countries, interest payable to non-residents was taxed on a net basis if the lender was engaged in business in the country; otherwise it was taxed on a gross basis. Members from those countries generally were of the opinion that interest should be taxed on a gross basis, both for administrative convenience and for substantive reasons. They agreed on the whole that withholding taxes on interest income should be set at a rate corresponding to the usual corporate tax rate on net income. They conceded that the tax on interest could be higher than that on business income under that method. In that respect, one member from a developing country stressed the importance of taxing on a gross basis as a matter of practical administration, while recognizing that the actual rate of gross interest used should, as far as possible, take account of the fact that expenses were incurred in earning the interest.

The members from developing countries agreed to the solution of taxation by both the country of residence and the source country embodied in article 11, paragraphs 1 and 2, of the OECD Model Convention but found the ceiling of 10 per cent of the gross amount of the interest mentioned in paragraph 2 thereof unacceptable. It may be noted in that connexion that within OECD the 10 per cent ceiling has been considered "a reasonable maximum" in the light of the fact that the source country was already entitled to tax profits on income produced in its territory by investments financed out of funds borrowed abroad. Since the Group was unable to reach a consensus on an alternative higher ceiling the matter was left to bilateral negotiations.

Within the framework of this compromise solution, a very relevant question is that of the expenses involved in the earning of the interest. Clearly, the gross interest on such loans is far higher than the net profit, since banks incur large expenses in attracting the funds constituting the loans. While the Group recognized the importance of expenses, it considered that no precise ratio of expenses to gross interest could be provided. The target as far as expenses were concerned was the rate of withholding tax on gross interest that would approximate the tax proceeds resulting from the application of the regular domestic business tax of the source country to the net income component of the interest, that is, gross interest less expenses applicable to that gross interest. A withholding rate so determined would indirectly take account of the expense component of the interest.

A precise level of withholding tax for a source country should take into account a number of factors including the following: the fact that the capital originated in the residence country; the possibility that a high source rate might cause lenders to pass the cost of the tax on to the borrowers, which would mean that the source country would increase its revenue at the expense of its own residents rather than the foreign lenders; the possibility that a tax rate higher than the foreign tax credit limit in the residence country might deter investment; the fact that a lowering of the withholding rate has revenue and foreign exchange consequences for the source country and the fact that interest flows mainly in one direction, namely from developing to developed countries.

In that connexion, it may be of interest to note that the withholding rates imposed on interest in developing countries under their domestic laws seem to be somewhat lower than those imposed on dividends. Some developing countries impose no tax. A 15 per cent rate is fairly common; there are also instances of 10 and 20 per cent rates, but very few countries impose rates between 30 and 40 per cent.

In connexion with the article on interest the Group of Experts discussed the question of what considerations would be involved if two countries which had generally agreed on a treatment of interest entailing a withholding rate on gross interest subsequently desired specifically to consider interest on deferred-payment sales. It was recalled that, side by side with conventional transactions for the sale of raw materials or goods on short-term credit, sales of heavy capital goods and large-scale public works gave rise to credits which had steadily increased in size and duration, from an average of from three to five years in the 1950s to more than 20 years in certain cases. It was suggested that the character of interest should be recognized not only where interest was specified in the contract, but even where the instalment payments made no distinction between the part of the payment corresponding to the purchase price and the part representing financial charges. In the latter case, it might be somewhat difficult to determine what part represented interest, although it was possible to isolate the interest component by comparing the total sum to be paid by the purchaser with the cash value of the article purchased.

It was indicated that if a country wished to tax interest on credit sales, the aim should be to tax only net interest, i.e., the amount of the profit which could be made on the interest paid. However, sales credits, and in particular long-term credits, were generally granted, not by the suppliers themselves out of their own funds, but by banks or other financial institutions, which, in turn, had to obtain their resources on the money market at borrower's interest. As their profit was far smaller than the gross interest received, the amount of tax payable in the lender's country might be less than the amount of tax levied in the debtor's country on the gross amount of interest paid. The procedure for granting credit and the conditions on which it was granted varied according to whether short-term or long-term credit was involved. Short-term credits corresponded to commercial transactions; hence, the accompanying interest was immediately passed on. Long-term credits corresponded to investments which should be profitable enough to be repaid in instalments over a period. In the latter case, interest must be paid out of earnings at the same time as instalments of credit were repaid out of capital. Consequently, any excessive fiscal burden on such interest must be passed on to the book value of the capital goods purchased on credit, with the result that the fiscal charge levied on the interest might, in the last analysis, diminish the amount of tax payable on the profits made by the user of the capital goods.

It was observed that long-term credits, which in reality were granted only in international transactions, called for special guarantees owing to the difficulty of long-term political, economic and monetary forecasting. Moreover, the Governments of the majority of developed countries, in order to ensure full employment in their capital goods industries or public works enterprises, had adopted various measures which added up to privileged treatment for long-term credits in the form of credit insurance or interest-rate reductions by government agencies. Such advantages might be granted in the form of direct loans by such agencies tied to loans from private banks (the Export-Import Bank in the United States of America was an example) or by private banks which enjoyed credit facilities or interest terms more favourable than those obtainable on the money market.

It was also observed that competition among industrialists in the developed countries had the effect of increasing the volume of credit granted by those countries to developing countries and of giving them the benefit of below-normal interest rates. Such advantages could not, as a rule, be granted without the co-operation of the public authorities in the developed countries, which in turn would find it difficult to agree to such sacrifices if the corresponding advantages were to be cancelled out or reduced by taxation in the debtor's country which was considered excessive. Under tax treaties, countries normally agreed not to tax interest paid on loans granted by a Government or by an agency of the Government. The issue was thus raised whether that attitude should equally apply in favour of interest on long-term loans made by private banks where such loans were guaranteed or refinanced by a Government or by an agency of the Government.

It was further observed that, over and above the purely fiscal aspects of the treatment of interest, there were economic considerations; for example, taking into account the real rate of interest there was the possibility, in a market characterized by a steadily growing demand for capital, of passing on to the borrower any burden imposed on interest.

In the light of the foregoing, it was suggested that when two countries negotiating a tax treaty took up the question of interest on deferred payment sales, the country of the seller might draw attention to a number of factors that would in its view justify different treatment for such interest. Thus it could ask whether the negotiating parties really wanted to become involved in questions that might be difficult to solve, such as separating discount and short-term credit sales from long-term sales, determining the implied interest rate when no explicit rate was stated (and then, perhaps, using for the sake of consistency only the basic sales price for custom valuation purposes) or considering whether distinctions should be drawn in tax treaties between export credit granted directly or by a government agency and credit granted by commercial institutions which were, in turn, assisted or backed by governmental bodies. Moreover, related economic issues might have to be faced if that interest were to be taxed, for example the seller's effort to shift the burden of the tax to the buyer because of the amounts involved and the effect that the intrusion of a tax could have on the terms of the basic transaction and the extension of credit itself. The factors involved might in the actual process of negotiation cause some countries to decide not to pursue the taxation of such interest, even though in other cases interest payments were taxed. However, such factors might not appear sufficiently persuasive to some negotiators. In that case, the consideration could still arise whether the margin of actual net profit on the extension of such credit was less than the profit margins the negotiators had had in mind when they had set the general withholding rate on interest. Moreover, in some export credit situations, whatever the margin of profit that arose, that margin might be earned not by the seller but by the financial institution with which the seller had refinanced the transaction, so that the seller might have problems in absorbing a tax at source. Those factors might persuade some negotiators to decide against taxing such interest or at least to provide a more favourable rate than for interest in general; other negotiators might be less influenced by those factors.

The Group therefore concluded that, while interest on deferred-payment or credit sales should be considered in the context of the treaty article on interest, the nature of that consideration and the final resolution should be settled through negotiations between the parties.

It may be recalled that the OECD commentary on article 11, paragraph 2, of the OECD Model Convention contains the following passages:

> "Under paragraph 2, the limitation of tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State. States which wish to make this more explicit are free to do so during bilateral negotiations.
>
> "The paragraph lays down nothing about the mode of taxation in the State of source. It therefore leaves that State free to apply its own laws and, in particular, to levy the tax either by deduction at source or by individual assessment.
>
> "It does not specify whether or not the relief in the State of source should be conditional upon the interest being subject to tax in the State of residence. This question can be settled by bilateral negotiations.
>
> "The Article contains no provisions as to how the State of the beneficiary's residence should make allowance for the taxation in the State of source of the interest. This question is dealt with in Articles 23 A and 23 B.
>
> "Attention is drawn generally to the following case: the beneficial owner of interest arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether, in the case of such a company, it is justifiable to allow in the State of source of the interest the limitation of tax which is provided in paragraph 2. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this article, in order to define the treatment applicable to such companies.
>
> "It should, however, be pointed out that the solution adopted, given the combined effect of the right to tax accorded to the State of source and the allowance to be made for the tax levied there against that due in the State of residence, could, in certain cases, result in maintaining partial double taxation and

lead to adverse economic consequences. In fact, when the beneficiary of the interest has himself had to borrow in order to finance the operation which earns him interest the profit he will realise by way of interest will be much smaller than the nominal amount of interest he receives; if the interest he pays and that which he receives balance, there will be no profit at all. In such a case, the allowance to be made under paragraph 2 of Article 23 A, or paragraph 1 of Article 23 B, raises a difficult and sometimes insoluble problem in view of the fact that the tax levied in the State where the interest arises is calculated on the gross amount thereof, whereas the same interest is reflected in the beneficiary's business results at its net amount only. The result of this is that part, or sometimes even the whole amount, of the tax levied in the State where the interest arises cannot be allowed as a credit in the beneficiary's State of residence and so constitutes an excess charge for the beneficiary, who, to that extent, suffers double taxation. Moreover, the latter, in order to avoid the disadvantage just mentioned, will tend to increase the rate of interest he charges his debtor, whose financial burden would then be increased to a corresponding extent. Thus in certain cases the practice of taxation at the source can constitute an obstacle to international trade. Furthermore, if the payer of the interest happens to be the State itself, a public sector institution, or an enterprise guaranteed by the State, the end result may well be that the tax levied at source is actually borne by the Treasury of the debtor's State, which latter thus derives no real benefit from its own taxation.

"The disadvantages just mentioned arise in business, particularly with the sale on credit of equipment, other commercial credit sales, and loans granted by banks. The supplier in such cases very often merely passes on to the customer, without any additional charge, the price he will himself have had to pay to a bank or an export finance agency to finance the credit; similarly, the banker generally finances the loan which he grants with funds lent to his bank and, in particular, funds accepted by him on deposit. In the case especially of the person selling equipment on credit, the interest is more an element of the selling price than income from invested capital.

"If two Contracting States, in order to eliminate all risks of double taxation, should desire to avoid the imposition of a tax in the State of source on interest arising from the above-mentioned categories of debts, their common intenton can be expressed by an additional paragraph which would follow paragraph 2 of the Article, and which might be in the following terms:

"3. Notwithstanding the provisions of paragraph 2, any such interest as is mentioned in paragraph 1 shall be taxable only in the Contracting State of which the recipient is a resident, if such recipient is the beneficial owner of the interest and if such interest is paid:

"(*a*) in connection with the sale on credit of any industrial, commercial or scientific equipment,

"(*b*) in connection with the sale on credit of any merchandise by one enterprise to another enterprise, or

"(*c*) on any loan of whatever kind granted by a bank.

"As regards, more particularly, the types of credit sale referred to in subparagraph (*a*) of the text suggested above, they comprise not only sales of complete units, but also sales of separate components thereof. Furthermore, as regards credit sales of the types referred to in subparagraphs (*a*) and (*b*) of the suggested text, it is immaterial whether the interest is stipulated separately and as additional to the sale price, or is included from the outset in the price payable by instalments.

"Contracting States may add to the categories of interest enumerated . . . above, other categories in regard to which the imposition of a tax in the State of source might appear to them to be undesirable. They may also agree that the exclusion of a right to tax in the State of source shall be limited to certain of the categories of interest mentioned."

Paragraph 3

This paragraph reproduces article 11, paragraph 3, of the OECD Model Convention, the commentary on which reads as follows:

"Paragraph 3 specifies the meaning to be attached to the term 'interest' for the application of the taxation treatment defined by the article. The term designates, in general, income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in profits. The term 'debt-claims of every kind' obviously embraces cash deposits and security in the form of money, as well as Government securities, and bonds and debentures, although the three latter are specially mentioned because of their importance and of certain peculiarities that they may present. It is recognised, on the one hand, that mortgage interest comes within the category of income from movable capital ('revenus de capitaux mobiliers'), even though certain countries assimilate it to income from immovable property. On the other hand, debt-claims, and bonds and debentures in particular, which carry a right to participate in the debtor's profits are nonetheless regarded as loans if the contract by its general character clearly evidences a loan at interest. In the contrary case, where the participation in profits rests upon a provision of funds that is subject to the hazards of the enterprise's business, the operation is not in the nature of a loan and article 11 does not apply. As regards, more particularly, Government securities, and bonds and debentures, the text specifies that premiums or prizes attaching thereto constitute interest. Generally speaking, what constitutes interest yielded by a loan security, and may properly be taxed as such in the State of source, is all that the institution issuing the loan pays over and above the amount paid by the subscriber, that is to say, the interest accruing plus any premium paid at redemption or at issue. It follows that when a bond or debenture has been issued at a premium, the excess of the amount paid by the subscriber over that repaid to him may constitute negative interest which should be deducted from the interest that is taxable. On the other hand, any profit or loss which a holder of such a security realises by the sale thereof to another person does not enter into the concept of interest. Such profit or loss may, depending on the case, constitute either a business profit or a loss, a capital gain or a loss, or income falling under Article 21.

"Moreover, the definition of interest in the first sentence of paragraph 3 is, in principle, exhaustive. It has seemed preferable not to include a subsidiary reference to domestic laws in the text; this is justified by the following considerations:

"(*a*) the definition covers practically all the kinds of income which are regarded as interest in the various domestic laws;

"(*b*) the formula employed offers greater security from the legal point of view and ensures that conventions would be unaffected by future changes in any country's domestic laws;

"(*c*) in the Model Convention references to domestic laws should as far as possible be avoided.

It nevertheless remains understood that in a bilateral convention two Contracting States may widen the formula employed so as to include in it any income which is taxed as interest under either of their domestic laws but which is not covered by the definition and in these circumstances may find it preferable to make reference to their domestic laws.

"The second sentence of paragraph 3 excludes from the definition of interest penalty charges for late payment but Contracting States are free to omit this sentence and treat charges as interest in their bilateral conventions. Penalty charges, which may be payable under the contract, or by customs or by virtue of a judgement, consist either of payments calculated pro rata temporis or else of fixed sums; in certain cases they may combine both forms of payment. Even if they are determined pro rata temporis they constitute not so much income from capital as a special form of compensation for the loss suffered by the creditor through the debtor's delay in meeting his obligations. Moreover, considerations of legal security and practical convenience make it advisable to place all penalty charges of this kind, in whatever form they be paid, on the same footing for the purposes of their taxation treatment. On the other hand, two Contracting States may exclude from the application of Article 11 any kinds of interest which they intend to be treated as dividends.

"Finally, the question arises whether annuities ought to be assimilated to interest; it is considered that they ought not to be. On the one hand, annuities granted in consideration of past employment are referred to in Article 18 and are subject to the rules governing pensions. On the other hand, although it is true that instalments of purchased annuities include an interest element on the purchase capital as well as return of capital, such instalments thus constituting 'fruits civils' which accrue from day to day, it would be difficult for many countries to make a distinction between the element representing income from capital and the element representing a return of capital in order merely to tax the income element under the same category as income from movable capital. Taxation laws often contain special provisions classifying annuities in the category of salaries, wages and pension, and taxing them accordingly."

Paragraph 4

This paragraph modifies article 11, paragraph 4, of the OECD Model Convention. The commentary on the paragraph reads as follows:

"Certain States consider that dividends, interest and royalties arising from sources in their territory and payable to individuals or legal persons who are residents of other States fall outside the scope of the arrangement made to prevent them from being taxed both in the State of source and in the State of the beneficiary's residence when the beneficiary has a permanent establishment in the former State. Paragraph 4 is not based on such a conception which is sometimes referred to as 'the force of attraction of the permanent establishment'. It does not stipulate that interest arising to a resident of a Contracting State from a source situated in the other State must, by a kind of legal presumption, or fiction even, be related to a permanent establishment which that resident may have in the latter State, so that the said State would not be obliged to limit its taxation in such a case. The paragraph merely provides that in the State of source the interest is taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident in the other State, if it is paid in respect of debt-claims forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 4 relieves the State of source of the interest from any limitation under the article. The foregoing explanations accord with those in the commentary on Article 7.

"The rules set out also apply where the beneficiary of the interest has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base with which the debt-claim in respect of which the interest is paid is effectively connected."

In order to extend the force of attraction principle, the Group decided to amend the provisions of paragraph 4 of article 11 of OECD. In addition to interest excluded from the application of paragraph 1 by paragraph 4 of the OECD article, paragraph 4 of the United Nations Model excludes interest which is paid in connexion with business activities described in subparagraph 1 (*c*) of article 7, even if the business activities are not carried on through a permanent establishment or a fixed base.

Paragraph 5

This paragraph reproduces article 11, paragraph 5, of the OECD Model Convention, which specifies the source rule. However, in the course of discussion, the Group agreed that countries that wished to use a different rule from the source might do so by specifying a rule that would identify the source of interest as the State in which the loan giving rise to the interest was used. Where, in bilateral negotiations, the two parties differed on the appropriate rule, a possible solution would be a rule which, in general, would accept the place of residence of the payer as the source of interest; but where the loan for which the interest was paid was used in the State having a "place of use" rule, the interest would be deemed to arise in that State. The OECD commentary on article 11, paragraph 5, reads as follows:

"This paragraph lays down the principle that the State of source of the interest is the State of which the payer of the interest is a resident, who may, moreover, be that State itself or one of its political subdivisions or local authorities. It provides, however, for an exception to this rule in the case of interest-bearing loans which have an obvious economic link with a permanent establishment owned in the other Contracting State by the payer of the interest. If the loan was contracted for the requirements of that establishment and the interest is borne by the latter, the paragraph determines that the source of the interest is in the Contracting State in which the permanent establishment is situated, leaving aside the place of residence of the owner of the permanent establishment, even when he resides in a third State.

"In the absence of an economic link between the loan on which the interest arises and the permanent establishment, the State where the latter is situated cannot on that account be regarded as the State where the interest arises; it is not entitled to tax such interest, not even within the limits of a "taxable quota" proportional to the importance of the permanent establishment. Such a practice would be incompatible with paragraph 5. Moreover, any departure from the rule fixed in the first sentence of paragraph 5 is justified only where the economic link between the loan and the permanent establishment is sufficiently clear-cut. In this connection, a number of possible cases may be distinguished:

"(*a*) The management of the permanent establishment has contracted a loan which it uses for the specific requirements of the permanent establishment; it shows it among its liabilities and pays the interest thereon directly to the creditor.

"(*b*) The head office of the enterprise has contracted a loan the proceeds of which are used solely for the purposes of a permanent establishment situated in another country. The interest is serviced by the head office but is ultimately borne by the permanent establishment.

"(*c*) The loan is contracted by the head office of the enterprise and its proceeds are used for several permanent establishments situated in different countries.

In cases (*a*) and (*b*) the conditions laid down in the second sentence of paragraph 5 are fulfilled, and the State where the permanent establishment is situated is to be regarded as the State where the interest arises. Case (*c*), however, falls outside the provisions of paragraph 5, the text of which precludes the attribution of more than one source to the same loan. Such a solution, moreover, would give rise to considerable administrative complications and make it impossible for lenders to calculate in advance the taxation that interest would attract. It is, however, open to two Contracting States to restrict the application of the final provision in paragraph 5 to case (*a*) or to extend it to case (*c*).

"Paragraph 5 provides no solution for the case, which it excludes from its provisions, where both the beneficiary and the payer are indeed residents of the Contracting States, but the loan was borrowed for the requirements of a permanent establishment owned by the payer in a third State and the interest is borne by that establishment. As paragraph 5 now stands, therefore, only its first sentence will apply in such a case. The interest will be deemed to arise in the Contracting State of which the payer is a resident and not in the third State in whose territory is situated the permanent establishment for the account of which the loan was effected and by which the interest is payable. Thus the interest will be taxed both in the Contracting State of which the payer is a resident and in the Contracting State of which the beneficiary is a resident. But, although double taxation will be avoided between these two States by the arrangements provided in the article, it will not be avoided between them and the third State if the latter taxes the interest on the loan at the source when it is borne by the permanent establishment in its territory.

"It has not, however, been considered possible to refer to such a case in a bilateral convention and provide for it a solution consisting, for example, in obliging the Contracting State of the payer's residence to relinquish its tax at the source in favor of the third State in which is situated the permanent establishment for the account of which the loan was effected and by which the interest is borne. The risk of double taxation just referred to can only be fully avoided through a bilateral convention containing a similar provision to that in paragraph 5, between the Contracting State of which the payer of the interest is a resident and the third State in which the permanent establishment paying the interest is situated, or through a multilateral convention containing such a provision.

"Moreover, in the case—not settled in paragraph 5—where whichever of the two Contracting States is that of the payer's residence and the third State in which is situated the permanent establishment for the account of which the loan is effected and by which the interest is borne, together claim the right to tax the interest at the source, there would be nothing to prevent those two States—together with, where appropriate, the State of the beneficiary's residence—from concerting measures to avoid the double taxation that would result from such claims. The proper remedy, it must be said again, would be the establishment between these different States of bilateral conventions, or a multilateral convention, containing a provision similar to that in paragraph 5. Another solution would be for two Contracting States to word the second sentence of paragraph 5 in the following way:

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

"If two Contracting States agree in bilateral negotiations to reserve to the State where the beneficiary of the income resides the exclusive right to tax such income, then ipso facto there is no value in inserting in the convention which fixes their relations that provision in paragraph 5 which defines the State of source of such income. But it is equally obvious that double taxation would not be fully avoided in such a case if the payer of the interest owned, in a third State which charged its tax at the source on the interest, a permanent establishment for the account of which the loan had been borrowed and which bore the interest payable on it. The case would then be just the same as is contemplated . . . above."

Paragraph 6

This paragraph reproduces article 11, paragraph 6, of the OECD Model Convention, the commentary on which reads as follows:

"The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of interest in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the interest paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the article apply only to that last-mentioned amount and that the excess part of the interest shall remain taxable according to the laws of the two Contracting States, due regard being had to the other provisions of the Convention.

"It is clear from the text that for this clause to apply the interest held excessive must be due to a special relationship between the payer and the beneficial owner or between either of them and some other person. There may be cited as examples cases where interest is paid to an individual or legal person who directly or indirectly controls the payer, or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.

"On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the interest.

"With regard to the taxation treatment to be applied to the excess part of the interest, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purposes of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases require, to the excess part of the interest, there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 6, as long as they do not alter its general purport.

"Should the principles and rules of their respective laws oblige the two Contracting States to apply different articles of the Convention for the purpose of taxing the excess, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 11 OF THE OECD MODEL CONVENTION

Observations on the commentary

"The *United Kingdom* does not adhere to paragraph 18 above. Under United Kingdom law, certain interest payments are treated as distributions, and are therefore dealt with under Article 10.

"The *United States* observes that the Article does not limit the taxation by internal law of interest not attributable to a United States permanent establishment in cases where 50 per cent or more of a non-resident payer's gross income is effectively connected with a trade or business in the United States. The United States is willing, in appropriate situations, to limit such taxation by making appropriate modifications in the text of the Article."

Reservations on the article

"*Paragraph 2*

"*Belgium, Portugal* and *Spain* reserve their position on the rate provided in paragraph 2.

"*Canada* reserves its position on paragraph 2 and wishes to retain a 15 per cent rate of tax at source in its bilateral conventions.

"*Turkey* cannot accept a rate of tax which is lower than 20 per cent.

"*Paragraph 4*

"*Italy* reserves the right to subject interest to the taxes imposed by its law whenever the recipient thereof has a permanent establishment in Italy, even if the indebtedness in respect of which the interest is paid is not effectively connected with such permanent establishment."

Article 12

Royalties

A. General considerations

Article 12 of the United Nations Model Convention reproduces the provisions of article 12 of the OECD Model Convention with substantive changes in paragraph 1, the addition of new paragraphs 2 and 5, the renumbering of the other paragraphs, a substantive change in the new paragraph 3, broadening its scope, and a drafting adjustment in the newly renumbered paragraph 4.

When the user of a patent or similar property is resident in one country and pays royalties to the owner thereof who is resident in another country, the amount paid by the user is generally subject to withholding tax in his country, that is, the source country. The latter country imposes a tax on the gross payments. It thus does not take into account any related expenses that may have been incurred by the owner. Without such recognition of expenses, the after-tax profit which the owner receives may in some cases be only a small percentage of gross royalties. Consequently, in practice, the owner may have to take the withholding tax in the source country into account in fixing the amount of the royalty, so that the user and the source country will pay more for the use of the patent or similar property than they would if the withholding tax levied by the source country were lower and took into account the expenses incurred by the owner. A manufacturing enterprise or an inventor may have spent substantial sums on the development of the property generating the royalties, because the work of research and testing involves considerable capital outlays and does not always yield successful results. The problem of determining the appropriate tax rate to be applied by the source country to gross royalty payments is therefore complex, especially since the user may make a lump sum payment for the use of the patent or similar property, in addition to regular royalty payments.

It may be recalled that the OECD commentary on article 12 of the OECD Model Convention contains the following preliminary remarks:

> "In principle, royalties in respect of licenses to use patents and similar property and similar payments are income to the recipient from a letting. The letting may be granted in connection with an industrial or commercial enterprise (e.g. the use of literary copyright granted by a publisher) or an independent profession (e.g. use of a patent granted by the inventor) or quite independently of any activity of the grantor (e.g. use of a patent granted by the inventor's heirs).
>
> "Certain countries do not allow royalties paid to be deducted for the purposes of the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise

they forbid the deduction. The question whether the deduction should also be allowed in cases where the royalties are paid by a resident of a Contracting State to a resident of the other State is dealt with in paragraph 5 of Article 24."

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 12

Paragraphs 1 and 2

Paragraph 1 departs substantively from article 12, paragraph 1, of the OECD Model Convention which provides that "royalties arising in a Contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State if such resident is the beneficial owner of the royalties".

Paragraph 2 is an addition which flows logically from the premises embodied in paragraph 1.

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

Members from developed countries considered that it would be unrealistic to assume that enterprises selected the oldest patents for licensing to developing countries. Normally, an enterprise would license its patents to foreign subsidiaries and therefore select the most up-to-date inventions, in the hope of expanding existing markets or opening up new ones. A member from a developed country emphasized that it should be borne in mind that patents were not merchandise but instruments for promoting industrial production. Several members from developed countries held as a matter of principle that the country of residence of the owner of a patent or similar property should have the exclusive or primary right to tax royalties paid thereon.

Since no consensus emerged concerning a specific rate for the withholding tax to be charged on royalties on a gross basis, it was decided that the rate should be established through bilateral negotiations. That decision is reflected in paragraph 2 of article 12. The Group agreed that the following considerations might be taken into account in such negotiations:

First, the country of source, in establishing a withholding tax on the gross royalty in a tax treaty, would, from the standpoint of the effect of expenses allocable to the royalty payments, recognize that both current expenses allocable to the royalty and expenditure incurred in the development of the property whose use gave rise to the royalty were to be considered, bearing in mind that the latter expenditure was also allocable to profits derived from other royalties or activities, past or future, associated with such expenditure, and also that other expenditure not directly incurred in the development of that property might, nevertheless, have contributed significantly to that development;

Secondly, as a technical matter, if an expense ratio were agreed upon in fixing a gross rate in the source country, it would appear as a consequence that the country of the recipient, if following a credit method, would apply that expense ratio as the basis for determining the application of its credit, whenever feasible. Therefore, that matter should be considered under article 23 A or 23 B.

In addition various members of the Group mentioned factors which in their view might influence the determination of the withholding tax on gross royalties. Those factors included: the developing countries' need to earn revenue and conserve foreign exchange; the fact that royalty-payments flowed almost entirely from developing countries to developed countries; the extent of assistance that developed countries should, for a variety of reasons, extend to developing countries, and the special importance of providing such assistance in the context of royalty payments; the desirability of preventing a shift of the tax burden to the licencees in the licencing arrangement; the ability that taxation at source conferred on a developing country to make selective judgements by which, through reduced taxation or exemption, it could encourage those licencing arrangements if they were considered desirable for its development; the lessening of the risks of tax evasion if there was, in fact, taxation at the source at least; the fact that the country of the licensor supplied the facilities and activities necessary for the development of the patent and thus undertook the risks associated with the patent; the desirability of obtaining and encouraging a flow of technology to developing countries; the desirability of expanding the field of activity of the licensor in the utilization of his research; the benefits that developed countries would obtain from world development in general; the relative importance of revenue sacrifice; the relation of the royalty decision to other decisions in the negotiations.

The Group recognized the difficulty involved in the definition of royalties but agreed to consider income from such activities as business profits and to include in article 5, paragraph 3, a new subparagraph (*b*) which provided that the term permanent establishment should likewise encompass "the furnishing of services, including consultancy services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose, but only where activities of that nature continue (for the same or a connected project) within the country for a period or periods aggregating more than six months within any 12-month period".

With regard to film rentals, there was a consensus that income from such rentals should not be treated as industrial and commercial profits but should be dealt with in the context of royalties. The tax would thus be levied on a gross basis but expenses would be taken into account in fixing the withholding rate. With regard to expenses, some members mentioned factors that could be regarded as peculiarly relevant to film rentals. Thus, it was said that, as a general rule, the expenses of film producers might be much higher and the profits lower than in the case of industrial royalties. On the other hand, it was pointed out that a considerable part of film expenses represented high salaries paid to actors and other participants who were taxed solely by the country of residence, and not by the source country, and might therefore not justify any great reduction of the withholding tax at source. However, it could be said that the amounts involved were nevertheless real costs for the producer and should be taken into account, while at the same time all countries involved should join in efforts to make sure that such income did not escape tax. Further, while the write-off of expenses in the country of residence did not mean that the expenses should not be taken into account at source, at some point old films could present a different expense situation.

With regard to copyright royalties, some members felt that because such royalties represented cultural efforts, they should be exempted from taxation by the source country. Other members, however, felt that that was merely a sentimental gesture, and that since tax would be levied by the residence country, the reduction at source would not benefit the author. Other members were in favour of exempting copyright royalties at the source, not necessarily for cultural reasons, but because the country of residence was in a better position to evaluate the expenses and personal circumstances of the creator of the royalties, including the period over which the books or other copyrighted items had been created; a reduction of the source-country tax could be supported in some cases by the fact that the tax was too high to be absorbed by the tax credit of the residence country. However, it was recognized that source countries might not be willing to accept that approach to the problem. Furthermore, those contending for exemption of the royalties by the source country on cultural grounds faced certain problems. The party dealing with the source country might be the publisher and not the author, and arguments supporting the exemption of the author's income because of his personal situation obviously would not apply to the publisher.

Paragraph 3

This paragraph reproduces article 12, paragraph 2, of the OECD Model Convention, the commentary on which reads as follows:

"Paragraph 2 contains a definition of the term 'royalties'. These relate, in general, to rights or property constituting the different forms of literary and artistic property, the elements of industrial and commercial property specified in the text and information concerning industrial, commercial or scientific experience. The definition applies to payments for the use of, or the entitlement to use, rights of the kind mentioned, whether or not they have been or are required to be, registered in a public register. The definition covers both payments made under a licence and compensation which a person would be obliged to pay for fraudulently copying of infringing the right. As a guide, certain explanations are given below in order to define the scope of Article 12 in relation to that of other articles of the Convention, as regards, in particular, equipment renting and the provision of information.

"A clear distinction must be made between royalties paid for the use of equipment, which fall under Article 12, and payments constituting consideration for the sale of equipment, which may, depending on the case, fall under Articles 7, 13, 14 or 21. Some contracts combine the hire element and the sale element, so that it sometimes proves difficult to determine their true legal import. In the case of credit sale agreements and hire-purchase agreements, it seems clear that the sale element is the paramount use, because the parties have from the outset agreed that the ownership of the property in question shall be transferred from one to the other, although they have made this dependent upon the payment of the last instalment. Consequently, the instalments paid by the purchaser/hirer do not, in principle, constitute royalties. In the case, however, of lend-lease, and of leasing in particular, the sole, or at least the principal, purpose of the contract is normally that of hire, even if the hirer has the right thereunder to opt during its term to purchase the equipment in question outright. Article 12 therefore applies in the normal case to the rentals paid by the hirer, including all rentals paid by him up to the date he exercises any right to purchase.

"Rents in respect of cinematograph films are also treated as royalties, whether such films are exhibited in cinemas or on the television. It may, however, be agreed through bilateral negotiations that rents in respect of cinematograph films shall be treated as industrial and commercial profits and, in consequence, subjected to the provisions of Articles 7 and 9.

"The rules set out above in regard to rents in respect of cinematograph films could also be applied in regard to rentals derived by a shipping enterprise from the hire of its containers for the conveyance of goods on land after leaving the ship. It is considered, however, that where the hire of the containers is a supplementary or incidental activity of a transport company, the income should be treated as profits falling under Article 8.

"In classifying as royalties payments received as consideration for information concerning industrial, commercial or scientific experience, paragraph 2 alludes to the concept of 'know-how'. Various specialist bodies and authors have formulated definitions of know-how which do not differ intrinsically. One such definition, given by the 'Association des Bureaux pour la Protection de la Propriété Industrielle' (ANBPPI). states that 'know-how is all the undivulged technical information, whether capable of being patented or not, that is necessary for the industrial reproduction of a product or process, directly and under the same conditions; inasmuch as it is derived from experience, know-how represents what a manufacturer cannot know from mere examination of the product and mere knowledge of the progress of technique.' In the know-how contract, one of the parties agrees to impart to the other, so that he can use them for his own account, his special knowledge and experience which remain unrevealed to the public. It is recognized that the grantor is not required to play any part himself in the application of the formulae granted to the licensee and that he does not guarantee the result thereof. This type of contract thus differs from contracts for the provision of services, in which one of the parties undertakes to use the customary skills of his calling to execute work himself for the other party. Thus, payments obtained as consideration for after-sales service, for services rendered by a seller to the purchaser under a guarantee, for pure technical assistance, or for an opinion given by an engineer, an advocate or an accountant, do not constitute royalties within the meaning of paragraph 2. Such payments generally fall under Article 7 or Article 14. In business practice, contracts are encountered which cover both know-how and the provision of technical assistance. One example, amongst others, of contracts of this kind is that of franchising, where the franchisor imparts his knowledge and experience to the franchisee and, in addition, provides him with varied technical assistance, which, in certain cases, is backed up with financial assistance and the supply of goods. The appropriate course to take with a mixed contract is, in principle, to break down, on the basis of the information contained in the contract or by means of a reasonable apportionment, the whole amount of the stipulated consideration according to the various parts of what is being provided under the contract, and then to apply to each part of it so determined the taxation treatment proper thereto. If, however, one part of what is being provided constitutes by far the principal purpose of the contract and the other parts stipulated therein are only of an ancillary and largely unimportant character, then it seems possible to apply to the whole amount of the consideration the treatment applicable to the principal part.

"The suggestions made above regarding mixed contracts could also be applied in regard to certain performances by artists and, in particular, in regard to an orchestral concert given by a conductor or a recital given by a musician. The fee for the musical performance, together with that paid for any simultaneous radio broadcasting thereof, seems to fall to be treated under Article 17. Where, whether under the same contract or under a separate one, the musical performance is recorded and the artist has stipulated that he be paid royalties on the sale or public playing of the records, then so much of the payment received by him as consists of such royalties falls to be treated under Article 12.

"It is further pointed out that variable or fixed payments for the working of mineral deposits, sources or other natural resources are governed by Article 6 and do not, therefore, fall within the present article. If two Contracting States should have difficulty from the legal standpoint in applying this distinction in regard to consideration for the use of, or the right to use, equipment, they could add to the text of paragraph 2, after the words 'industrial, commercial or scientific equipment', the words 'not constituting immovable property referred to in Article 6'."

The Group considered the problem involving the broad definition of royalties. A member from a developed country explained that in his view the problem was that the definition made an imperfect distinction between revenues that constituted royalties in the strict sense and payments received for brain-work and technical services, such as surveys of any kind (engineering, geological research etc.). The member also mentioned the problem of distinguishing between royalties akin to income from capital and payments received for services. Given the broad definition of "information concerning industrial, commercial or scientific experience", certain countries tended to regard the provision of brain-work and technical services as the provision of "information concerning industrial, commercial or scientific experience" and to regard payment for it as therefore taxable as royalties.

In order to avoid those difficulties, the member from a developed country proposed that the definition of royalties be restricted by excluding from the definition payments received for "information concerning industrial, commercial or scientific experience". The member also suggested that a protocol should be annexed to the treaty making it clear that such payments should be deemed to be profits of an enterprise to which article 7, dealing with business profits, would apply and that payments received for studies or surveys of a scientific or technical nature, such as geological surveys, or for consultant or supervisory services, should be deemed to be profits of an enterprise to which the provisions of article 7 would apply. It was pointed out that the effect of those different provisions would be to ensure that the source country could not tax such payments unless the enterprise had a permanent establishment, as defined by the treaty, situated in that country, and that taxes should be payable only on the net income element of such payments attributable to that permanent establishment.

On the other hand, a member from a developing country pointed out that the narrower definition of royalties suggested by the member from a developed country would help to clarify the interpretation of article 12, paragraph 2. But if the definition of royalties in the OECD Model Convention was left unchanged, he understood that brain-work and technical services would be covered by the expression "information concerning industrial, commercial and technical experience", and as such would be included in the definition of royalties.

Some members from developing countries pointed out that the phrase "information concerning industrial, commercial or scientific experience" could be interpreted to mean specialized knowledge, having intrinsic property value relating to industrial, commercial, or managerial processes, conveyed in the form of instructions, advice, teaching or formulas, plans or models, permitting the use or application of experience gathered on a particular subject. They also pointed out that the definition of the term royalties could be broadened through bilateral negotiations to include gains derived from the alienation of any such right or property that were contingent on the productivity, use or disposition thereof. The Group agreed that literary copyrights could be interpreted to include copyrights relating to international news.

Paragraph 4

This paragraph modifies article 12, paragraph 3, of the OECD Model Convention, the commentary on which reads as follows:

> "Certain States consider that dividends, interest and royalties arising from sources in their territory and payable to individuals or legal persons who are residents of other States fall outside the scope of the arrangement made to prevent them from being taxed both in the State of source and in the State of the beneficiary's residence when the beneficiary has a permanent establishment in the former State. Paragraph 3 is not based on such a conception which is sometimes referred to as 'the force of attraction of the permanent establishment'. It does not stipulate

that royalties arising to a resident of a Contracting State from a source situated in the other State must, by a kind of legal presumption, or fiction even, be related to a permanent establishment which that resident may have in the latter State, so that the said State would not be obliged to limit its taxation in such a case. The paragraph merely provides that in the State of source the royalties are taxable as part of the profits of the permanent establishment there owned by the beneficiary which is a resident of the other State, if they are paid in respect of rights or property forming part of the assets of the permanent establishment or otherwise effectively connected with that establishment. In that case, paragraph 3 relieves the State of source of the royalties from any limitations under the Article. The foregoing explanations accord with those in the commentary on Article 7.

"The rules set out above also apply where the beneficiary of the royalties has in the other Contracting State, for the purpose of performing any of the kinds of independent personal services mentioned in Article 14, a fixed base with which the right or property in respect of which the royalties are paid is effectively connected."

The Group decided in paragraph 4 of the United Nations Model Convention to modify paragraph 3 of the OECD Model Convention by inserting the words "and 2" after the words "paragraph 1" and by extending the "force of attraction" principle. In addition to royalties excluded from the application of paragraph 1 by paragraph 3 of the OECD article, paragraph 4 of the United Nations Model Convention excludes royalties which are paid in connexion with business activities described in subparagraph (*c*) of article 7, even if the business activities are not carried on through a permanent establishment or a fixed base.

Paragraph 5

This paragraph, which concerns the definition of the source of royalties, represents an innovation as compared with the text of article 12 of the OECD Model Convention.

As in the case of interest, some members suggested that those countries which wished to do so might use a different rule from the source rule specified in the Convention, a rule which would identify the source of a royalty as the State in which the property or right giving rise to the royalty (the patent etc.) was used. Where, in bilateral negotiations, the two parties differed on the appropriate rule, a possible solution would be a rule which, in general, would accept the place of residence of the payer as the source of royalty; but where the right or property for which the royalty was paid was used in the State having a "place of use" rule, the royalty would be deemed to arise in that State.

Paragraph 6

This paragraph reproduces article 12, paragraph 4, of the OECD Model Convention, the commentary on which reads as follows:

"The purpose of this paragraph is to restrict the operation of the provisions concerning the taxation of royalties in cases where, by reason of a special relationship between the payer and the beneficial owner or between both of them and some other person, the amount of the royalties paid exceeds the amount which would have been agreed upon by the payer and the beneficial owner had they stipulated at arm's length. It provides that in such a case the provisions of the Article apply only to that last-mentioned amount and that the excess part of the royalty shall remain taxable according to the laws of the two Contracting States, due regard being had to the other provision of the Convention.

"It is clear from the text that for this clause to apply the payment held excessive must be due to a special relationship between the payer and the beneficial owner or between both of them and some other person. There may be cited as examples cases where royalties are paid to an individual or legal person who directly or indirectly controls the payer or who is directly or indirectly controlled by him or is subordinate to a group having common interest with him. These examples, moreover, are similar or analogous to the cases contemplated by Article 9.

"On the other hand, the concept of special relationship also covers relationship by blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the royalty.

"With regard to the taxation treatment to be applied to the excess part of the royalty, the exact nature of such excess will need to be ascertained according to the circumstances of each case, in order to determine the category of income in which it should be classified for the purpose of applying the provisions of the tax laws of the States concerned and the provisions of the Convention. If two Contracting States should have difficulty in determining the other provisions of the Convention applicable, as cases required, to the excess part of the royalties there would be nothing to prevent them from introducing additional clarifications in the last sentence of paragraph 4, as long as they do not alter its general purport.

"Should the principles and rules of their respective laws oblige the two Contracting States to apply different articles of the Convention for the purpose of taxing the excess, it will be necessary to resort to the mutual agreement procedure provided by the Convention in order to resolve the difficulty."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 12 OF THE OECD MODEL CONVENTION

Observations on the commentary

"The observation made by *Portugal*, *Spain* and *Turkey* on the Commentary on Article 8 (cf. paragraph 28 of the Commentary thereon) applies also to paragraph 11 of the present Commentary for the leasing of containers."

Reservations on the article

"*Paragraph 1*

"*Australia* reserves the right to tax royalties that, under Australian law, have a source in Australia.

"*Austria*, *Greece* and *Luxemburg* are unable to accept a provision which would preclude them, in bilateral conventions for the avoidance of double taxation, from stipulating a clause conferring on them the right to tax royalties at a rate of up to 10 per cent.

"*Canada* reserves its position on paragraph 1 and wishes to retain a 10 per cent rate of tax at source in its bilateral conventions. However, Canada would be prepared to provide an exemption from tax for copyright royalties in respect of any literary, dramatic, musical or artistic work, but not including royalties in respect of motion picture films, and films or video tapes for use in connection with television.

"*Finland* reserves the right to tax royalties at source. However, Finland would be prepared to provide an exemption from tax for copyright royalties in respect of any literary, artistic or scientific work.

"*France* reserves the right to retain some tax on royalties of French origin when flows of royalties between France and the other Contracting State are unbalanced to France's disadvantage.

"*Japan, New Zealand, Portugal* and *Spain* reserve the right to tax royalties at source.

"*Turkey* cannot accept a rate of tax which is lower than 20 per cent.

"*Paragraph 3*

"*Italy* reserves the right to subject royalties and profits from the alienation of rights or property giving rise to royalties to the taxes imposed by its law whenever the recipient thereof has a permanent establishment in Italy, even if the rights or property in respect of which the royalties are paid is not effectively connected with such permanent establishment.

"*Belgium* reserves the right, in order to fill what it considers as a gap in the Article, to propose a provision defining the source of royalties by analogy with the provision in paragraph 5 of Article 11, which deals with the same problem in the case of interest."

Article 13

CAPITAL GAINS

A. GENERAL CONSIDERATIONS

Article 13 of the United Nations Model Convention consists of the first three paragraphs of article 13 of the OECD Model Convention, followed by two new paragraphs (paragraphs 4 and 5) and by the text of article 13, paragraph 4, of the OECD Model Convention renumbered as paragraph 6 and adjusted to take into account the insertion of the two new paragraphs.

The text of this article resulted from a compromise which the Group felt would be the form most acceptable to both developed and developing countries. Some members from developed countries advocated the use of article 13 of the OECD Model Convention, which granted the source country the right to tax capital gains from the alienation of immovable property and from movable property that was a part of a permanent establishment or pertains to a fixed base for performing independent personal services and reserves to the residence country the right to tax gains on other forms of alienable property. In that connexion they mentioned that gains from the alienation of ships and aircraft should only be taxed in the State of effective management of the relevant enterprises, while all other gains should only be taxed in the State in which the alienator was resident. Article 13 of the OECD Model Convention reads as follows:

"*Capital Gains*

"1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.

"2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

"3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

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

On the other hand most members from developing countries advocated the right of the source country to levy a tax in situations in which the OECD reserved that right to the country of residence. They suggested the following text as an alternative:

"Capital gains

"1. Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.

"2. Gains from the alienation of movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State or of movable property pertaining to a fixed base available to a resident of a Contracting State in the other Contracting State for the purpose of performing independent personal services, including such gains from the alienation of such a permanent establishment (alone or with the whole enterprise) or of such fixed base, may be taxed in that other State.

"3. Gains from the alienation of ships or aircraft operated in international traffic, boats engaged in inland waterways transport or movable property pertaining to the operation of such ships, aircraft or boats, shall be taxable only in the Contracting State in which the place of effective management of the enterprise is situated.

"4. Gains from the alienation of any property other than those gains mentioned in paragraphs 1, 2 and 3 may be taxed in the Contracting State in which they arise according to the law of that State."

The draft of paragraph 4 in its alternative form is equivalent to saying that either or both States may tax according to their own laws and the form in which it is worded ensures that the State of residence will eliminate double taxation under article 23. Countries choosing the alternative in the commentary may wish through bilateral negotiations to clarify which particular source rules will be applied to establish where the gain shall be considered to arise.

Concerning the taxation of, and taxes on, capital gains in both developed and developing countries, the following remarks adapted from the preliminary remarks in the commentary on article 13 of the OECD Model Convention would seem to be called for:

"—In some countries capital gains are not deemed to be taxable income; In other countries capital gains accrued to an enterprise are taxed, but capital gains made by an individual outside the course of his trade or business are not taxed;

"—Even where capital gains made by an individual outside the course of his trade or business are taxed, such taxation often applies only in specified cases, e.g. profits from the sale of immovable property or speculative gains (where an asset was bought to be resold).

"Moreover, the taxes on capital gains vary from country to country. In some OECD Member countries, capital gains are taxed as ordinary income and therefore added to the income from other sources. This applies especially to the capital gains made by the alienation of assets of an enterprise. In a number of OECD Member countries, however, capital gains are subject to special taxes, such as taxes on profits from the alienation of immovable property, or general capital gains taxes, or taxes on capital appreciation (increment taxes). Such taxes are levied on each capital gain or on the sum of the capital gains accrued during a year, mostly at special rates which do not take into account the other income (or losses) of the taxpayer. It does not seem necessary to describe all those taxes.

"The Article does not deal with the above-mentioned questions. It is left to the domestic law of each Contracting State to decide whether capital gains should be taxed and, if they are taxable, how they are to be taxed. The article can in no way be construed as giving a State the right to tax capital gains if such right is not provided for in its domestic law. The article does not specify to what kind of tax it applies. It is understood that the article must apply to all kinds of taxes levied by a Contracting State on capital gains. The wording of Article 2 is large enough to achieve this aim and to include also special taxes on capital gains.

It may be recalled that the OECD commentary on article 13 of the OECD Model Convention contains the following general remarks:

"It is normal to give the right to tax capital gains on a property of a given kind to the State which under the Convention is entitled to tax both the property and the income derived therefrom. The right to tax a gain from the alienation of a business asset must be given to the same State without regard to the question whether such gain is a capital gain or a business profit. Accordingly, no distinction between capital gains and commercial profits is made nor is it necessary to have special provisions as to whether the article on capital gains or Article 7 on the taxation of business profits should apply. It is however left to the domestic law of the taxing State to decide whether a tax on capital gains or on ordinary income must be levied. The Convention does not prejudge this question.

"The Article does not give a detailed definition of capital gains. This is not necessary for the reasons mentioned above. The words 'alienation of property' are used to cover in particular capital gains resulting from the sale or exchange of property and also from a partial alienation, the expropriation, the transfer to a company in exchange for stock, the sale of a right, the gift and even the passing of property on death.

"Most States taxing capital gains do so when an alienation of capital assets takes place. Some of them, however, tax only so-called realised capital gains. Under certain circumstances, though there is an alienation no realised capital gain is recognised for tax purposes (e.g. when the alienation proceeds are used for acquiring new assets). Whether or not there is a realisation has to be determined according to the applicable domestic tax law. No particular problems arise when the State which has the right to tax does not exercise it at the time the alienation takes place.

"As a rule, appreciation in value not associated with the alienation of a capital asset is not taxed, since, as long as the owner still holds the asset in question, the capital gain exists only on paper. There are, however, tax laws under which capital appreciation and revaluation of business assets are taxed even if there is no alienation.

"Special circumstances may lead to the taxation of the capital appreciation of an asset that has not been alienated. This may be the case if the value of a capital asset has increased in such a manner that the owner proceeds to the revaluation of this asset in his books. Such revaluation of assets in the books may also occur in the case of a depreciation of the national currency. A number of States levy special taxes on such book profits, amounts put into reserve, an increase in the paid-up capital and other revaluations resulting from the adjustment of the book-value to the intrinsic value of a capital asset. These taxes on capital appreciation (increment taxes) are covered by the Convention according to Article 2.

"Where capital appreciation and revaluation of business assets are taxed, the same principle should, as a rule, apply as in the case of the alienation of such assets. It has not been found necessary to mention such cases expressly in the article or to lay down special rules. The provisions of the Article as well as those of Articles 6, 7 and 21, seem to be sufficient. As a rule, the right to tax is conferred by the above-mentioned provisions on the

State of which the alienator is a resident, except that in the cases of immovable property or of movable property forming part of the business property of a permanent establishment or pertaining to a fixed base, the prior right to tax belongs to the State where such property is situated. Special attention must be drawn, however, to the cases dealt with . . . below.

"In some States the transfer of an asset from a permanent establishment situated in the territory of such State to a permanent establishment or the head office of the same enterprise situated in another State is assimilated to an alienation of property. The article does not prevent these States from taxing profits or gains deemed to arise in connection with such a transfer, provided, however, that such taxation is in accordance with Article 7.

"The article does not distinguish as to the origin of the capital gain. Therefore all capital gains, those accruing over a long term, parallel to a steady improvement in economic conditions, as well as those accruing in a very short period (speculative gains) are covered. Also capital gains which are due to depreciation of the national currency are covered. It is, of course, left to each State to decide whether or not such gains should be taxed.

"The article does not specify how to compute a capital gain, this being left to the domestic law applicable. As a rule, capital gains are calculated by deducting the cost from the selling price. To arrive at cost all expenses incidental to the purchase and all expenditure for improvements are added to the purchase price. In some cases the cost after deduction of the depreciation allowances already given is taken into account. Some tax laws prescribe another base instead of cost, e.g. the value previously reported by the alienator of the asset for capital tax purposes.

"Special problems may arise when the basis for the taxation of capital gains is not uniform in the two Contracting States. The capital gain from the alienation of an asset computed in one State according to the rules mentioned . . . above, may not necessarily coincide with the capital gain computed in the other State under the accounting rules used there. This may occur when one State has the right to tax capital gains because it is the State of situs while the other State has the right to tax because the enterprise is a resident of that other State.

"The following example may illustrate this problem; an enterprise of State A bought immovable property situated in State B. The enterprise may have entered depreciation allowances in the books kept in State A. If such immovable property is sold at a price which is above cost, a capital gain may be realised and, in addition, the depreciation allowances granted earlier may be recovered. State B in which the immovable property is situated and where no books are kept does not have to take into account, when taxing the income from the immovable property, the depreciation allowances booked in State A. Neither can State B substitute the value of the immovable property shown in the books kept in State A for the cost at the time of the alienation. State B cannot, therefore, tax the depreciation allowances realised in addition to the capital gain as mentioned . . . above.

"On the other hand, State A, of which the alienator is a resident, cannot be obliged in all cases to exempt such book profits fully from its taxes under paragraph 1 of the Article and Article 23 A (there will be hardly any problems for States applying the tax credit method). To the extent that such book profits are due to the realisation of the depreciation allowances previously claimed in State A and which had reduced the income or profits taxable in such State A, that State cannot be prevented from taxing such book profits. The situation corresponds to that dealt with in paragraph 44 of the Commentary on Article 23 A.

"Further problems may arise in connection with profits due to changes of the rate of exchange between the currencies of State A and State B. After the devaluation of the currency of State A, enterprises of such State A may, or may have to, increase the book value of the assets situated outside the territory of State A. Apart from any devaluation of the currency of a State, the usual fluctuations of the rate of exchange may give rise to so-called currency gains or losses. Take for example an enterprise of State A having bought and sold immovable property situated in State B. If the cost and the selling price, both expressed in the currency of State B, are equal, there will be no capital gain in State B. When the value of the currency of State B has risen between the purchase and the sale of the asset in relation to the currency of State A, in the currency of that State a profit will accrue to such enterprise. If the value of the currency of State B has fallen in the meantime, the alienator will sustain a loss which will not be recognised in State B. Such currency gains or losses may also arise in connection with claims and debts contracted in a foreign currency. If the balance-sheet of a permanent establishment situated in State B of an enterprise of State A shows claims and debts expressed in the currency of State B, the books of the permanent establishment do not show any gain or loss when repayments are made. Changes of the rate of exchange may be reflected, however, in the accounts of the head office. If the value of the currency of State B has risen (fallen) between the time the claim has originated and its repayment, the enterprise, as a whole will realise a gain (sustain a loss). This is true also with respect to debts if between the time they have originated and their repayment, the currency of State B has fallen (risen) in value.

"The provisions of the article do not settle all questions regarding the taxation of such currency gains. Such gains are in most cases not connected with an alienation of the asset; they may often not even be determined in the State on which the right to tax capital gains is conferred by the article. Accordingly, the question, as a rule, is not whether the State in which a permanent establishment is situated has a right to tax, but whether the State of which the taxpayer is a resident must, if applying the exemption method, refrain from taxing such currency gains which, in many cases, cannot be shown but in the books kept in the head office. The answer to that latter question depends not only on the Article but also on Article 7 and on Article 23 A. If in a given case differing opinions of two States should result in an actual double taxation, the case should be settled under the mutual agreement procedure provided for by Article 25.

"Moreover the question arises which Article should apply when there is paid for property sold an annuity during the lifetime of the alienator and not a fixed price. Are such annuity payments, as far as they exceed costs, to be dealt with as a gain from the alienation of the property or as 'income not dealt with' according to Article 21? Both opinions may be supported by arguments of equivalent weight, and it seems difficult to give one rule on the matter. In addition such problems are rare in practice, so it therefore seems unnecessary to establish a rule for insertion in the Convention. It may be left to Contracting States, who may be involved in such a question, to adopt a solution in the mutual agreement procedure provided for by Article 25.

"The Article is not intended to apply to prizes in a lottery or to premiums and prizes attaching to bonds or debentures.

"The Article deals first with the gains which may be taxed in the State where the alienated property is situated. For all other capital gains, paragraph 4 gives the right to tax to the State of which the alienator is a resident.

"As capital gains are not taxed by all States, it may be considered reasonable to avoid only actual double taxation of capital gains. Therefore, Contracting States are free to supplement their bilateral convention in such a way that a State has to forego its right to tax conferred on it by the domestic laws only if the other State on which the right to tax is conferred by the Convention makes use thereof. In such a case, paragraph 4 of the article should be supplemented accordingly. Besides, a modification of Article 23 A as suggested in paragraph 35 of the Commentary on article 23 A is needed."

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 13

Paragraph 1

This paragraph reproduces article 13, paragraph 1, of the OECD Model Convention, the commentary on which reads as follows:

"Paragraph 1 states that gains from the alienation of immovable property may be taxed in the State in which it is situated. This rule corresponds to the provisions of Article 6 and of paragraph 1 of Article 22. It applies also to immovable property forming part of the assets of an enterprise or used for performing independent personal services. For the definition of immovable property paragraph 1 refers to Article 6. Paragraph 1 of article 13 deals only with gains which a resident of a Contracting State derives from the alienation of immovable property situated in the other Contracting State. It does not, therefore, apply to gains derived from the alienation of immovable property situated in the Contracting State of which the alienator is a resident in the meaning of Article 4 or situated in a third State; the provisions of paragraph 1 of Article 21 shall apply to such gains.

"Certain tax laws assimilate the alienation of all or part of the shares in a company, the exclusive or main aim of which is to hold immovable property, to the alienation of such immovable property. In itself paragraph 1 does not allow that practice: a special provision in the bilateral convention can alone provide for such an assimilation. Contracting States are of course free either to include in their bilateral conventions such special provision; or to confirm expressly that the alienation of shares cannot be assimilated to the alienation of the immovable property."

Paragraph 2

This paragraph reproduces article 13, paragraph 2, of the OECD Model Convention, the commentary on which reads as follows:

"Paragraph 2 deals with movable property forming part of the business property of a permanent establishment of an enterprise or pertaining to a fixed base used for performing independent personal services. The term 'movable property' means all property other than immovable property which is dealt with in paragraph 1. It includes also incorporeal property, such as goodwill, licences, etc. Gains from the alienation of such assets may be taxed in the State in which the permanent establishment or fixed base is situated, which corresponds to the rules for business profits and for income from independent personal services (Articles 7 and 14).

"The paragraph makes clear that its rules apply when movable property of a permanent establishment or fixed base is alienated as well as when the permanent establishment as such (alone or with the whole enterprise) or the fixed base as such is alienated. If the whole enterprise is alienated, then the rule applies to such gains which are deemed to result from the alienation of movable property forming part of the business property of the permanent establishment. The rules of Article 7 should then apply mutatis mutandis without express reference thereto . . .

"On the other hand, paragraph 2 may not always be applicable to capital gains from the alienation of a participation in an enterprise. The provision applies only to property which was owned by the alienator, either wholly or jointly with another person. Under the laws of some countries, captial assets of a partnership are considered to be owned by the partners. Under some other laws, however, partnerships and other associations are treated as body corporate for tax purposes, distinct from their partners (members), which means that participations in such entities are dealt with in the same way as shares in a company. Capital gains from the alienation of such participations like capital gains from the alienation of shares, are therefore taxable only in the State of residence of the alienator. Contracting States may agree bilaterally on special rules governing the taxation of capital gains from the alienation of a participation in a partnership.

"Certain States consider that all capital gains arising from sources in their territory should be subject to their taxes according to their domestic laws, if the alienator has a permanent establishment within their territory. Paragraph 2 is not based on such a conception which is sometimes referred to as 'the force of attraction of the permanent establishment'. The paragraph merely provides that gains from the alienation of movable property forming part of the business property of a permanent establishment or of movable property pertaining to a fixed base used for performing independent personal services may be taxed in the State where the permanent establishment or the fixed base is situated. The gains from the alienation of all other movable property are taxable only in the State of residence of the alienator as provided in paragraph 4 [paragraph 6 of the United Nations text]".

Paragraph 3

This paragraph reproduces article 13, paragraph 3, of the OECD Model Convention, the commentary on which reads as follows:

"An exception from the rule of paragraph 2 is provided for ships and aircraft operated in international traffic and for boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, aircraft and boats.

Gains from the alienation of such assets are taxable only in the State in which the place of effective management of the enterprise operating such ships, aircraft and boats is situated. This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 22. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of such enterprise is aboard a ship or a boat. Contracting States which would prefer to confer the exclusive taxing right on the State of residence or to use a combination of the residence criterion and the place of effective management criterion are free, in bilateral conventions, to substitute to paragraph 3 a provision corresponding to those proposed in paragraphs 2 and 3 of the commentary on Article 8 [i.e., the first two paragraphs quoted from the OECD commentary and reproduced as part of the commentary on article 8 A, paragraph 1, of the United Nations Model Convention]."

Paragraph 4

This paragraph is designed to prevent the avoidance of taxes on the gains from the sale of immovable property. Since it is often relatively easy to avoid taxes on such gains through the incorporation of such property, it is necessary to tax the sale of shares in such a company. This is especially so where ownership of the shares carries the right to occupy the property. In order to fulfil its purpose paragraph 4 would have to apply regardless of whether the company is a resident of the Contracting State in which the immovable property is situated or a resident of another State.

Paragraph 5

During the discussion relating to the provisions of this paragraph, a number of members considered that a Contracting State should have jurisdiction to tax the gain on the sale of shares of a company resident in that State whether the sale occurred within or outside the State, but it was recognized that for administrative reasons the right to tax should be limited to a sale of substantial participation. The determination of what was a substantial participation was left to bilateral negotiations, in the course of which an agreed percentage would be determined.

The Group noted that some countries might consider that the Contracting State in which the company was resident should tax the alienation of its shares only if a substantial portion of the assets were situated in that State, and in bilateral negotiations might urge such a limitation. Other countries might prefer that paragraph 5 be omitted entirely.

Paragraph 6

This paragraph reproduces article 13, paragraph 4, of the OECD Model Convention with a drafting adjustment under which the words "in paragraphs 1, 2 and 3" are replaced by "in paragraphs 1, 2, 3, 4 and 5". The commentary on article 13, paragraph 4 of the OECD Model Convention is therefore relevant, *mutatis mutandis,* to paragraph 6. This commentary reads as follows:

"As regards gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3, paragraph 4 provides that they are taxable only in the State of which the alienator is a resident. This corresponds to the rules laid down in Article 22.

"The Article does not contain special rules for gains from the alienation of shares in a company or of securities, bonds, debentures and the like. Such gains are, therefore, taxable only in the State of which the alienator is a resident.

"If shares are sold by a shareholder to the issuing company in connection with the liquidation of such company or the reduction of its paid-up capital, the difference between the selling price and the par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated profits and not as a captial gain. The Article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in Article 10: such taxation is permitted because such difference is covered by the definition of the term "dividends" contained in paragraph 3 of Article 10 and interpreted in paragraph 27 of the commentary relating thereto. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with article 11."

C. SPECIAL DEROGATION AND RESERVATIONS ON ARTICLE 13 OF THE OECD MODEL CONVENTION

Special derogation

"In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic, to remuneration of crews of such ships, to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships, and to capital gains from the alienation of such ships and assets."

Reservations on the article

"*Australia* reserves the right to propose changes to reflect the facts that Australia does not levy a capital gains tax and that the terms 'movable property' and 'immovable property' are terms not used in Australian law.

"*Canada* reserves its position on paragraph 4 of the Article, in order to reserve the right to tax gains from the alienation of property, other than those mentioned in the first three paragraphs.

"*Finland* reserves the right to tax gains from the alienation of shares or other corporate rights in Finnish companies, where the ownership of such shares or other corporate rights entitles to the enjoyment of immovable property situated in Finland and owned by the company.

"*France* can accept the provisions of paragraph 4, but wishes to retain the possibility of applying the provisions in its laws relative to the taxation of gains from the alienation of shares or rights which are part of a substantial participation in a company which is a resident of France, or of shares or rights of companies the assets of which consist mainly of immovable property situated in France.

"*Italy* reserves the right to subject capital gains from Italian sources to the taxes imposed by its law whenever the alienator has a permanent establishment in Italy, even if the property or assets alienated did not form part of the business property employed in such permanent establishment.

"*New Zealand* reserves its position on paragraphs 3 and 4.

"*Portugal* reserves the right to tax gains from the increase in capital of companies with a head office or place of effective management in Portugal, when the increase results from the capitalisation of reserves or the issue of shares.

"*Turkey* reserves the right, in accordance with its legislation, to tax capital gains from the alienation, within its territory, of movable capital and any property other than those mentioned in paragraph 2 if the delay between their acquisition and their alienation is less than two years."

Article 14

INDEPENDENT PERSONAL SERVICES

Article 14 of the United Nations Model Convention reproduces in the introductory part of paragraph 1, in subparagraph 1 (*a*) and in paragraph 2 the essential provisions of article 14 of the OECD Model

Convention. In paragraph 1, subparagraphs 1 (*b*) and 1 (*c*), it contains two new exceptions in addition to the one contained in article 14, paragraph 1, of the OECD Model Convention, which is reproduced in subparagraph 1 (*a*).

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

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

Several members from developing countries proposed a third criterion, namely, that of the amount of remuneration. Under that criterion, remuneration for independent personal services could be taxed by the source country if it exceeded a specified amount, regardless of the existence of a fixed base or the length of stay in that country.

As a compromise, the Group decided to include three alternative criteria, the satisfaction of any one of which would give the source country the right to tax the income derived from the performance of personal activities by an individual who is a resident of the other State. These criteria are found in subparagraphs (*a*)–(*c*) of paragraph 1.

Subparagraph (*a*), which reproduces the sole criterion in the OECD Model Convention, provides that the income may be taxed if the individual has a fixed base regularly available to him for performing his activities. Though the presence of a fixed base gives the right to tax, the amount of income that is subject to tax is limited to that which is attributable to the fixed base.

Subparagraph (*b*) extends the source country's right to tax (in comparison with the OECD Model) by providing that the source country may tax if the individual is present in that country for a period or periods aggregating at least 183 days in the fiscal year, even if there is no fixed base. Only the amount of income derived from activities exercised in that country, however, may be taxed.

Subparagraph (*c*) provides a further criterion for source country tax when neither of the conditions specified in subparagraphs (*a*) and (*b*) are met. If the remuneration for the services performed in the source country exceeds a certain amount (to be determined in bilateral negotiations), the source country may tax, but only if the remuneration is derived from a resident of the source country or from a permanent establishment or fixed base of a resident of any other country which is situated in that country. Though the subparagraph does not so state, it is understood that, as in the other subparagraphs, only income from activities performed in the source country may be taxed there.

The Group discussed the relationship between article 14 and subparagraph 3 (*b*) of article 5 and it was generally agreed that remuneration paid directly to an individual for his performance of activity in an independent capacity was subject to the provisions of article 14. Payments made to an enterprise in respect of the furnishing by that enterprise of the activities of employees or other personnel are subject to article 5. The remuneration paid by the enterprise to the individual who performed the activities is subject either to article 14 (if he is an independent contractor engaged by the enterprise to perform the activities) or article 15 (if he is an employee of the enterprise). If the parties believe that further clarification of the relationship between article 14 and subparagraph 3 (*b*) of article 5 is needed, they may make such clarification in the course of negotiations.

Since article 14 of the United Nations Model Convention contains all the essential provisions of article 14 of the OECD Model Convention, the commentary on that article is relevant. That commentary reads as follows:

> "The Article is concerned with what are commonly known as professional services and with other activities of an independent character. This excludes industrial and commercial activities and also professional services performed in employment, e.g. a physician serving as a medical officer in a factory. It should, however, be observed that the article does not concern independent activities of entertainers and athletes, these being covered by Article 17.
>
> "The meaning of the term 'professional services' is illustrated by some examples of typical liberal professions. The enumeration has an explanatory character only and is not exhaustive. Difficulties of interpretation which might arise in special cases may be solved by mutual agreement between the competent authorities of the Contracting States concerned.
>
> "The provisions of the article are similar to those for business profits and rest in fact on the same principles as those of Article 7. The provisions of Article 7 and the Commentary thereon could therefore be used as guidance for interpreting and applying Article 14. Thus the principles laid down in Article 7 for

instance as regards allocation of profits between head office and permanent establishment could be applied also in apportioning income between the State of residence of a person performing independent personal services and the State where such services are performed from a fixed base. Equally, expenses incurred for the purposes of a fixed base, including executive and general expenses, should be allowed as deductions in determining the income attributable to a fixed base in the same way as such expenses incurred for the purposes of a permanent establishment. Also in other respects Article 7 and the Commentary thereon could be of assistance for the interpretation of Article 14.

"Even if Articles 7 and 14 are based on the same principles, it was thought that the concept of permanent establishment should be reserved for commercial and industrial activities. The term 'fixed base' has therefore been used. It has not been thought appropriate to try to define it, but it would cover, for instance, a physician's consulting room or the office of an architect or a lawyer. A person performing independent personal services would probably not as a rule have premises of this kind in any other State than of his residence. But if there is in another State a centre of activity of a fixed or a permanent character, then that State should be entitled to tax the person's activities."

C. RESERVATIONS ON ARTICLE 14 OF THE OECD MODEL CONVENTION

"*New Zealand* and *Turkey* reserve the right to tax persons performing professional services or other activities of an independent character if they are present in these countries for a period or periods exceeding in the aggregate 183 days in the fiscal (for New Zealand) or calendar (for Turkey) year, even if they do not have a fixed base available to them for the purpose of performing such services or activities.

"*Portugal* and *Spain* reserve their position on paragraph 1.

"The *United States* reserves the right to tax services performed by individuals who are present in the United States for more than 183 days during the taxable year. The United States also believes that this Article should be limited to individuals and to income from the performance of personal services."

Article 15

DEPENDENT PERSONAL SERVICES

A. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 15

Article 15 of the United Nations Model Convention reproduces article 15 of the OECD Model Convention, the commentary on which reads as follows:

"Paragraph 1 establishes the general rule as to the taxation of income from employment (other than pensions), namely, that such income is taxable in the State where the employment is actually exercised. One consequence of this would be that a resident of a Contracting State who derived remuneration, in respect of an employment, from sources in the other State could not be taxed in that other State in respect of that remuneration merely because the results of this work were exploited in that other State.

"The general rule is subject to exception only in the case of pensions (Article 18) and of remuneration and pensions in respect of government service (Article 19). Remuneration of members of boards of directors of companies is the subject of Article 16.

"Paragraph 2 contains, however, a general exception to the rule in paragraph 1. This exception, which concerns employment of short duration abroad, is mainly intended to facilitate the international movement of qualified personnel, as in the case of firms which sell capital goods and are responsible for installing and assembling them abroad. The three conditions prescribed in this paragraph must be satisfied for the remuneration to qualify for the exemption. The exemption is limited to the 183-day period. It is further stipulated that this time period may not be exceeded 'in the fiscal year concerned'. The formulation used may create difficulties in cases where the fiscal years of the Contracting States do not coincide. In order to avoid these difficulties such Contracting States may prefer to use another phrasing, for instance 'fiscal year of that other State' or 'calendar year'. The employer paying the remuneration must not be a resident of the State in which the employment is exercised. Furthermore, should the employer have in that State a permanent establishment (or a fixed base if he performs professional services or other activities of an independent character), the exemption is given only on condition that the remuneration is not borne by a permanent establishment or a fixed base which the employer has in the other State. It should be noted that, under the provisions of Article 17, the exemption does not apply to remuneration of artistes and athletes.

"Paragraph 3 applies to the remuneration of crews of ships or aircraft operated in international traffic, or of boats engaged in inland waterways transport, a rule which follows up to a certain extent the rule applied to the income from shipping, inland waterways transport and air transport—that is, to tax them in the Contracting State in which the place of effective management of the enterprise concerned is situated. In the Commentary on Article 8, it is indicated that Contracting States may agree to confer the right to tax such income on the State of the enterprise operating the ships, boats or aircraft. The reasons for introducing that possibility in the case of income from shipping, inland waterways and air transport operations are valid also in respect of remuneration of the crew. Accordingly Contracting States are left free to agree on a provision which gives the right to tax such remuneration to the State of the enterprise. Such a provision, as well as that of paragraph 3 of Article 15, assumes that the domestic laws of the State on which the right to tax is conferred allows it to tax the remuneration of a person in the service of the enterprise concerned, irrespective of his residence. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat. According to the domestic laws of some Member countries, tax is levied on remuneration received by non-resident members of the crew in respect of employment aboard ships only if the ship has the nationality of such a State. For that reason conventions concluded between these States provide that the right to tax such remuneration is given to the State of the nationality of the ship. On the other hand many States cannot make use of such a taxation right and the provision could in such cases lead to non-taxation. However, States having that taxation principle in their domestic laws may agree bilaterally to confer the right to tax remuneration in respect of employment aboard ships on the State of the nationality of the ship.

"It should be noted that no special rule regarding the taxation of income of frontier workers is included as it would be more suitable for the problems created by local conditions to be solved directly between the States concerned.

"No special provision has been made regarding remuneration derived by visiting professors or students employed with a view to their acquiring practical experience. Many conventions contain rules of some kind or other concerning such cases, the main purpose of which is to facilitate cultural relations by providing for a limited tax exemption. Sometimes, tax exemption is already provided under domestic taxation laws. The absence of specific rules should not be interpreted as constituting an obstacle to the inclusion of such rules in bilateral conventions whenever this is felt desirable."

B. SPECIAL DEROGATION OF ARTICLE 15 OF THE OECD MODEL CONVENTION

"In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic, to remuneration of crews of such ships, to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships, and to capital gains from the alienation of such ships and assets."

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS

A. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 16

Article 16 of the United Nations Model Convention reproduces article 16 of the OECD Model Convention; in addition, it contains a new second paragraph, dealing with payments received by top-level managerial officials.

The Group of Experts observed that the top-level managerial positions of a company resident in a Contracting State might be occupied by persons resident in the other Contracting State. In that situation the principle applicable by the first Contracting State to the taxation of Directors' fees should also apply to the taxation of the remuneration paid to such top-level managerial officials. The term "top-level managerial positions" referred to a limited group of positions that involved primary responsibility for the general direction of the affairs of the company, apart from the activities of the directors. The term would cover a person acting as both a director and a top-level manager.

Since article 16 of the United Nations Model Convention reproduces the whole of article 16 of the OECD Model Convention, the commentary on the latter article, which reads as follows, is relevant:

> "This Article relates to remuneration received by a resident of a Contracting State, whether an individual or a legal person, in the capacity of a member of a board of directors of a company which is a resident of the other Contracting State. Since it might sometimes be difficult to ascertain where the services are performed, the provision treats the services as performed in the State of residence of the company.
>
> "A member of the board of directors of a company often also has other functions with the company, e.g. as ordinary employee, adviser, consultant, etc. It is clear that the Article does not apply to remuneration paid to such a person on account of such other functions.
>
> "In some countries organs of companies exist which are similar in function to the board of directors. Contracting States are free to include in bilateral conventions such organs of companies under a provision corresponding to Article 16."

B. RESERVATIONS ON ARTICLE 16 OF THE OECD MODEL CONVENTION

"*Portugal* reserves the right to tax under Article 15 any remuneration of a member of the board of directors or of any other body of a company, for the carrying out of a permanent activity.

"The *United States* reserves its position with regard to this Article. The United States believes that directors' fees should be subject to tax under Article 14."

Article 17

INCOME EARNED BY ENTERTAINERS AND ATHLETES

A. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 17

Article 17 of the United Nations Model Convention reproduces article 17 of the OECD Model Convention.

In adopting the OECD text, the Group of Experts agreed that the term "athlete", which, unlike the term "entertainer" was not followed in paragraph 1 by illustrative examples, was nevertheless likewise to be construed in a broad manner consistent with the spirit and purpose of the article.

Since the text of article 17 is the same as that of article 17 of the OECD Model Convention, the following commentary on the latter article is relevant:

"Paragraph 1 provides that entertainers and athletes who are residents of a Contracting State may be taxed in the other Contracting State in which their personal activities as such are performed, whether these are of an independent or of a dependent nature. This provision is an exception to the rules in Article 14 and to that in paragraph 2 of Article 15, respectively.

"This provision makes it possible to avoid the practical difficulties which often arise in taxing entertainers and athletes performing abroad. Moreover, too strict provisions might in certain cases impede cultural exchanges. In order to overcome this disadvantage, the States concerned may, by common agreement, limit the application of paragraph 1 to independent activities by adding its provisions to those of Article 14. In such a case, entertainers and athletes performing for a salary or wages would automatically come within Article 15 and thus be entitled to the exemptions provided for in paragraph 2 of that Article.

"The provisions of the Article do not apply when the entertainer or athlete is employed by a Government and derives the income from that Government. Such income is to be treated under the provisions of Article 19. Certain conventions contain provisions excluding entertainers and athletes employed in organisations which are subsidised out of public funds from the application of article 17. The provisions of the article shall not prevent Contracting States from agreeing bilaterally on particular provisions concerning such entertainers and athletes.

"The purpose of paragraph 2 is to counteract certain tax avoidance devices in cases where remuneration for the performance of an entertainer or athlete is not paid to the entertainer or athlete himself but to another person, e.g. a so-called artiste-company, in such a way that the income is taxed in the State where the activity is performed neither as personal service income to the entertainer or athlete nor as profits of the enterprise in the absence of a permanent establishment. Paragraph 2 permits the State in which the performance is given to impose a tax on the profits diverted from the income of the entertainer or athlete to the enterprise where for instance the entertainer or athlete has control over or rights to the income thus diverted or has obtained or will obtain some benefit directly or indirectly from that income. It may be, however, that the domestic laws of some States do not enable them to apply such a provision. Such States are free to agree to alternative solutions or to leave paragraph 2 out of their bilateral convention.

"Where in the cases dealt with in paragraph 2 the exemption method for relieving double taxation is used by the State of residence of the person receiving the income, that State would be precluded from taxing such income even if the State where the activities were performed could not make use of its right to tax. It is therefore understood that the credit method should be used in such cases. The same result could be achieved by stipulating a subsidiary right to tax for the State of residence of the person receiving the income, if the State where the activities are performed cannot make use of the right conferred on it by paragraph 2. Contracting States are free to choose any of these methods in order to ensure that the income does not escape taxation."

Some members of the Group indicated that the examples given in the commentary on article 17, paragraph 2, of the OECD Model Convention should not be understood as limiting the field of application of taxation to the incomes mentioned in that commentary. In fact, the wording of the commentary would allow taxation of the enterprise in the other Contracting State, with the same limitations as those imposed for artists or athletes resident in a Contracting State and carrying out activities in the other State.

On the other hand, members expressed the view that some countries might wish paragraph 2 to have a narrower scope.

B. OBSERVATION ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 17 OF THE OECD MODEL CONVENTION

Observation on the commentary

"*Canada* and the *United States* are of the opinion that paragraph 2 of the Article applies only to cases mentioned in paragraph 4 above and these countries will propose an amendment to that effect when negotiating conventions with other Member countries."

Reservations on the article

"*Greece* and *Portugal* reserve the right to apply the provisions of Article 17, not 19, to income of Government artistes and athletes.

"*Japan* reserves the right to apply the provisions of this Article to income derived in connection with trade or business by entertainers or athletes who are employed by the Government.

"The *United States* reserves the right to limit paragraph 1 to situations where the entertainer or athlete is present in the other State for a specified period or earns a specified amount."

Article 18

PENSIONS AND SOCIAL SECURITY PAYMENTS

A. GENERAL CONSIDERATIONS

Two alternative versions are given for article 18 of the United Nations Model Convention, article 18 A and article 18 B. Article 18 A, like article 18 of the OECD Model Convention, assigns to the country of residence the exclusive right to tax pensions and other similar remuneration. It departs from the OECD article, however, by granting to the source country the exclusive right to tax when the payments involved are made within the framework of a public scheme which is part of the social security system of that State or a political subdivision or a local authority thereof.

Article 18 B provides for a sharing between the country of residence and the country of source of the right to tax pensions and other similar remuneration when the payments involved are not made within the framework of a public scheme which is part of the social security system of a State or a political subdivision or a local authority thereof. In the latter case, the right to tax belongs only to the source country. Some members of the Group pointed out that some countries wanted to be able to negotiate the question whether the country of residence should have the right to tax residents on social security payments.

B. COMMENTARY ON THE TWO ALTERNATIVE VERSIONS OF ARTICLE 18

Commentary on the paragraphs of article 18 A

Paragraph 1

Since article 18 A reproduces in its first paragraph the text of article 18 of the OECD Model Convention it is therefore relevant to reproduce the commentary on the latter article, which reads as follows:

> "According to this Article, pensions paid in respect of private employment are taxable only in the State of residence of the recipient. The provision also covers widows' and orphans' pensions and other similar payments such as annuities paid in respect of past employment. It also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19.
>
> "Some States consider pensions paid out under a public pension scheme which is part of their social security system similar to Government pensions. Such States argue on that basis that the State of source, i.e. the State from which the pension is paid, should have a right to tax such pensions. Many conventions concluded by these States contain provisions to that effect, sometimes including also other payments made under the social security legislation of the State of source. Such payments are for instance sickness benefits, unemployment benefits and benefits on account of industrial injury. Contracting States having that view may agree bilaterally on an additional paragraph to the Article giving the State of source a right to tax payments made under its social security legislation. A paragraph of that kind could be drafted along the following lines:
>
> " 'Notwithstanding the provisions of paragraph 1, pensions and other payments made under the social security legislation of a Contracting State may be taxed in that State.'
>
> "Where the State of which the recipient of such payments is a resident applies the exemption method the payments will be taxable only in the State of source while States using the credit method may tax the payments and give credit for the tax levied in the State of source. Some States using the credit method as the general method in their conventions may, however, consider that the State of source should have an exclusive right to tax such payments. Such States should then substitute the words 'shall be taxable only' for the words 'may be taxed' in the above draft provision.
>
> "The treatment under the taxation laws of the OECD Member countries of amounts paid to an employee on the cessation of his employment is highly diversified. Some States regard

such a payment as a pension, private or Government as the case may be, paid as a lump sum. In such a case it would be natural to consider the income as falling under Article 18 or 19. In the tax laws of other States such a payment is looked upon as the final remuneration for the work performed. Then it should of course be treated under Article 15 or 19, as the case may be. Others again consider such a payment as a bonus which is not taxable under their income tax laws but perhaps subjected to a gift tax or a similar tax. It has not been possible to reach a common solution on the tax treatment of payments of this kind under the Model Convention. If the question of taxing such payments should arise between Contracting States, the matter therefore has to be solved by recourse to the provisions of Article 25."

Paragraph 2

As stated in the general considerations, the paragraph assigns to the country of source the exclusive right to tax pensions paid out and other payments made within the framework of a public scheme which is part of the social security system of that State or a political subdivision or a local authority thereof. As can be seen from the second paragraph of the above OECD quotation, no consensus emerged within the OECD Committee on Fiscal Affairs on the inclusion in the text of article 18 of such an exclusive right. The provisions of the United Nations Model Convention are more restrictive in scope, since the paragraph suggested in the OECD commentary for a possible inclusion in a treaty provides that "pensions and other payments made under the social security legislation of a Contracting State may be taxed in that State."

The assignment to the source country of the exclusive right to tax pensions paid out and other payments made under a public scheme which is part of the social security system is predicated on the rationale that the payments involved are wholly or largely financed out of the tax revenues of the source country. This is the case when there are no contributions by the prospective beneficiaries of the payments or when the contractual savings contributed under the social security scheme have to be supplemented by the tax revenues of the source country. Such may not be always the case however when the social security system functions on the basis of the capitalization principle rather than that of the distribution principle.

Commentary on the paragraphs of article 18 B

During the discussion, several members of the Group of Experts from developing countries expressed the view that pensions should not be taxed exclusively in the beneficiary's country of residence. They pointed out that, since pensions were in substance a form of deferred compensation for services performed in the source country, they should be taxed at source as normal employment income would be. They further observed that pension flows between some developed and developing countries were not reciprocal and in some cases represented a relatively substantial net outflow for the developing country. A number of members from developing countries said they favoured exclusive taxation of pensions at source but would be willing to grant an exemption from source taxation for amounts equivalent to the personal exemptions allowable in the source country. Members from developed countries were generally of the view that pensions should be taxed only in the beneficiary's country of residence. They suggested that, since the amounts involved were generally not substantial, developing countries would not suffer measurably if they agreed to taxation in the country of residence. Those members also made the point that the country of residence was probably in a better position than the source country to structure its taxation of pensions to the taxpayer's ability to pay.

A question was raised about how pension payments would be taxed in the case of employees who had performed services consecutively in several different countries—a fairly common practice among employees of transnational corporations. If such employees were taxed in each jurisdiction in which they had previously worked to earn the pension, then each pension payment might be taxed in a number of jurisdictions. It was also observed on the other hand that it would be very difficult for the head office of a company to allocate each pension among the various countries in which the pensioner had worked during his years of employment. It was generally agreed, therefore, that taxation of pension at source should be construed to mean taxation at the place in which the pension payments originated, not the place in which the services had been performed.

Paragraph 1

This paragraph, although it recognizes the right of the country of residence to tax pensions and other similar remuneration, leaves open the possibility that the country of source may be also given the right to tax in certain conditions which are defined in paragraph 2.

Paragraph 2

As indicated above, the country of source may be allowed to tax but only if the payments involved are made by a resident of that country or a permanent establishment situated therein.

Paragraph 3

Since paragraph 3 of article 18 B is identical to paragraph 2 of article 18 A, the commentary in the latter paragraph (see above) is fully applicable to the former.

C. RESERVATIONS ON ARTICLE 18 OF THE OECD MODEL CONVENTION

"*Australia* reserves its position on this Article. When negotiating with other Member countries, the Australian authorities will propose that all pensions be taxable only in the country of residence of the recipient.

"*Canada* reserves its position on this Article. When negotiating conventions, the Canadian authorities will propose that the country in which the pensions arise be given a limited right to tax. Canada would also wish to apply this rule to pensions referred to in Article 19 in order to achieve uniformity of treatment.

"*Sweden*, when negotiating conventions with other Member countries, would wish to retain the right to tax pensions paid to non-residents of Sweden, where such pensions are paid in respect of past services rendered mainly within Sweden."

Article 19

REMUNERATION AND PENSIONS IN RESPECT OF GOVERNMENT SERVICE

A. GENERAL CONSIDERATIONS

Article 19 of the United Nations Model Convention reproduces article 19 of the OECD Model Convention. The Group observed that, while the provisions of the article were generally acceptable to its members, some developing countries might in bilateral negotiations desire to limit by reference to a ceiling amount the restriction in subparagraph 2 (*b*) on the taxation of pensions by the Government making the pension payments where the recipient is a resident or a national of another country. The Group also felt that some developing countries might prefer that payments dealt with in article 19 should be taxed only by the beneficiary's country of residence.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 19

Since article 19 of the United Nations Model Convention incorporates all the provisions of article 19 of the OECD Model Convention, the following commentary on the OECD article is relevant:

"This Article applies to remuneration in respect of government service. Similar provisions in old bilateral conventions were framed in order to conform with the rules of international courtesy and mutual respect between sovereign States. They were therefore rather limited in scope. However, the importance and scope of Article 19 has increased on account of the fact that, consequent on the growth of the public sector in many countries, governmental activities abroad have been considerably extended. According to the original version of paragraph 1 of article 19 in the 1963 Draft Convention the paying State had a right to tax payments made for services rendered to that State or political subdivision or local authority thereof. The expression 'may be taxed' was used and this did not connote an exclusive right of taxation.

"On revision of the Article, paragraph 1 was split into two paragraphs, paragraph 1 concerning remuneration other than a pension and paragraph 2 concerning pensions, respectively. Unlike the original provision, subparagraph (*a*) of paragraphs 1 and 2 are both based on the principle that the paying State shall have an exclusive right to tax the payments. Countries using the credit method as the general method for relieving double taxation in their conventions are thus, as an exception to that method, obliged to exempt from tax such payments to their residents as are dealt with under paragraphs 1 and 2. If both Contracting States apply the exemption method for relieving double taxation, they can continue to use the expression 'may be taxed' instead of 'shall be taxable only'. In relation to such countries the effect will of course be the same irrespective of which of these expressions they use. It is understood that the expression 'shall be taxable only' shall not prevent a Contracting State from taking into account the income exempted under subparagraph (*a*) of paragraphs 1 and 2 in determining the rate of tax to be imposed on income derived by its residents from other sources. The principle of giving the exclusive taxing right to the paying State is contained in so many of the existing conventions between OECD Member countries that it can be said to be already internationally accepted. It is also in conformity with the conception of international courtesy which is at the basis of the article and with the provisions of the Vienna Conventions on Diplomatic and Consular Relations. It should, however, be observed that the Article is not intended to restrict the operation of any rules originating from international law in the case of diplomatic missions and consular posts (cf. Article 27) but deals with cases not covered by such rules.

"The provisions of the Article apply to payments made not only by a State but also by its political subdivisions and local authorities (constituent states, regions, provinces, 'départements', cantons, districts, 'arrondissements', 'Kreise', municipalities, or groups of municipalities, etc.).

"An exception from the principle of giving exclusive taxing power to the paying State is contained in subparagraph (*b*) of paragraph 1. It is to be seen against the background that, according to the Vienna Conventions mentioned above, the receiving State is allowed to tax remuneration paid to certain categories of personnel of foreign diplomatic missions and consular posts, who are permanent residents or nationals of that State. Given that pensions paid to retired government officials ought to be treated for tax purposes in the same way as salaries or wages paid to such employees during their active time, an exception like the one in subparagraph (*b*) of paragraph 1 is incorporated also in subparagraph (*b*) of paragraph 2 regarding pensions. Since the condition laid down in subparagraph (*b*) (ii) of paragraph 1 cannot be valid in relation to a pensioner, the only prerequisite for the receiving State's power to tax the pension is that the pensioner must be one of its own residents and nationals. It should be noted that the expression 'out of funds created by' in subparagraph (*a*) of paragraph 2 covers the situation where the pension is not paid directly by the State, a political subdivision or a local authority but out of separate funds created by them.

"According to Article 19 of the 1963 Draft Convention, the services rendered to the State, political subdivision or local authority had to be rendered 'in the discharge of functions of a governmental nature'. In the course of the revision of the Article, it was decided to delete that expression. Some OECD Member countries, however, thought that the exclusion would lead to a widening of the scope of the Article. Contracting States who are of that view and who feel that such a widening is not desirable may continue to use, and preferably specify, the expression 'in the discharge of functions of a governmental nature' in their bilateral conventions.

"Paragraphs 1 and 2 do not apply if the services are performed in connection with business carried on by the State, or one of its political subdivisions or local authorities, paying the remuneration. In such cases the ordinary rules apply: Article 15 for wages and salaries, Article 16 for directors' fees and other similar payments and Article 18 for pensions. Article 17 is not mentioned because paragraphs 1 and 2 of Article 19 are to apply to remuneration paid to artistes employed by the State, a political subdivision or a local authority thereof, irrespective of whether such artistes could be said to be rendering services in connection with business carried on by the State, the political subdivision or the local authority. Contracting States, wishing for specific reasons to dispense with paragraph 3 in their bilateral conventions, are free to do so, thus bringing in under paragraphs 1 and 2 also services rendered in connection with business. In view of the specific functions carried out by certain public bodies, e.g. State Railways, the Post Office, State-owned theatres etc., Contracting States wanting to keep paragraph 3 may agree in bilateral negotiations to include under the provisions of paragraphs 1 and 2 remuneration paid by such bodies, even if they could be said to be performing business activities."

It was the intention of the Group that all pensions paid in respect of services rendered to a Contracting State, political subdivision or local authority thereof should be subject to the provisions of article 19, even if they were paid under the social security system of one of the States. In most cases the treatment would be the same whether such payments were subject to article 18 or article 19. The treatment differs, however, in those cases described in subparagraph 2 (*a*) of article 19—where the recipient is both a resident and a national of the other State. Under article 19, government service pensions received by such individuals are taxable only in the country of residence. If they were to be subject to tax under article 18, they would be taxable only in the country of source. The purpose of this paragraph is to indicate that a public service pension paid by one country, even if it is paid under its social security system, to a resident of the other country who is a national of that other country is taxable only in the latter country.

C. RESERVATIONS ON ARTICLE 19 OF THE OECD MODEL CONVENTION

"*Japan* and the *United States* believe that a reference to Article 17 should be added to paragraph 3, so that government-employed artistes may be governed by Article 17 if their services are rendered in connexion with a business.

"The *United States* reserves the right to modify the text to indicate that its application is not limited by Article 1."

Article 20

PAYMENTS RECEIVED BY STUDENTS AND APPRENTICES

A. GENERAL CONSIDERATIONS

Article 20 of the United Nations Model Convention reproduces, in its paragraph 1, article 20 of the OECD Model Convention. Paragraph 2 contains new provisions dealing with grants and scholarships and remuneration from employment not covered by paragraph 1.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 20

Paragraph 1

Since article 20 of the United Nations Model Convention incorporates all the provisions of article 20 of the OECD Model Convention, the following commentary on the latter articles, is relevant:

"The rule established in this Article concerns certain payments received by students or business apprentices for the purpose of their maintenance, education or training. All such payments received from sources outside the State in which the student or business apprentice concerned is staying shall be exempted from tax in that State.

"In the course of revision of the 1963 Draft Convention it was decided to insert the word 'immediately' in order to make clear that the article does not cover a person who has once been a resident of a Contracting State but has subsequently moved his residence to a third State before visiting the other Contracting State."

Paragraph 2

Some members of the Group felt that students or business apprentices should be exempted from tax on income received from employment in the Contracting State which they were visiting during their period of study or training. However, it was recognized that such an exemption could in some situations be regarded as discriminatory against local students or business apprentices receiving employment income. The limited approach suggested in paragraph 2 would eliminate any possible discrimination. It was observed that some countries in bilateral negotiations might wish to expand the article by adding a paragraph permitting a further exemption (beyond that generally applicable as a personal exemption or similar allowance under the internal law of the Contracting State) of employment income under certain conditions, either by limiting the relevant amount of income or by confining the exemption to amounts required for maintenance and support.

Some countries may for example, wish to extend the exemption to remuneration received for services performed in the country where the student or business apprentice is present, on condition that such services are in connexion with his studies or training or that the remuneration of such services is necessary for his maintenance, education or training.

Some other countries may also wish to extend the exemption to remuneration received for services performed in the country where the student or business apprentice is present but to limit such extension to an appropriate amount of remuneration. In fixing the amount, countries may take into account the fact that students or business apprentices may incur additional costs because they are away from their home country.

It may also be appropriate, in cases where the exemption is extended, to place a time-limit on such exemption in the case of business apprentices, and also perhaps in the case of students, a longer period presumably being allowed in the latter situation.

C. RESERVATIONS ON ARTICLE 20 OF THE OECD MODEL CONVENTION

"*Australia* reserves the right to have the operation of this Article limited to students."

Article 21

OTHER INCOME

A. GENERAL CONSIDERATIONS

Article 21 of the United Nations Model Convention reproduces article 21 of the OECD Model Convention in its entirety and also has a new paragraph (paragraph 3) containing a general provision relating to items of income of a resident of a Contracting State not dealt with in the preceding articles and arising in the other Contracting State.

The article covers not only income of a class not expressly dealt with in the preceding articles, but also income from sources not expressly referred to therein. The article covers income arising in third States as well as income from a Contracting State.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 21

Paragraph 1

This paragraph reproduces article 21, paragraph 1, of the OECD Model Convention. Part of the commentary on the latter paragraph, quoted below, is relevant:

> "Under this paragraph the exclusive right is given to the State of residence. In cases of conflict between two residences, Article 4 will also allocate the taxation right in respect of third State income . . . When income arises in a third State and the recipient of this income is considered as a resident by both Contracting States under their domestic law, the application of Article 4 will result in the recipient being treated as a resident of one Contracting State only and being liable to comprehensive taxation ('full tax liability') in that State only. In this case, the other Contracting State may not impose tax on the income arising from the third State, even if the recipient is not taxed by the State of which he is considered a resident under Article 4. In order to avoid non-taxation, Contracting States may agree to limit the scope of the article to income which is taxed in the Contracting State of which the recipient is a resident and may modify the provisions of the paragraph accordingly. . . ."

Paragraph 2

This paragraph reproduces article 21, paragraph 2, of the OECD Model Convention. The commentary on the latter paragraph, quoted below, is therefore relevant:

> "This paragraph provides for an exception from the provisions of paragraph 1 where the income is associated with the activity of a permanent establishment or fixed base which a

resident of a Contracting State has in the other Contracting State. The paragraph includes income from third States. In such a case, a right to tax is given to the Contracting State in which the permanent establishment or the fixed base is situated. Paragraph 2 does not apply to immovable property for which, according to paragraph 4 of Article 6, the State of situs has a primary right to tax. Therefore, immovable property situated in a Contracting State and forming part of the business property of a permanent establishment of an enterprise of that State situated in the other Contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient of the income is a resident. This is in consistency with the rules laid down in Articles 13 and 22 in respect of immovable property since paragraph 2 of those Articles applies only to movable property of a permanent establishment.

"The paragraph also covers the case where the beneficiary and the payer of the income are both residents of the same Contracting State, and the income is attributed to a permanent establishment or a fixed base, which the beneficiary of the income has in the other Contracting State. In such a case a right to tax is given to the Contracting State in which the permanent establishment or the fixed base is situated. Where double taxation occurs, the State of residence should give relief under the provisions of article 23 A or 23 B. However a problem may arise as regards the taxation of dividends and interest in the State of residence as the State of source: the combination of Articles 7 and 23 A prevents that State from levying tax on that income, whereas if it were paid to a resident of the other State, the first State, being the State of source of the dividends or interest, could tax such dividends or interest at the rates provided for in paragraph 2 of Articles 10 and 11. Contracting States which find this position unacceptable may include in their conventions a provision according to which the State of residence would be entitled, as State of source of the dividends or interest, to levy a tax on such income at the rates provided for in paragraph 2 of Articles 10 and 11. The State where the permanent establishment is situated would give a credit for such tax on the lines of the provisions of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B; of course, this credit should not be given in cases where the State in which the permanent establishment is situated does not tax the dividends or interest attributed to the permanent establishment, in accordance with its domestic laws.

"Some States which apply the exemption method (Article 23 A) may have reason to suspect that the treatment accorded in paragraph 2 may provide an inducement to an enterprise of a Contracting State to attach assets such as shares, bonds or patents, to a permanent establishment situated in the other Contracting State in order to obtain more favourable tax treatment there. To counteract such arrangements which they consider would represent abuse, some States might take the view that the transaction is artificial and, for this reason, would regard the assets as not effectively connected with the permanent establishment. Some other States may strengthen their position by adding in paragraph 2 a condition providing that the paragraph shall not apply to cases where the arrangements were primarily made for the purpose of taking advantage of this provision."

Paragraph 3

This paragraph constitutes an addition to article 21 of the OECD Model Convention. Its provisions are intended to permit the country in which the income arises to tax such income if its law so provides while the provisions of paragraph 1 would permit taxation in the country of residence; the concurrent application of the provisions contained in the two paragraphs may result in double taxation. In such a situation, the provisions of articles 23 A or 23 B as appropriate would be applicable, as in other cases of double taxation. In some cases paragraphs 2 and 3 may overlap; they would then produce the same result.

C. RESERVATIONS ON ARTICLE 21 OF THE OECD MODEL CONVENTION

"*Australia, Canada, New Zealand, Portugal* and *Spain* reserve their positions on this Article and would wish to maintain the right to tax income arising from sources in their own country.

"*Sweden*, when negotiating conventions with other Member countries, would wish to retain the right to tax certain annuities and similar payments to non-residents of Sweden, where such payments are made on account of a pension insurance issued in Sweden.

"In negotiating conventions with other Member States, the *United Kingdom* also wishes to maintain the right to tax income paid by residents of the United Kingdom to non-residents of the United Kingdom in the form of income from a trust."

Commentary on chapter IV

TAXATION OF CAPITAL

Article 22

CAPITAL

A. GENERAL CONSIDERATIONS

In the United Nations Model Convention, article 22 concerning the taxation of capital is left to be formulated in bilateral negotiations. The decision of the Group of Experts to leave the question to such negotiations should not be construed as indicating a position of principle with regard to the desirability of taxing such capital. The Group's decision is irrelevant in the case of countries which have not deemed it necessary to levy taxes on capital.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 22

Should the negotiating parties decide to include an article on the taxation of capital, they will have to determine whether to use the wording of paragraph 4 as shown or wording that leaves taxation to the State in which the capital is located. If the wording of paragraph 4 of the OECD Model Convention is used, the whole commentary on article 22 will be relevant. The commentary reads as follows:

"This Article deals only with taxes on capital, to the exclusion of taxes on estates and inheritances and on gifts and of transfer duties. Taxes on capital to which the article applies are those referred to in Article 2.

"Taxes on capital generally constitute complementary taxation of income from capital. Consequently, taxes on a given element of capital can be levied, in principle, only by the State which is entitled to tax the income from this element of capital. However, it is not possible to refer purely and simply to the rules relating to the taxation of such class of income, for not all items of income are subject to taxation exclusively in one State.

"The Article, therefore, enumerates first property which may be taxed in the State in which they are situated. To this category belong immovable property, referred to in Article 6, which a resident of a Contracting State owns and which is situated in the other Contracting State (paragraph 1), and movable property forming part of the business property of a permanent establishment which an enterprise of a Contracting State has in the other Contracting State, or pertaining to a fixed base which a resident of a Contracting State has in the other Contracting State for the performance of independent personal services (paragraph 2).

"Ships and aircraft operated in international traffic and boats engaged in inland waterways transport and movable property pertaining to the operation of such ships, boats or aircraft shall be taxable only in the State in which the place of effective management of the enterprise is situated (paragraph 3). This rule corresponds to the provisions of Article 8 and of paragraph 3 of Article 13. It is understood that paragraph 3 of Article 8 is applicable if the place of effective management of a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or boat. Contracting States which would prefer to confer the exclusive taxing right on the State of residence or to use a combination of the residence criterion and the place of effective management criterion are free in bilateral conventions to substitute for paragraph 3 a provision corresponding to those proposed in paragraphs 2 and 3 of the commentary on Article 8. Immovable property pertaining to the operation of ships, boats or aircraft may be taxed in the State in which they are situated, in accordance with the rule laid down in paragraph 1.

"As regards elements of capital other than those listed in paragraphs 1 to 3, the article provides that they are taxable only in the Contracting State of which the person to whom they belong is a resident (paragraph 4).

"If, when the provisions of paragraph 4 are applied to elements of movable property under usufruct, double taxation subsists because of the disparity between domestic laws, the States concerned may resort to the mutual agreement procedure or settle the question by means of bilateral negotiations.

"The Article does not provide any rule about the deductions of debts. The laws of OECD Member countries are too different to allow a common solution for such a deduction. The problem of the deduction of debts which could arise when the taxpayer and the creditor are not residents of the same State is dealt with in paragraph 5 of Article 24."

C. SPECIAL DEROGATION AND RESERVATIONS ON ARTICLE 22 OF THE OECD MODEL CONVENTION

Special derogation

"In view of its particular situation in relation to shipping, *Greece* will retain its freedom of action with regard to the provisions in the Convention relating to profits from the operation of ships in international traffic, to remuneration of crews of such ships, to capital represented by ships in international traffic and by movable property pertaining to the operation of such ships, and to capital gains from the alienation of such ships and assets."

Reservations on the article

"*Finland* reserves the right to tax shares or other corporate rights in Finnish companies, where the ownership of such shares or other corporate rights entitles to the enjoyment of immovable property situated in Finland and owned by the company.

"*New Zealand* and *Portugal* reserve their positions on this Article if and when they impose taxes on capital.

"The *United Kingdom* reserves its position on this Article pending the introduction of a wealth tax."

Commentary on chapter V

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

Article 23

METHODS FOR THE ELIMINATION OF DOUBLE TAXATION

A. GENERAL CONSIDERATIONS

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

With respect to investments in developing countries, one of the principal defects of the foreign tax credit method, in the eyes of the developing countries is the fact that the benefit of low taxes in developing countries or of special tax concessions granted by them may in large part inure to the benefit of the treasury of the capital-exporting country rather than to the foreign investor for whom the benefits were designed. Thus, revenue is shifted from the developing country to the capital-exporting country.

The effectiveness of the tax incentive measures introduced by most developing countries thus depends on the interrelationship between the tax systems of the developing countries and those of the capital-exporting countries from which the investment originates. It is of primary importance to developing countries to ensure that the tax incentive measures shall not be made ineffective by the taxation in the capital-exporting countries which use the foreign tax credit system resulting inadvertently in the cancellation of benefits designed to stimulate investment to the advantage of the treasuries of the capital-exporting countries. This undesirable result is to some extent avoided in bilateral treaties through the "tax sparing" credit, by which a developed country grants a credit not only for the tax paid but for the tax spared by incentive legislation in the developing country. It is also avoided, of course, under the exemption method.

In summary, the members of the Group from developing countries considered it necessary to underline those aspects mentioned in the immediately preceding paragraphs with the understanding that either the exemption method or the tax-sparing clause constituted, for these countries, a basic and fundamental aim in the negotiation of that kind of treaty.

Generally speaking, the method by which a country would give relief from double taxation depends primarily on its general tax policy and the structure of its tax system. Owing to the differences which exist in the various tax systems as regards the objectives pursued, bilateral tax treaties provide the most flexible instrument for reconciling conflicting tax systems and for avoiding or mitigating double taxation.

Members of the Group of Experts who were from developing countries felt that, as regards relief measures to be applied by developed countries, the methods of tax exemption and tax credit (including tax-sparing credit) could be used as appropriate. The exemption method was considered eminently suitable where exclusive tax jurisdiction over certain income was allotted to the country of source under a treaty: it might take therein the form of an exemption with progression. Where the investor's home country applied the principle of foreign tax credit, the most effective method of preserving the effect of the tax incentives and concessions extended by developing countries would be the application of a tax-sparing credit or investment credit in addition to the regular tax credit. Otherwise, under certain circumstances, the benefits would accrue to the treasury of the developed country rather than to the investor for whom they were designed.

Many members from both developed and developing countries agreed with the view that tax-sparing credits should be included in treaties between developed and developing countries, where the developed country used the credit method. However, a member from a developed country expressed the view that for a variety of reasons tax-sparing credits were not an appropriate tool for economic development. That objective, it was felt, might better be served by other measures.

The commentary on articles 23 A and 23 B of the OECD Model Convention, which is fully relevant in the case of the United Nations Model Convention, contains the following preliminary remarks.

"A. *The scope of the articles*

"These Articles deal with the so-called juridical double taxation where the same income or capital is taxable in the hands of the same person by more than one State.

"This case has to be distinguished especially from the so-called economic double taxation, i.e., where two different persons are taxable in respect of the same income or capital. If two States wish to solve problems of economic double taxation, they must do so in bilateral negotiations.

"International juridical double taxation may arise in three cases:

"(*a*) where each Contracting State subjects the same person to tax on his worldwide income or capital (concurrent full liability to tax);

"(*b*) where a person is a resident of a Contracting State (R)[1] and derives income from, or owns capital in, the other Contracting State (S or E) and both States impose tax on that income or capital;

"(*c*) where each Contracting State subjects the same person, not being a resident of either Contracting State to tax on income derived from, or capital owned in, a Contracting State; this may result, for instance, in the case where a non-resident person has a permanent establishment or fixed base in one Contracting State (E) through which he derives income from, or owns capital in, the other Contracting State (S) (concurrent limited tax liability).

"The conflict in case (*a*) is reduced to that of case (*b*) by virtue of Article 4. This is because that Article defines the term 'resident of a Contracting State' by reference to the liability to tax of a person under domestic law by reason of his domicile, residence, place of management or any other criterion of a similar nature (paragraph 1 of Article 4) and by listing special criteria for the case of double residence to determine which of the two States is the State of residence (R) within the meaning of the Convention (paragraphs 2 and 3 of Article 4).

"The conflict in case (*b*) may be solved by allocation of the right to tax between the Contracting States. Such allocation may be made by renunciation of the right to tax either by the State of source or situs (S) or of the situation of the permanent establishment or the fixed base (E), or by the State of residence (R), or by a sharing of the right to tax between the two States. The provisions of the Chapters III and IV of the Convention, combined with the provisions of Article 23 A or 23 B, govern such allocation.

"For some items of income or capital, an exclusive right to tax is given to one of the Contracting States, and the relevant article states that the income or capital in question 'shall be taxable only' in a Contracting State.[2] The words 'shall be taxable only'in a Contracting State preclude the other Contracting State

"[1] Throughout the Commentary on Articles 23 A and 23 B, the letter 'R' stands for the State of residence within the meaning of the Convention, 'S' for the State of source or situs, and 'E' for the State where a permanent establishment or a fixed base is situated.

"[2] Cf. first sentence of paragraph 1 of Article 7, paragraphs 1 and 2 of Article 8, paragraph 1 of Article 12, paragraphs 2, 3 and 4 of Article 13, first sentence of paragraph 1 of Article 14, first sentence of paragraph 1 and paragraph 2 of Article 15, Article 18, paragraphs 1 and 2 of Article 19, paragraph 1 of Article 21 and paragraphs 3 and 4 of Article 22.

from taxing, thus double taxation is avoided. The State to which the exclusive right to tax is given is normally the State of which the taxpayer is a resident within the meaning of article 4, that is State R, but in four articles[3] the exclusive right may be given to the other Contracting State (S) of which the taxpayer is not a resident within the meaning of article 4.

"For other items of income or capital, the attribution of the right to tax is not exclusive, and the relevant article then states that the income or capital in question 'may be taxed' in the Contracting State (S or E) of which the taxpayer is not a resident within the meaning of Article 4. In such case the State of residence (R) must give relief so to avoid the double taxation. Paragraphs 1 and 2 of Article 23 A and paragraph 1 of article 23 B are designed to give the necessary relief.

"Articles 23 A and 23 B apply to the situation in which a resident of State R derives income from, or owns capital in, the other Contracting State E or S (not being the State of residence within the meaning of the Convention) and that such income or capital, in accordance with the Convention, may be taxed in such other State E or S. The Articles, therefore, apply only to the State of residence and do not prescribe how the other Contracting State E or S has to proceed.

"Where a resident of the Contracting State R derives income from the same State R through a permanent establishment or a fixed base which he has in the other Contracting State E, State E may tax such income (except income from immovable property situated in State R) if it is attributable to the said permanent establishment or fixed base (paragraph 2 of Article 21). In this instance too, State R must give relief under Article 23 A or Article 23 B for income attributable to the permanent establishment or fixed base situated in State E, notwithstanding the fact that the income in question originally arises in State R. However, where the Contracting State agrees to give to State R which applies the exemption method a limited right to tax as the State of source of dividends or interest within the limits fixed in paragraph 2 of the Articles 10 or 11 . . . then the two States should also agree upon a credit to be given by State E for the tax levied by State R, on the lines of paragraph 2 of Article 23 A or of paragraph 1 of Article 23 B.

"Where a resident of State R derives income from a third State through a permanent establishment or a fixed base which he has in State E, such State E may tax such income (except income from immovable property situated in the third State) if it is

"[3] Cf. paragraphs 1 and 2 of Article 8, paragraph 3 of Article 13, subparagraph (*a*) of paragraphs 1 and 2 of Article 19 and paragraph 3 of Article 22.

attributable to such permanent establishment or fixed base (paragraph 2 of Article 21). State R must give relief under Article 23 A or Article 23 B in respect of income attributable to the permanent establishment or fixed base in State E. There is no provision in the Convention for relief to be given by Contracting State E for taxes levied in the third State where the income arises; however, under paragraph 4 of Article 24 any relief provided for in the domestic laws of State E (double taxation conventions excluded) for residents of State E is also to be granted to a permanent establishment in State E of an enterprise of State R. Cases in which more than two States are involved (triangular cases) raise many problems in regard to which not only the convention between the States R and E but also conventions between States R and/or E with State S may come into play. It could be argued that a provision in a convention between State R and State E obliging State E to give credit or exemption for income derived from a third State leads to a more favourable treatment of the permanent establishment than is granted by State E to its own residents, and that the effect of the combined application of domestic laws and of one or more conventions may even result in double or multiple relief. It is, therefore, left to Contracting States to settle the question bilaterally either generally in a convention to be concluded between them or by way of a mutual agreement procedure (Article 25).

"The conflict in case (*c*) of paragraph 3 above is outside the scope of the Convention as, under article 1, it applies only to persons who are residents of one or both of the States. It can, however, be settled by applying the mutual agreement procedure. . . .

"B. Description of methods for elimination of double taxation

"In the existing conventions, two leading principles are followed for the elimination of double taxation by the State of which the taxpayer is a resident. For purposes of simplicity, only income tax is referred to in what follows; but the principles apply equally to capital tax.

"1. *The principle of exemption*

"Under the principle of exemption, the State of residence R does not tax the income which according to the Convention may be taxed in State E or S (nor, of course, also income which shall be taxable only in State E or S . . .).

"The principle of exemption may be applied by two main methods:

"(*a*) the income which may be taxed in State E or S is not taken into account at all by State R for the purposes of its tax;

State R is not entitled to take the income so exempted into consideration when determining the tax to be imposed on the rest of the income; this method is called 'full exemption';

"(*b*) the income which may be taxed in State E or S is not taxed by State R, but State R retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income; this method is called 'exemption with progression'.

"2. *The principle of credit*

"Under the principle of credit, the State of residence R calculates its tax on the basis of the taxpayer's total income including the income from the other State E or S which, according to the Convention, may be taxed in that other State (but not including income which shall be taxable only in State S). It then allows a deduction from its own tax for the tax paid in the other State.

"The principle of credit may be applied by two main methods:

"(*a*) State R allows the deduction of the total amount of tax paid in the other State on income which may be taxed in that State; this method is called 'full credit';

"(*b*) The deduction given by State R for the tax paid in the other State is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State; this method is called 'ordinary credit'.

"Fundamentally, the difference between the methods is that the exemption methods look at income, while the credit methods look at tax."

"C. *Operation and effects of the methods*

"An example in figures will facilitate the explanation of the effects of the various methods. Suppose the total income to be 100,000, of which 80,000 is derived from one State (State of residence R) and 20,000 from the other State (State of source S). Assume that in State R the rate of tax on an income of 100,000 is 35 per cent and on an income of 80,000 is 30 per cent. Assume further that in State S the rate of tax is either 20 per cent—case (i)—or 40 per cent—case (ii), so that the tax payable therein on 20,000 is 4,000 in case (i) or 8,000 in case (ii), respectively.

"If the taxpayer's total income of 100,000 arises in State R, his tax would be 35,000. If he had an income of the same amount, but derived in the manner set out above, and if no relief is provided for in the domestic laws of State R and no conventions exist between State R and State S, then the total amount of tax would be, in case (i): 35,000 plus 4,000 = 39,000, and in case (ii): 35,000 plus 8,000 = 43,000.

"1. *Exemption methods*

"Under the exemption methods, State R limits its taxation to that part of the total income which, in accordance with the various articles of the Convention, it has a right to tax, i.e. 80,000.

"(a) *Full exemption*

State R imposes tax on 80,000 at the rate of tax applicable to 80,000, i.e., at 30 per cent.

	Case (i)	*Case (ii)*
Tax in State R, 30% of 80,000	24,000	24,000
plus tax in State S	4,000	8,000
Total taxes	28,000	32,000
Relief has been given by State R in the amount of	11,000	11,000

"(b) *Exemption with progression*

State R imposes tax on 80,000 at the rate of tax applicable to total income wherever it arises (100,000), i.e., at 35 per cent.

	Case (i)	*Case (ii)*
Tax in State R, 35% of 80,000	28,000	28,000
plus tax in State S	4,000	8,000
Total taxes	32,000	36,000
Relief has been given by State R in the amount of	7,000	7,000

"In both cases, the level of tax in State S does not affect the amount of tax given up by State R. If the tax on the income from State S is lower in State S than the relief to be given by State R—cases (*a*) (i), (*a*) (ii), and (*b*) (i)—then the taxpayer will fare better than if his total income were derived solely from State R. In the converse case—case (*b*) (ii)—the taxpayer will be worse off.

"The example shows also that the relief given where State R applies the full exemption method may be higher than the tax levied in State S, even if the rates of tax in State S are higher than those in State R. This is due to the fact that under the full exemption method, not only the tax of State R on the income from State S is surrendered (35 per cent of 20,000 = 7,000 as under the exemption with progression), but that also the tax on remaining income (80,000) is reduced by an amount corresponding to the differences in rates at the two income levels in State R (35 less 30 = 5 per cent applied to 80,000 = 4,000).

"2. *Credit methods*

"Under the credit methods, State R retains its right to tax the total income of the taxpayer, but against the tax so imposed, it allows a deduction.

"(a) *Full credit*

State R computes tax on total income of 100,000 at the rate of 35 per cent and allows the deduction of the tax due in State S on the income from S.

	Case (i)	*Case (ii)*
Tax in State R, 35% of 100,000	35,000	35,000
less tax in State S	– 4,000	– 8,000
Tax due	31,000	27,000
Total taxes	35,000	35,000
Relief has been given by State R in the amount of	4,000	8,000

"(b) *Ordinary credit*

State R computes tax on total income of 100,000 at the rate of 35 per cent and allows the deduction of the tax due in State S on the income from S, but in no case it allows more than the portion of tax in State R attributable to the income from S (maximum deduction). The maximum deduction would be 35 per cent of 20,000 = 7,000.

	Case (i)	*Case (ii)*
Tax in State R, 35% of 100,000	35,000	35,000
less tax in State S	– 4,000	
less maximum deduction		– 7,000
Tax due	31,000	28,000
Total taxes	35,000	36,000
Relief has been given by State R in the amount of	4,000	7,000

"TABLE I. TOTAL AMOUNT OF TAX IN THE DIFFERENT CASES ILLUSTRATED ABOVE

A. All income arising in State R	*Total tax = 35,000*	
B. Income arising in two States, viz. 80,000 in State R and 20,000 in State S	*Total tax if tax in State S is*	
	4,000 (case i)	*8,000 (case ii)*
No convention (19)[1]	39,000	43,000
Full exemption (20*a*)	28,000	32,000
Exemption with progression (20*b*)	32,000	36,000
Full credit (23*a*)	35,000	35,000
Ordinary credit (23*b*)	35,000	36,000

"[1] Numbers in brackets refer to paragraphs in this Commentary.

"TABLE II. AMOUNT OF TAX GIVEN UP BY THE STATE OF RESIDENCE

	If tax in State S is	
	4,000 (case i)	*8,000 (case ii)*
No convention	0	0
Full exemption (20*a*)[1]	11,000	11,000
Exemption with progression (20*b*)	7,000	7,000
Full credit (23*a*)	4,000	8,000
Ordinary credit (23*b*)	4,000	7,000

"[1] Numbers in brackets refer to paragraphs in this Commentary.

"A characteristic of the credit methods compared with the exemption methods is that State R is never obliged to allow a deduction of more than the tax due in State S.

"Where the tax due in State S is lower than the tax of State R appropriate to the income from State S (maximum deduction), the taxpayer will always have to pay the same amount of taxes as he would have had to pay if he were taxed only in State R, i.e. as if his total income were derived solely from State R.

"The same result is achieved, where the tax due in State S is the higher, while State R applies the full credit, at least as long as the total tax due to State R is as high or higher than the amount of the tax due in State S.

"Where the tax due in State S is higher and where the credit is limited (ordinary credit), the taxpayer will not get a deduction for the whole of the tax paid in State S. In such event the result would be less favourable to the taxpayer than if his whole income arose in State R, and in these circumstances the ordinary credit method would have the same effect as the method of exemption with progression.

"*D. The methods proposed in the articles*

"In the conventions concluded between OECD Member countries both leading principles have been followed. Some States have a preference for the first one, some for the other. Theoretically a single principle could be held to be more desirable, but, on account of the preferences referred to, each State has been left free to make its own choice.

"On the other hand, it has been found important to limit the number of methods based on each leading principle to be employed. In view of this limitation, the Articles have been drafted so that Member countries are left free to choose between two methods:

"—the exemption method with progression (Article 23 A), and

"—the ordinary credit method (Article 23 B).

"If two Contracting States both adopt the same method, it will be sufficient to insert the relevant Article in the convention. On the other hand, if the two Contracting States adopt different methods, both Articles may be amalgamated in one, and the name of the State must be inserted in each appropriate part of the Article, according to the method adopted by that State.

"Contracting States may use a combination of the two methods. Such combination is indeed necessary for a Contracting State R which generally adopts the exemption method in the case of income which under Articles 10 and 11 may be subjected to a limited tax in the other Contracting State S. For such case, Article 23 A provides in paragraph 2 a credit for the limited tax levied in the other Contracting State S. Moreover, States which in general adopt the exemption method may wish to exclude specific items of income from exemption and to apply to such items the credit method. In such case, paragraph 2 of Article 23 A could be amended to include these items of income.

"The two Articles are drafted in a general way and do not give detailed rules on how the exemption or credit is to be computed, this being left to the domestic laws and practice applicable. Contracting States which find it necessary to settle any problem in the convention itself are left free to do so in bilateral negotiations."

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 23 A

Since article 23 A of the United Nations Model Convention reproduces article 23 A of the OECD Model Convention, the commentary on that article is fully relevant:

"*Paragraph 1*

"A. *The obligation of the State of residence to give exemption*

"In the Article it is laid down that the State of residence R shall exempt from tax income and capital, which in accordance with the Convention 'may be taxed' in the other State E or S.

"The State of residence must accordingly give exemption whether or not the right to tax is in effect exercised by the other State. This method is regarded as the most practical one since it relieves the State of residence from undertaking investigations of the actual taxation position in the other State.

"Occasionally, negotiating States may find it reasonable in certain circumstances to make an exception to the absolute obligation on the State of residence to give exemption. Such may be the case, in order to avoid non-taxation, where under the domestic laws of the State of source no tax on specific items of income or capital is provided, or tax is not effectively collected owing to special circumstances such as the set-off of losses, a mistake, or the statutory time limit having expired. To avoid non-taxation of specific items of income, Contracting States may agree to amend the relevant Article itself. (. . .) One might also make an exception to the general rule, in order to achieve a certain reciprocity, where one of the States adopts the exemption method and the other the credit method. Finally, another exception to the general rule may be made where a State wishes to apply to specific items of income the credit method rather than exemption.

"As already mentioned, . . . the exemption method does not apply to such items of income which according to the Convention may be taxed in the State of residence but may also be subject to a limited tax in the other Contracting State. For such items of income, paragraph 2 of Article 23 A provides for the credit method."

In the United Nations Model Convention the right to tax in the country of source is extended in many cases to income which under the OECD Model Convention is taxable only in the country of residence. In view of this situation, many countries adopting the exemption method in their bilateral conventions may wish to restrict the application of paragraph 1 of article 23 A, e.g., by limiting the exemption from tax to income effectively taxed in the country of source or by applying to some items of income the tax credit provided for in paragraph 2 of article 23 A rather than the tax exemption.

The Group further decided to complement the commentary of the OECD Model Convention with the following observation:

Under the United Nations Model Convention paragraph 1 of article 23 A has a much broader scope than the corresponding provision of the OECD Model Convention. Consequently, since each State is free to adopt either the exemption method (article 23 A) or the credit method (article 23 B), a State which generally chooses the exemption method may elect the credit method for specific items of income not mentioned in paragraph 2 of article 23 A.

The OECD commentary continues as follows:

"B. Alternative formulation of the article

"An effect of the exemption method as it is drafted in the Article is that the taxable income or capital in the State of residence is reduced by the amount exempted in that State. If in a particular State the amount of income as determined for income tax purposes is used as a measure for other purposes, e.g. social benefits, the application of the exemption method in the form proposed may have the effect that such benefits may be given to persons who ought not to receive them. To avoid such consequences, the Article may be altered so that the income in question is included in the taxable income in the State of residence. The State of residence must, in such cases, give up that part of the total tax appropriate to the income concerned. This procedure would give the same result as the Article in the form proposed. States can be left free to make such modifications in the drafting of the Article. If a State wants to draft the Article as indicated above, paragraph 1 may be drafted as follows:

" 'Where a resident of a Contracting State derives income or owns capital which, in accordance with the provisions of this

Convention, shall be taxable only or may be taxed in the other Contracting State, the first mentioned State shall, subject to the provisions of paragraph 2, allow as a deduction from the income tax or capital tax that part of the income tax or capital tax, respectively, which is applicable, as the case may be, to the income derived from or the capital owned in that other State.

"If the Article is so drafted, paragraph 3 would not be necessary and could be omitted.

"C. *Miscellaneous problems*

"Article 23 A contains the principle that the State of residence has to give exemption, but does not give detailed rules on how the exemption has to be implemented. This is consistent with the general pattern of the Convention. Articles 6 to 22 too lay down rules attributing the right to tax in respect of the various types of income or capital without dealing, as a rule, with the determination of taxable income or capital, deductions, rate of tax, etc. (cf., however, paragraph 3 of Article 7 and Article 24). Experience has shown that many problems may arise. This is especially true with respect to Article 23 A. Some of them are dealt with in the following paragraphs. In the absence of a specific provision in the Convention, the domestic laws of each Contracting State are applicable. Some conventions contain an express reference to the domestic laws but of course this would not help where the exemption method is not used in the domestic laws. In such cases, Contracting States which face this problem should establish rules for the application of Article 23 A, if necessary, after having consulted with the competent authority of the other Contracting State (paragraph 3 of Article 25).

"1. *Amount to be exempted*

"The amount of income to be exempted from tax by the State of residence is the amount which, but for the Convention, would be subjected to domestic income tax according to the domestic laws governing such tax. It may, therefore, differ from the amount of income subjected to tax by the State of source according to its domestic laws.

"Normally, the basis for the calculation of income tax is the total net income, i.e. gross income less allowable deductions. Therefore, it is the gross income derived from the State of source less any allowable deductions (specified or proportional) connected with such income which is to be exempted.

"Problems arise from the fact that most countries provide in their respective taxation laws for additional deductions from total income or specific items of income to arrive at the income subject to tax. A numerical example may illustrate the problem:

"(*a*)	Domestic income (gross less allowable expenses)	100
"(*b*)	Income from the other State (gross less allowable expenses)	100
"(*c*)	Total income	200
"(*d*)	Deductions for other expenses provided for under the laws of the State of residence which are not connected with any of the income under (*a*) or (*b*), such as insurance premiums, contributions to welfare institutions	−20
"(*e*)	'Net' income	180
"(*f*)	Personal and family allowances	−30
"(*g*)	Income subject to tax	150

The question is, what amount should be exempted from tax, e.g.

"—100 (line *b*), leaving a taxable amount of 50;

"— 90 (half of line *e*, according to the ratio between line *b* and line *c*), leaving 60 (line *f* being fully deducted from domestic income);

"— 75 (half of line *g*, according to the ratio between line *b* and line *c*), leaving 75;

"—or any other amount.

"A comparison of the laws and practices of the OECD Member countries shows that the amount to be exempted varies considerably from country to country. The solution adopted by a State will depend on the policy followed by that State and its tax structure. It may be the intention of a State that its residents always enjoy the full benefit of their personal and family allowances and other deductions. In other States these tax free amounts are apportioned. In many States personal or family allowances form part of the progressive scale, are granted as a deduction from tax, or are even unknown, the family status being taken into account by separate tax scales.

"In view of the wide variety of fiscal policies and techniques in the different States regarding the determination of tax, especially deductions, allowances and similar benefits, it is preferable not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique. Contracting States which prefer to have special problems solved in their convention are, of course, free to do so in bilateral negotiations. Finally, attention is drawn to the fact that the problem is also of importance for States applying the credit method . . . .

"2. *Treatment of losses*

"Several States in applying Article 23 A treat losses incurred in the other State in the same manner as they treat income arising in that State: as State of residence (State R), they do not allow deduction of a loss incurred from immovable property or a permanent establishment situated in the other State (E or S). Provided that this other State allows carry over of such loss, the taxpayer will not be at any disadvantage as he is merely prevented from claiming a double deduction of the same loss namely in State E (or S) and in State R. Other States may, as State of residence R, allow a loss incurred in State E (or S) as a deduction from the income they assess. In such a case State R should be free to restrict the exemption under paragraph 1 of Article 23 A for profits or income which are made subsequently in the other State E (or S) by deducting from such subsequent profits or income the amount of earlier losses which the taxpayer can carry over in State E (or S). As the solution depends primarily on the domestic laws of the Contracting States and as the laws of the OECD Member countries differ from each other substantially, no solution can be proposed in the Article itself, it being left to the Contracting States, if they find it necessary, to clarify the above-mentioned question and other problems connected with losses . . . bilaterally, either in the Article itself or by way of a mutual agreement procedure (paragraph 3 of Article 25).

"3. *Taxation of the rest of income*

"Apart from the application of progressive tax rates which is now dealt with in paragraph 3 of the Article . . . some problems may arise from specific provisions of the tax laws. Thus, e.g. some tax laws provide that taxation starts only if a minimum amount of taxable income is reached or exceeded (tax exempt threshold). Total income before application of the Convention may clearly exceed such tax free threshold; but by virtue of the exemption resulting from the application of the Convention which leads to a deduction of the tax exempt income from total taxable income, the remaining taxable income may be reduced to an amount below this threshold. For the reasons mentioned in paragraph 43 above, no uniform solution can be proposed. It may be noted, however, that the problem will not arise, if the alternative formulation of paragraph 1 of Article 23 A . . . is adopted.

"Certain States have introduced special systems for taxing corporate income. . . . In States applying a split rate corporation tax . . ., the problem may arise whether the income to be exempted has to be deducted from undistributed income (to which the normal rate of tax applies) or from distributed income (to which the reduced rate applies) or whether the income to be exempted has to be attributed partly to distributed and partly to undistributed income. Where, under the laws of a State applying the split rate corporation tax, a supplementary tax is levied in the hands of a parent company on dividends which it received from a domestic subsidiary company but which it does not redistribute (on the grounds that such supplementary tax is a compensation for the benefit of a lower tax rate granted to the subsidiary on the distributions), the problem arises, whether such supplementary tax may be charged where the subsidiary pays its dividends out of income exempt from tax by virtue of the Convention. Finally a similar problem may arise in connection with taxes ('précompte', Advance Corporation Tax) which are levied on distributed profits of a corporation in order to cover the tax credit attributable to the shareholders. . . . The question is whether such special taxes connected with the distribution of profits could be levied in so far as distributions are made out of profits exempt from tax. It is left to Contracting States to settle these questions by bilateral negotiations.

"*Paragraph 2*

"In Articles 10 and 11 the right to tax dividends and interest is divided between the State of residence and the State of source. In these cases, the State of residence is left free not to tax if it wants to do so . . . and to apply the exemption method also to the above-mentioned items of income. However, where the State of residence prefers to make use of its right to tax such items of income, it cannot apply the exemption method to eliminate the double taxation since it would thus give up fully its right to tax the income concerned. For the State of residence, the application of the credit method would normally seem to give a satisfactory solution. Moreover, as already indicated . . ., States which in general apply the exemption method may wish to apply to specific items of income the credit method rather than exemption. Consequently, the paragraph is drafted in accordance with the ordinary credit method. The Commentary on Article 23 B hereafter applies mutatis mutandis to paragraph 2 of Article 23 A.

"In the cases referred to in the previous paragraph, certain maximum percentages are laid down for tax reserved to the State of source. In such cases, the rate of tax in the State of residence will very often be higher than the rate in the State of source. The limitation of the deduction which is laid down in the second sentence of paragraph 2 and which is in accordance with the ordinary credit method is therefore of consequence only in a limited number of cases. If, in such cases, the Contracting States prefer to waive the limitation and to apply the full credit method, they can do so by deleting the second sentence of paragraph 2. . . .

"*Dividends from substantial holdings by a company*

"The combined effect of paragraphs 1 and 2 of Article 10 and Article 23 (Article 23 A and 23 B as appropriate) is that the State of residence of the shareholder is allowed to tax dividends arising in the other State, but that it must credit against its own tax on such dividends the tax which has been collected by the State where the dividends arise at a rate fixed under paragraph 2 of Article 10. This regime equally applies when the recipient of the dividends is a parent company receiving dividends from a subsidiary; in this case, the tax withheld in the State of the subsidiary—and credited in the State of the parent company—is limited to 5 per cent of the gross amount of the dividends by the application of sub-paragraph (*a*) of paragraph 2 of Article 10.

"These provisions, effectively avoid the juridical double taxation of dividends but they do not prevent recurrent corporate taxation on the profits distributed to the parent company: first at the level of the subsidiary and again at the level of the parent company. Such recurrent taxation creates a very important obstacle to the development of international investment. Many States have recognised this and have inserted in their domestic laws provisions designed to avoid this obstacle. Moreover, provisions to this end are frequently inserted in double taxation conventions.

"The Committee on Fiscal Affairs has considered whether it would be appropriate to modify Article 23 of the Convention in order to settle this question. Although many States favoured the insertion of such a provision in the Model Convention this met with many difficulties, resulting from the diverse opinions of States and the variety of possible solutions. Some States, fearing tax evasion, preferred to maintain their freedom of action and to settle the question only in their domestic laws.

"In the end, it appeared preferable to leave States free to choose their own solution to the problem. For States preferring to solve the problem in their conventions, the solutions would most frequently follow one of the principles below:

"(a) *Exemption with progression*

"The State of which the parent company is a resident exempts the dividends it receives from its subsidiary in the other State, but it may nevertheless take these dividends into account in computing the tax due by the parent company on the remaining income (such a provision will frequently be favoured by States applying the exemption method specified in Article 23 A).

"(b) *Credit for underlying taxes*

"As regards dividends received from the subsidiary, the State of which the parent company is a resident gives credit as provided for in paragraph 2 of Article 23 A or in paragraph 1 of Article 23 B, as appropriate, not only for the tax on dividends as such, but also for the tax paid by the subsidiary on the profits distributed (such a provision will frequently be favoured by States applying as a general rule the credit method specified in Article 23 B).

"(c) *Assimilation to a holding in a domestic subsidiary*

"The dividends that the parent company derives from a foreign subsidiary are treated, in the State of the parent company, in the same way for tax purposes as dividends received from a subsidiary which is a resident of that State.

"When the State of the parent company levies taxes on capital, a similar solution should also be applied to such taxes.

"Moreover, States are free to fix the limits and methods of application of these provisions (definition and minimum duration of holding of the shares, proportion of the dividends deemed to be taken up by administrative or financial expenses) or to make the relief granted under the special regime subject to the condition that the subsidiary is carrying out a genuine economic activity in the State of which it is a resident, or that it derives the major part of its income from that State or that it is subject to a substantial taxation on profits therein.

"*Paragraph 3*

"The 1963 Draft Convention reserved expressly the application of the progressive scale of tax rates by the State of residence (last sentence of paragraph 1 of Article 23 A) and most conventions concluded between OECD Member countries, which adopt the exemption method follow this principle. According to paragraph 3 of Article 23 A, as amended, the State of residence retains the right to take the amount of exempted income or capital into consideration when determining the tax to be imposed on the rest of the income or capital. The rule applies even where the exempted income (or items of capital) and the taxable income (or items of capital) accrue to those persons (e.g. husband and wife) whose incomes (or items of capital) are taxed jointly according to the domestic laws. This principle of progression applies to income or capital exempted by virtue of paragraph 1 of Article 23 A as well as to income or capital which under any other provision of the Convention 'shall be taxable only' in the other Contracting State. . . . This is the reason why the principle of progression is transferred from paragraph 1 of Article 23 A to a new paragraph 3 of the said Article, and reference is made to exemption 'in accordance with any provision of the Convention'.

"Paragraph 3 of Article 23 A relates only to the State of residence. The form of the Article does not prejudice the application by the State of source of the provisions of its domestic laws concerning the progression."

C. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 23 B

Since article 23 B of the United Nations Model Convention reproduces article 23 B of the OECD Model Convention, the commentary on that article, quoted below, is fully relevant:

"Paragraph 1

"A. Methods

"Article 23 B, based on the credit principle, follows the ordinary credit method: the State of residence (R) allows, as a deduction from its own tax on the income or capital of its resident, an amount equal to the tax paid in the other State E (or S) on the income derived from, or capital owned in, that other State E (or S), but the deduction is restricted to the appropriate proportion of its own tax.

"The ordinary credit method is intended to apply also for a State which follows the exemption method but has to give credit, under paragraph 2 of Article 23 A, for the tax levied at limited rates in the other State on dividends and interest. The possibility of some modification could, of course, also be of relevance in the case of dividends and interest paid to a resident of a State which adopted the ordinary credit method. . . .

"It is to be noted that Article 23 B applies in a State R only to items of income or capital which, in accordance with the Convention, 'may be taxed' in the other State E (or S). Items of income or capital which according to Article 8, to paragraph 3 of Article 13, to subparagraph (*a*) of paragraphs 1 and 2 of Article 19 and to paragraph 3 of Article 22, 'shall be taxable only' in the other State, are from the outset exempt from tax in State R, and the Commentary on Article 23 A applies to such exempted income and capital. As regards progression, reference is made to paragraph 2 of the Article.

"Article 23 B sets out the main rules of the credit method, but does not give detailed rules on the computation and operation of the credit. This is consistent with the general pattern of the Convention. Experience has shown that many problems may arise. Some of them are dealt with in the following paragraphs. In many States, detailed rules on credit for foreign tax already exist in their domestic laws. A number of conventions, therefore, contain a reference to the domestic laws of the Contracting States and further provide that such domestic rules shall not affect the principle laid down in Article 23 B. Where the credit method is not used in the domestic laws of a Contracting State, this State should establish rules for the application of Article 23 B, if necessary after consultation with the competent authority of the other Contracting State (paragraph 3 of Article 25).

"The amount of foreign tax for which a credit has to be allowed is the tax effectively paid in accordance with the Convention in the other Contracting State. Problems may arise, e.g., where such tax is not calculated on the income of the year for which it is levied but on the income of a preceding year or on the average income of two or more preceding years. Other problems may arise in connection with different methods of determining the income or in connection with changes in the currency rates (devaluation or revaluation). However, such problems could hardly be solved by an express provision in the Convention.

"According to the provisions of the second sentence of . . . Article 23 B, the deduction which the State of residence (R) is to allow is restricted to that part of the income tax which is appropriate to the income derived from the State S, or E (so-called 'maximum deduction'). Such maximum deduction may be computed either by apportioning the total tax on total income according to the ratio between the income for which credit is to be given and the total income, or by applying the tax rate for total income to the income for which credit is to be given. In fact, in cases where the tax in State E (or S) equals or exceeds the appropriate tax of State R, the credit method will have the same effect as the exemption method with progression. Also under the credit method, similar problems as regards the amount of income, tax rate, etc. may arise as are mentioned in the Commentary on Article 23 A. It is preferable also for the credit method, not to propose an express and uniform solution in the Convention, but to leave each State free to apply its own legislation and technique. This is also true for some further problems which are dealt with below.

"The maximum deduction is normally computed as the tax on net income, i.e. on the income from State E (or S) less allowable deductions (specified or proportional) connected with such income. For such reason, the maximum deduction in many cases may be lower than the tax effectively paid in State E (or S). This may especially be true in the case where, for instance, a resident of State R deriving interest from State S has borrowed funds from a third person to finance the interest-producing loan. As the interest due on such borrowed money may be offset against the interest derived from State S, the amount of net income subject to tax in State R may be very small, or there may even be no net income at all. This problem could be solved by using the full credit method in State R as mentioned in paragraph 2 above. Another solution would be to exempt such income from tax in State S, as it is proposed in the commentary in respect of interest on credit sales and on loans granted by banks.

"If a resident of State R derives income of different kinds from State S, and the latter State, according to its tax laws imposes tax only on one of these items, the maximum deduction which State R is to allow will normally be that part of its tax which is appropriate only to that item of income which is taxed in State S. However, other solutions are possible, especially in view of the following broader problem: the fact that credit has to be given, e.g., for several items of income on which tax at different rates is levied in State S, or for income from several States, with or without conventions, raises the question whether the maximum deduction or the credit has to be calculated separately for each item of income, or for each country, or for all foreign income qualifying for credit under domestic laws and under conventions. Under an 'overall credit' system, all foreign income is aggregated, and the total of foreign taxes is credited against the domestic tax appropriate to the total foreign income.

"Further problems may arise in case of losses. A resident of State R, deriving income from State E (or S), may have a loss in State R, or in State E (or S) or in a third State. For purposes of the tax credit, in general, a loss in a given State will be set off against other income from the same State. Whether a loss suffered outside State R (e.g., in a permanent establishment) may be deducted from other income, whether derived from State R or not, depends on the domestic laws of State R. Here similar problems may arise, as mentioned in the commentary on Article 23 A. When the total income is derived from abroad, and no income but a loss not exceeding the income from abroad arises in State R, then the total tax charged in State R will be appropriate to the income from State S, and the maximum deduction which State R is to allow will consequently be the tax charged in State R. Other solutions are possible.

"The aforementioned problems depend very much on domestic laws and practice, and the solution must, therefore, be left to each State. In this context, it may be noted that some States are very liberal in applying the credit method. Some States are also considering or have already adopted the possibility of carrying over unused tax credits. Contracting States are, of course, free in bilateral negotiations to amend the article to deal with any of the aforementioned problems.

". . . .

"B. *Remarks concerning capital tax*

"As paragraph 1 is drafted, credit is to be allowed for income tax only against income tax and for capital tax only against capital tax. Consequently, credit for or against capital tax will be given only if there is a capital tax in both Contracting States.

"In bilateral negotiations, two Contracting States may agree that a tax called a capital tax is of a nature closely related to income tax and may, therefore, wish to allow credit for it against income tax and vice versa. There are cases where because one State does not impose a capital tax or because both States impose capital taxes only on domestic assets, no double taxation of capital will arise. In such cases it is, of course, understood that the reference to capital taxation may be deleted. Furthermore, States may find it desirable, regardless of the nature of the taxes under the convention, to allow credit for the total amount of tax in the State of source or situs against the total amount of tax in the State of residence. Where, however, a convention includes both real capital taxes and capital taxes which are in their nature income taxes, the States may wish to allow credit against income tax only for the latter capital taxes. In such cases, States are free to alter the proposed Article so as to achieve the desired effect.

"C. *The relation in special cases between the taxation in the State of source and the ordinary credit method*

"In certain cases a State, especially a developing country, may for particular reasons give concessions to taxpayers, e.g. tax incentive reliefs to encourage industrial output. In a similar way, a State may exempt from tax certain kinds of income, e.g. pensions to war-wounded soldiers.

"When such a State concludes a convention with a State which applies the exemption method, no restriction of the relief given to the taxpayers arises, because that other State must give exemption regardless of the amount of tax, if any, imposed in the State of source. But when the other State applies the credit method, the concession may be nullified to the extent that such other State will allow a deduction only of the tax paid in the State of source. By reason of the concessions, that other State secures what may be called an unconvenanted gain for its own Exchequer.

"Should the two States agree that the benefit of the concessions given to the taxpayers in the State of source are not to be nullified, a derogation from paragraph 2 of Article 23 A, or from Article 23 B will be necessary.

"Various formulae can be used to this effect as for example:

"(*a*) the State of residence will allow as a deduction the amount of tax which the State of source could have imposed in accordance with its general legislation or such amount as limited by the Convention (e.g. limitations of rates provided for dividends and interest in articles 10 and 11) even if the State of source, as a developing country, has waived all or part of that tax under special provisions for the promotion of its economic development;

"(*b*) as a counterpart for the tax sacrifice which the developing country makes by reducing in a general way its tax at the source, the State of residence agrees to allow a deduction against its own tax of an amount (in part fictitious) fixed at a higher rate;

"(*c*) the State of residence exempts the income which has benefited from tax incentives in the developing country.

Contracting States are free to devise other formulae in the course of bilateral negotiations.

"If a Contracting State agrees to stimulate especially investments in the other State being a developing country, the above provisions will generally be accompanied by guarantees for the investors, that is to say, the convention will limit the rate of tax which can be imposed in the State of source on dividends, interest and royalties.

"Moreover, time restrictions or time limits can be provided for the application of the advantages referred to in formula (*a*), and possibly (*c*), above: the extended credit (or the exemption) may be granted only in respect of incentives applied temporarily in developing countries, or only for investments made or contracts concluded in the future (for instance, from the date of entry into force of the convention) or for a determined period of time.

"Thus, there exists a considerable number of solutions to this problem. In fact, the concrete effects of the provisions concerned can also vary as a result of other factors such as the amount to be included in the taxable income in the State of residence (formulae (*a*) and (*b*) above); it may be the net income derived (after deduction of the tax effectively paid in the State of source), or the net income grossed-up by an amount equal to the tax effectively paid in the State of source, or to the tax which could have been levied in accordance with the convention (rates provided for in Articles 10 and 11) or to the tax which the State of residence agrees to allow as a deduction.

"*Paragraph 2*

"This paragraph has been added to enable the State of residence to retain the right to take the amount of income or capital exempted in that State into consideration when determining the tax to be imposed on the rest of the income or capital. The right so retained extends to income or capital which 'shall be taxable only' in the other State. The principle of progression is thus safeguarded for the State of residence, not only in relation to income or capital which 'may be taxed' in the other State, but also for income or capital which 'shall be taxable only' in that other State. The Commentary on paragraph 3 of Article 23 A in relation to the State of source also applies to paragraph 2 of Article 23 B."

Commentaries on chapter VI

SPECIAL PROVISIONS

Article 24

NON-DISCRIMINATION

A. GENERAL CONSIDERATIONS

Article 24 of the United Nations Model Convention reproduces article 24 of the OECD Model Convention.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 24

Paragraph 1

Since this paragraph reproduces article 24, paragraph 1, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

> "This paragraph establishes the principle that for purposes of taxation discrimination on the grounds of nationality is forbidden, and that, subject to reciprocity, the nationals of a Contracting State may not be less favourably treated in the other Contracting State than nationals of the latter State in the same circumstances.
>
> "It is noteworthy that the principle of non-discrimination, under various descriptions and with a more or less wide scope, was applied in international fiscal relations well before the appearance, at the end of the 19th Century, of the classic type of double taxation conventions. Thus, in a great many agreements of different kinds (consular or establishment conventions, treaties of friendship or commerce, etc.) concluded by States, especially in the 19th Century, in order to extend and strengthen the diplomatic protection of their nationals wherever resident, there are clauses under which each of the two Contracting States undertakes to accord nationals of the other State equality of treatment with their own nationals. The fact that such clauses subsequently found their way into double taxation conventions has in no way affected their original justification and scope. The text of paragraph 1 provides that the application of this paragraph is not restricted by article 1 to nationals solely who are residents of a Contracting State, but on the contrary, extends to all nationals of each Contracting State, whether or not they be residents of one

of them. In other words, all nationals of a Contracting State are entitled to invoke the benefit of this provision as against the other Contracting State. This holds good, in particular, for nationals of the Contracting States who are not residents of either of them but of a third State.

"The expression 'in the same circumstances' refers to taxpayers (individuals, legal persons, partnerships and associations) placed, from the point of view of the application of the ordinary taxation laws and regulations, in substantially similar circumstances both in law and in fact.

"Consequently if a Contracting State, in giving relief from taxation on account of family responsibilities, distinguishes between its own nationals according to whether they reside in its territory or not, that State cannot be obliged to give nationals of the other State who do not reside in its territory the same treatment as it gives its resident nationals but it undertakes to extend to them the same treatment as is available to its non-resident nationals.

"Likewise, the provisions of paragraph 1 are not to be construed as obliging a State which accords special taxation privileges to its own public bodies or services as such, to extend the same privileges to the public bodies and services of the other State.

"Neither are they to be construed as obliging a State which accords special taxation privileges to private institutions not for profit whose activities are performed for purposes of public benefit, which are specific to that State to extend the same privileges to similar institutions whose activities are not for its benefit.

"To take the first of these two cases, if a State accords immunity from taxation to its own public bodies and services, this is justified because such bodies and services are integral parts of the State and at no time can their circumstances be comparable to those of the public bodies and services of the other State. Nevertheless, this reservation is not intended to apply to State corporations carrying on gainful undertakings. To the extent that these can be regarded as being on the same footing as private industrial and commercial undertakings, the provisions of paragraph 1 will apply to them.

"As for the second case, if a State accords taxation privileges to certain private institutions not for profit, this is clearly justified by the very nature of these institutions' activities and by the benefit which that State and its nationals will derive from those activities.

"Furthermore, paragraph 1 has been deliberately framed in a negative form. By providing that the nationals of a Contracting

State may not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of the other Contracting State in the same circumstances are or may be subjected, this paragraph has the same mandatory force as if it enjoined the Contracting States to accord the same treatment to their respective nationals. But since the principal object of this clause is to forbid discrimination in one State against the nationals of the other, there is nothing to prevent the first State from granting to persons of foreign nationality, for special reasons of its own, or in order to comply with a special stipulation in a double taxation convention, such as, notably, the requirement that profits of permanent establishments are to be taxed on the basis of separate accounts, certain concessions or facilities which are not available to its own nationals. As it is worded, paragraph 1 would not prohibit this.

"Subject to the foregoing observation, the words '. . . . shall not be subjected . . . to any taxation or any requirement connected therewith which is other or more burdensome . . .' mean that when a tax is imposed on nationals and foreigners in the same circumstances, it must be in the same form as regards both the basis of charge and the method of assessment, its rate must be the same and, finally, the formalities connected with the taxation (returns, payment, prescribed times, etc.) must not be more onerous for foreigners than for nationals."

Paragraph 2

Since this paragraph reproduces article 24, paragraph 2, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"Paragraph 2 merely stipulates that the term 'nationals' applies to all individuals possessing the nationality of a Contracting State. It has not been judged necessary here to introduce into the text of the article any considerations on the signification of the concept of nationality, any more than it seemed indispensable to make any special comment here on the meaning and application of the word. Obviously, in determining in relation to individuals, what is meant by 'the nationals of a Contracting State', reference must be made to the sense in which the term is usually employed and each State's particular rules on the acquisition or loss of nationality.

"But paragraph 2 is more specific as to legal persons, partnerships and associations. By declaring that all legal persons, partnerships and associations deriving their status as such from the laws in force in a Contracting State are considered to be nationals for the purposes of paragraph 1, the provision disposes of a difficulty which often arises in determining the nationality of companies. In defining the nationality of companies, certain States have regard less to the law which governs the company than to the origin of the capital with which the company was formed or the nationality of the individuals or legal persons controlling it.

"Moreover, in view of the legal relationship created between the company and the State under whose law it is constituted, which from certain points of view is closely akin to the relationship of nationality in the case of individuals, it seems justifiable not to deal with legal persons, partnerships and associations in a special provision, but to assimilate them with individuals under the term 'nationals'."

Paragraph 3

Since this paragraph reproduces article 24, paragraph 3, of the OECD Model Convention, the commentary on the latter paragraph, which reads as follows, is fully relevant:

"On 28th September, 1954, a number of States concluded in New York a Convention relating to the status of stateless persons, under article 29 of which stateless persons must be accorded national treatment. The signatories of the Convention include several OECD Member countries.

"It should, however, be recognised that the provisions of paragraph 3 will, in a bilateral convention, enable national treatment to be extended to stateless persons who, because they are in one of the situations enumerated in paragraph 2 of article 1 of the above-mentioned Convention of 28th September, 1954, are not covered by that Convention. This is mainly the case, on the one hand, of persons receiving at the time of signature of that Convention, protection or assistance from organs or agencies of the United Nations other than the United Nations High Commissioner for Refugees, and, on the other hand, of persons who are residents of a country and who there enjoy and are subject to the rights and obligations attaching to the possession of that country's nationality.

"The purpose of paragraph 3 is to limit the scope of the clause concerning equality of treatment with nationals of a Contracting State solely to stateless persons who are residents of that or the other Contracting State.

"By thus excluding stateless persons who are residents of neither Contracting State, such a clause prevents their being privileged in one State as compared with nationals of the other state.

"However, if States were to consider it desirable in their bilateral relations, to extend the application of paragraph 3 to all stateless persons, whether residents of a Contracting State or not, so that in all cases they enjoy the most favourable treatment accorded to nationals of the State concerned, in order to do this they would need only to adopt the following text which contains no condition as to residence in a Contracting State:

" 'Notwithstanding the provisions of Article 1, stateless persons shall not be subjected in a Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that State in the same circumstances are or may be subjected'.

"It is possible that in the future certain States will take exception to the provisions of paragraph 3 as being too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. If such States wished to avoid this latter consequence, they would have to modify paragraph 3 as follows:

" 'Stateless persons who are residents of a Contracting State shall not be subjected in the other Contracting State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which nationals of that other State in the same circumstances are or may be subjected.'

"Finally, it should be understood that the definition of the term 'stateless person' to be used for the purposes of such a clause can only be that laid down in paragraph 1 of Article 1 of the Convention of 28th September, 1954, which defines a stateless person as 'a person who is not considered as a national by any State under the operation of its law'."

Paragraph 4

Since this paragraph reproduces article 24, paragraph 4, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"Strictly speaking, the type of discrimination which this paragraph is designed to end is discrimination based not on nationality but on the actual situs of an enterprise. It therefore affects without distinction, and irrespective of their nationality, all residents of a Contracting State who have a permanent establishment in the other Contracting State.

"It appears necessary first to make it clear that the wording of the first sentence of paragraph 4 must be interpreted in the sense that it does not constitute discrimination to tax non-resident persons differently, for practical reasons, from resident persons, as long as this does not result in more burdensome taxation for the former than for the latter. In the negative form in which the provision concerned has been framed, it is the result alone which counts, it being permissible to adapt the mode of taxation to the particular circumstances in which the taxation is levied.

"By the terms of the first sentence of paragraph 4, the taxation of a permanent establishment shall not be less favourably levied in the State concerned than the taxation levied on enterprises of that State carrying on the same activities. The purpose of this provision is to end all discrimination in the treatment of permanent establishments as compared with resident enterprises belonging to the same sector of activities, as regards taxes based on industrial and commercial activities, and especially taxes on business profits.

"However, the second sentence of paragraph 4 specifies the conditions under which the principle of equal treatment set forth in the first sentence should be applied to individuals who are residents of a Contracting State and have a permanent establishment in the other State. It is designed mainly to ensure that such persons do not obtain greater advantages than residents, through entitlement to personal allowances and reliefs for family responsibilities, both in the State of which they are residents, by the application of its domestic laws, and in the other State by virtue of the principle of equal treatment. Consequently, it leaves it open to the State in which the permanent establishment is situated whether or not to give personal allowances and reliefs to the persons concerned in the proportion which the amount of the permanent establishment's profits bears to the world income taxable in the other State.

"As regards the first sentence, experience has shown that it was difficult to define clearly and completely the substance of the principle of equal treatment and this has led to wide differences of opinion with regard to the many implications of this principle. The main reason for difficulty seems to reside in the actual nature of the permanent establishment which is not a separate legal entity but only a part of an enterprise that has its head office in another State. The situation of the permanent establishment is different from that of a domestic enterprise, which constitutes a single entity all of whose activities, with their fiscal implications, can be fully brought within the purview of the State where it has its head office. The implications of the equal treatment clause will be examined below under several aspects of the levying of tax.

"A. *Assessment of tax*

"With regard to the basis of assessment of tax, the principle of equal treatment normally has the following implications:

"(*a*) Permanent establishments must be accorded the same right as resident enterprises to deduct the trading expenses that are, in general, authorized by the taxation law to be deducted from taxable profits in addition to the right to attribute to the permanent establishment a proportion of the overheads of the head office of the enterprise. Such deductions should be allowed without any restrictions other than those also imposed on resident enterprises.

"(*b*) Permanent establishments must be accorded the same facilities with regard to depreciation and reserves. They should be entitled to avail themselves without restriction not only of the depreciation facilities which are customarily available to enterprises (straight line depreciation, declining balance depreciation), but also of the special systems that exist in a number of countries ('wholesale' writing down, accelerated depreciation, etc.). As regards reserves, it should be noted that these are sometimes authorised for purposes other than the offsetting—in accordance with commercial accounting principles—of depreciation on assets, expenses or losses which have not yet occurred but which circumstances make likely to occur in the near future. Thus, in certain countries, enterprises are entitled to set aside, out of taxable profit provisions or 'reserves' for investment. When such a right is enjoyed by all enterprises, or by all enterprises in a given sector of activity, it should normally also be enjoyed, under the same conditions, by non-resident enterprises, or by all enterprises in a given sector of activity, it should in the State concerned insofar, that is, as the activities to which such provisions or reserves would pertain are taxable in that State.

"(*c*) Permanent establishments should also have the option that is available in most countries to resident enterprises of carrying forward or backward a loss brought out at the close of an accounting period within a certain period of time (e.g. 5 years). It is hardly necessary to specify that in the case of permanent establishments it is the loss on their own business activities, as shown in the separate accounts for these activities, which will qualify for such carry-forward.

"(*d*) Permanent establishments should further have the same rules applied to resident enterprises, with regard to the taxation of capital gains realised on the alienation of assets, whether during or on the cessation of business.

"Although the general rules mentioned above rarely give rise to any difficulties with regard to the principle of non-discrimination, the same does not always hold good for the tax incentive measures which most countries, faced with such problems as decentralisation of industry, development of economically backward regions, or the promotion of new activities necessary for the expansion of the economy, have introduced in order to facilitate the solution of these problems by means of tax exemptions, reductions or other tax advantages given to enterprises for investment which is in line with official objectives.

"As such measures are in furtherance of objectives directly related to the economic activity proper of the State concerned, it is right that the benefit of them should be extended to permanent establishments of enterprises of another State which has a double taxation convention with the first embodying the provisions of Article 24, once they have been accorded the right to engage in industrial or commercial activity in that State, either under its legislation or under an international agreement (treaties of commerce, establishment conventions, etc.) concluded between the two States.

"It should, however, be noted that although non-resident enterprises are entitled to claim these tax advantages in the State concerned, they must fulfil the same conditions and requirements as resident enterprises. They may, therefore, be denied such advantages if their permanent establishments are unable or refuse to fulfil the special conditions and requirements attached to the granting of them.

"Finally, it goes without saying that non-resident enterprises are not entitled to tax advantages attaching to activities the exercise of which is strictly reserved, on grounds of national interest, defence, protection of the national economy, etc., to domestic enterprises, since non-resident enterprises are not allowed to engage in such activities.

"B. Special treatment of dividends received in respect of holdings owned by permanent establishments

"In many countries special rules exist for the taxation of dividends distributed between companies (parent company–subsidiary treatment, the 'Schachtelprivileg', the rule 'non bis in idem'). The question arises whether such treatment should by effect of the provisions of paragraph 4 also be enjoyed by permanent establishments in respect of dividends on holdings forming part of their assets.

"On this point opinions differ. Some States consider that such special treatment should be accorded to permanent establishments. They take the view that such treatment was enacted in order to avoid double taxation on profits made by a subsidiary and distributed to a parent company. In principle profits tax should be levied once, in the hands of the subsidiary performing the profit-generating activities. The parent company should be exempted from tax on such profits when received from the subsidiary or should, under the indirect credit method, be given relief for the taxation borne by the subsidiary. In cases where shares are held as direct investment by a permanent establishment the same principle implies that such a permanent establishment receiving dividends from the subsidiary should likewise be granted the special treatment in view of the fact that a profits tax has already been levied in the hands of the subsidiary. On the other hand, it is hardly conceivable on this line of thought to leave it to the State where the head office of the parent company is situated to give relief from double taxation brought about by a second levying of tax in the State of the permanent establishment. The State of the parent company, in which no activities giving rise to the doubly taxed profits have taken place, will normally exempt the profits in question or will levy a profits tax which is not sufficient to bear a double credit (i.e. for the profits tax on the subsidiary as well as for such tax on the permanent establishment). All this assumes that the shares held by the permanent establishment are effectively connected with its activity. Furthermore, an obvious additional condition is that the profits out of which the dividends are distributed should have borne a profits tax.

"Other States, on the contrary, consider that assimilating permanent establishments to their own enterprises does not entail any obligation to accord such special treatment to the former. They justify their position on various grounds. The purpose of such special treatment is to avoid economic double taxation of dividends and it should be for the recipient company's State of residence and not the permanent establishment's State to bear its cost, because it is more interested in the aim in view. Another reason put forward related to the sharing of tax revenue between States. The loss of tax revenue incurred by a State in applying such special treatment is partly offset by the taxation of the dividends when they are redistributed by the parent company which has enjoyed such treatment (withholding tax on dividends, shareholder's tax). A State which accorded such treatment to permanent establishments would not have the benefit of such a compensation. Another argument made is that when such treatment is made conditional upon redistribution of the dividends its extension to permanent establishments would not be justified, for in such a case the permanent establishment, which is only a part of a company of another State and does not distribute dividends, would be more favourably treated than a resident company. Finally, the States which feel that paragraph 4 does not entail any obligation to extend such treatment to permanent establishments argue that there is a risk that companies of one State might transfer their holdings in companies of another State to their permanent establishments in that other State for the sole purpose of availing themselves of such treatment.

"The fact remains that there can be very valid reasons for a holding being owned and managed by a permanent establishment rather than by the head office of the enterprise, viz.,

"—reasons of necessity arising principally from a legal or regulatory obligation on banks and financial institutions and insurance companies to keep deposited in countries where they operate a certain amount of assets, particularly shares, as security for the performance of their obligations;

"—or reasons of expediency, where the holdings are in companies which have business relations with the permanent establishment or whose head offices are situated in the same country as the permanent establishment;

"—or simple reasons of practical convenience, in line with the present tendency towards decentralisation of management functions in large enterprises.

"In view of these divergent attitudes, as well as of the existence of the situations just described, it would be advisable for States, when concluding bilateral conventions, to make clear the interpretation they give to the first sentence of paragraph 4. They can, if they so desire, explain their position, or change it as compared with their previous practice, in a protocol or any other document annexed to the convention.

"A solution could also be provided in such a document to meet the objection mentioned above that the extension of the treatment of holdings in a State (A) to permanent establishments of companies which are residents of another State (B) results in such companies unduly enjoying privileged treatment as compared with other companies which are residents of the same State and whose head offices own holdings in the capital of companies which are residents of State A, in that whereas the dividends on their holdings can be repatriated by the former companies without bearing withholding tax, such tax is levied on dividends distributed to the latter companies at the rate of 5 or 15 per cent as the case may be. Tax neutrality and the equality of tax burdens as between permanent establishments and subsidiary companies, as advocated by the States concerned, could be ensured by adapting, in the bilateral convention between States A and B, the provisions of paragraphs 2 and 4 of Article 10, so as to enable withholding tax to be levied in State A on dividends paid by companies which are residents of that State to permanent establishments of companies which are residents of State B in the same way as if they are received directly, i.e. by the head offices of the latter companies, viz., at the rate of:

"—5 per cent in the case of a holding of at least 25 per cent;

"—15 per cent in all other cases.

"Should it not be possible, because of the absence of appropriate provisions in the domestic laws of the State concerned, to levy a withholding tax there on dividends paid to permanent establishments, the treatment of inter-company dividends could be extended to permanent establishments, as long as its application is limited in such manner that the tax levied by the State of source of the dividends is the same whether the dividends are received by a permanent establishment of a company which is a resident of the other State or are received directly by such a company.

"C. *Structure and rate of tax*

"In countries where enterprises, mainly companies, are charged a tax on their profits which is specific to them, the provisions of paragraph 4 raise, with regard to the rate applicable in the case of permanent establishments, especially difficult and delicate problems, which here too arise from the fact that the permanent establishment is only a part of a legal entity which is not under the jurisdiction of the State where the permanent establishment is situated.

"When the taxation of profits made by companies which are residents of a given State is calculated according to a progressive scale of rates, such a scale should, in principle, be applied to permanent establishments situated in that State. If in applying the progressive scale, the permanent establishment's State takes into account the profits of the whole company to which such a permanent establishment belongs, such a rule would not appear to conflict with the equal treatment rule, since resident companies are in fact treated in the same way. States that tax their own companies in this way could therefore define in their bilateral conventions the treatment applicable to permanent establishments.

"When a system of taxation based on a progressive scale of rates includes a rule that a minimum rate is applicable to permanent establishments, it cannot be claimed a priori that such a rule is incompatible with the equal treatment principle. The profits of the whole enterprise to which the permanent establishment belongs should be taken into account in determining the rate applicable according to the progressive scale. The provisions of the first sentence of paragraph 4 are not observed only if the minimum rate is higher.

"However, even if the profits of the whole enterprise to which the permanent establishment belongs is taken into account when applying either a progressive scale of rates or a minimum rate, this should not conflict with the principle of the distinct and separate enterprise, according to which the profits of the permanent establishment must be determined under paragraph 2 of article 7. The minimum amount of the tax levied in the State where the permanent establishment is situated is, therefore, the amount which would be due if it were a distinct and separate enterprise, without reference to the profits of the whole enterprise to which it belongs. The State where the permanent establishment is situated is, therefore, justified in applying the progressive scale applicable to resident enterprises solely to the profits of the permanent establishment, leaving aside the profits of the whole enterprise when the latter are less than those of the permanent establishment. This State may likewise tax the profits of the permanent establishment at a minimum rate, provided that the same rate applies also to resident enterprises, even if taking into account the profits of the whole enterprise to which it belongs would result in a lower amount of tax, or no tax at all.

"As regards the split-rate system of company tax, it should first be pointed out as being a fact central to the issue here that most OECD Member countries which have adopted this system do not consider themselves bound by the provisions of paragraph 4 to extend it to permanent establishments of non-resident companies. This attitude is based, in particular, on the view that the split rate is only one element amongst others (in particular a withholding tax on distributed income) in a system of taxing company profits and dividends which must be considered as a whole and is therefore, both for legal and technical reasons, of domestic application only. The State where the permanent establishment is situated could claim the right not to tax such profits at the reduced rate, as generally, it does not tax the dividends distributed by the company to which the permanent establishment belongs. Moreover, a State which has adopted a split-rate system usually has other economic policy objectives, such as the promotion of the capital market, by encouraging resident companies to distribute dividends. The extension of the reduced rate to the profits of the permanent establishment would not serve such a purpose at all, as the company distributing the dividends is not a resident of the State concerned.

"This view is, however, disputed. The States in favour of extending the split-rate system to permanent establishments urge that as the essential feature of this system is a special technique of taxing profits which enterprises in a corporate form derive from their activities, and is designed to afford immediate relief from the double taxation levied on the profits distributed, it should be applied to permanent establishments in bilateral conventions against double taxation. It is generally recognised that, by the effects of their provisions, such conventions necessarily result in some integration of the taxation systems of the Contracting States. On this account, it is perfectly conceivable that profits made in a State (A) by a permanent establishment of a company resident in another State (B) should be taxed in State A according to the split-rate system.

As a practical rule, the tax could in such case be calculated at the reduced rate (applicable to distributed profits) on that proportion of an establishment's profits which corresponds to the ratio between the profit distributed by the company to which it belongs and the latter's total profit; the remaining profit could be taxed at the higher rate. Of course, the two Contracting States would have to consult together and exchange all information necessary for giving practical effect to this solution. Similar considerations apply to systems where distributions of profits made can be deducted from the taxable income of a company.

"As regards the imputation system ('avoir fiscal' or 'tax credit'), it seems doubtful, at least on a literal interpretation of the provisions of paragraph 4, whether it should be extended to non-resident companies in respect of dividends paid out of profits made by their permanent establishment. In fact, it has identical effects to those of the split-rate system but these effects are not immediate as they occur only at the time of the shareholder's personal taxation. From a purely economic and financial standpoint, however, it is conceivable that such profits should be treated as though they were profits of a distinct company in State A where the permanent establishment of a company which is a resident of State B is situated, and, to the extent that they are distributed, carry the 'avoir fiscal' or 'tax credit'. But to take the matter further, to avoid all discrimination it is necessary that this advantage should already have been accorded to shareholders who are residents of State B of companies which are residents of State A. From the practical standpoint, the two States concerned should, of course, agree upon the conditions and procedures for allowing the 'avoir fiscal' or 'tax credit' to shareholders who are themselves residents of either State, of the companies concerned that are residents of State B.

"Contracting States which are faced with the problems described above may settle them in bilateral negotiations in the light of their peculiar circumstances.

"*D. Withholding tax on dividends, interest and royalties received by a permanent establishment*

"When permanent establishments receive dividends, interest or royalties such income, by virtue of paragraph 4 of Articles 10 and 11 and paragraph 3 of Article 12, respectively, comes under the provisions of Article 7 and consequently—subject to the observations made . . . as regards dividends received on holdings of permanent establishment—falls to be included in the taxable profits of such permanent establishments.

"According to the respective Commentaries on the abovementioned provisions of Articles 10, 11 and 12 these provisions dispense the State of source of the dividends, interest or royalties received by the permanent establishment from applying any limitation provided for in those Articles, which means—and this is the generally accepted interpretation—that they leave completely unaffected the right of the State of source, where the permanent establishment is situated, to apply its withholding tax at the full rate.

"While this approach does not create any problems with regard to the provisions of paragraph 4 of article 24 in the case of countries where a withholding tax is levied on all such income, whether the latter be paid to residents (permanent establishments, like resident enterprises, being allowed to set such withholding tax off against the tax on profits due by virtue of Article 7) or to non-residents (subject to the limitations provided for in Articles 10, 11 and 12), the position is different when withholding tax is applied exclusively to income paid to non-residents.

"In this latter case, in fact, it seems difficult to reconcile the levy of withholding tax with the principle set out in paragraph 4 that for the purpose of taxing the income which is derived from their activity or which is normally connected with it—as is recognised to be the case with dividends, interest and royalties referred to in paragraph 4 of Articles 10 and 11 and in paragraph 3 of Article 12—permanent establishments must be treated as resident enterprises and hence in respect of such income be subjected to tax on profits solely.

"In any case, it is for Contracting States which have this difficulty to settle it in bilateral negotiations in the light of their peculiar circumstances.

"*E. Credit for foreign tax*

"In a related context, when a permanent establishment receives foreign income which is included in its taxable profits, it is right by virtue of the same principle to grant to the permanent establishment credit for foreign tax borne by such income when such credit is granted to resident enterprises under domestic laws.

"If in a Contracting State (A) in which is situated a permanent establishment of an enterprise of the other Contracting State (B) credit for tax levied in a third State (C) can be allowed only by virtue of a convention, then the more general question arises, as to the extension to permanent establishments of the benefit of conventions concluded with third States. . . .

"It should, however, be pointed out that difficulties may arise as to the amount of the credit to be allowed, if permanent establishments in State A benefit from the convention which State B has concluded with State C. Such amount may be either the amount of tax effectively collected by State C or the amount of tax which State C may collect by virtue either of its convention with State A or its convention with State B. Moreover, the question arises whether such credit is not given twice, i.e. once in State A, where the permanent establishment is situated, and again in State B, the State of residence. It is for Contracting States to settle such problems, if necessary, in their bilateral negotiations.

"F. *Extension to permanent establishments of the benefit of double taxation conventions concluded with third states*

"While an enterprise of a State (A) can normally claim, in respect of the permanent establishment which it possesses in another State (B), the benefit of the provisions of the convention between those two States A and B, it nevertheless cannot, should such permanent establishment derive income from a third State (C), invoke the provisions of the convention between States B and C for the benefit of such permanent establishment since it, the enterprise, is in fact resident of neither of those two States. . . . This is the consequence of the well-known principle of the relative effect of treaties, which means that they have effect only as between the Contracting States.

"Nor could such an enterprise invoke for this purpose a most-favoured-nation clause, however general its terms, included in a treaty or agreement concluded between States A and B. In fact, it has always been accepted that such a clause did not apply in the case of double taxation conventions because these are essentially based on the principle of reciprocity. It should, however, be noted that some States have made provision in their double taxation conventions enabling the provisions of the latter to be applied 'in special cases', to permanent establishments of enterprises of a third State."

Paragraph 5

Since this paragraph reproduces article 24, paragraph 5, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"This paragraph is designed to end a particular form of discrimination resulting from the fact that in certain countries the deduction of interest, royalties and other disbursements allowed without restriction when the recipient is resident, is restricted or even prohibited when he is a non-resident. The same situation may also be found in the sphere of capital taxation, as regards debts contracted to a non-resident. It is however open to Contracting States to modify this provision in bilateral conventions to avoid its use for tax avoidance purposes."

In the course of the discussion by the Group of Experts of paragraph 5 a question was raised whether such a paragraph was suitable for inclusion in a tax treaty between developed and developing countries. It was suggested that the paragraph would not be acceptable to those countries that made deductibility of disbursements made abroad by foreign-owned corporations conditional on the recipient being taxed in such countries. After substantial discussion, the feeling of the Group was that the special circumstances mentioned above ought not to be the basis for treaty articles of broad application but that in cases where they were likely to create a problem they should be raised in bilateral negotiations.

Paragraph 6

Since this paragraph reproduces article 24, paragraph 6, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"This paragraph forbids a Contracting State to give less favourable treatment to an enterprise, the capital of which is owned or controlled, wholly or partly, directly or indirectly, by one or more residents of the other Contracting State. This provision, and the discrimination which it puts an end to, relates to the taxation only of enterprises and not of the persons owning or controlling their capital. Its object therefore is to ensure equal treatment for taxpayers residing in the same State, and not to subject foreign capital, in the hands of the partners or shareholders, to identical treatment to that applied to domestic capital."

In the course of the Group's discussion of paragraph 6, some members from developing countries proposed that special measures applicable to foreign-owned enterprises should not be construed as constituting prohibited discrimination as long as all foreign-owned enterprises were treated alike; they said that that change represented a notable departure from the general principle of taxing foreign persons on the same basis as nationals but that the problems of tax compliance in cases in which foreign ownership was involved and the politically sensitive position of foreign-owned enterprises in developing countries warranted the change. Therefore, they proposed that article 24, paragraph 6, of the OECD Model Convention be amended to read as follows:

> "6. Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first-mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which are subjected other similar enterprises *the capital of which is wholly or partly owned or controlled, directly or indirectly, by residents of third countries.*"

They went on to point out that the proposed change in paragraph 6 had been included in several tax treaties to which developed countries were parties. Some members from developed countries pointed out that such a proposal would in fact limit the effect of the non-discrimination article to the prevention of discrimination between enterprises owned by non-residents, thus leaving the door open to discrimination against enterprises owned by non-residents as a class.

Several members from developed countries expressed reservations concerning the proposed change and pointed out that they considered the OECD non-discrimination article as the backbone of the Convention. They recalled that the antecedents of the non-discrimination article in the present OECD Model Convention dated from the nineteenth century. They felt that if such a fundamental principle were to be altered, it would have a significant effect on international tax relations generally. Further, since the proposed change was motivated in part by problems with tax compliance where foreign ownership was involved—essentially, problems with transfer pricing—it was suggested that the problem might be dealt with more properly in other parts of the tax convention, such as in article 9 dealing with associated enterprises.

Some members from developing countries indicated that, while recognizing the essential importance of and need for the article on non-discrimination, some countries might wish to modify certain paragraphs of that article in bilateral negotiations. It was suggested for example that, because of the difficulties involved in determining what constituted reasonable amounts in the case of transfer payments on account of royalties, technical assistance fees, head office expenses and so on, a country might desire to deny deductions for such payments or compute the amount of deduction in accordance with the domestic law of the country when such payments were made by an enterprise situated within its territory to a foreign controlling company, whether the latter was resident in another Contracting State or in a third country. Another example cited was that of a country which granted tax preferences with a view to the attainment of certain national objectives which might wish to make a given percentage of local ownership of the enterprise involved a condition for the granting of such tax preferences. The Group recognized that special situations such as those mentioned as examples should be resolved in bilateral negotiations.

Paragraph 7

Since this paragraph reproduces article 24, paragraph 7, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

> "This paragraph states that the scope of the article is not restricted by the provisions of article 2. The article therefore applies to taxes of every kind and description levied by, or on behalf of, the State, its political subdivisions or local authorities."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 26 OF THE OECD MODEL CONVENTION

Observations on the commentary

> "The interpretation given in paragraphs 40 and 41 above is not endorsed by *Germany*, the tax laws of which require the application of a minimum rate with respect to non-residents. Under German tax laws, the profits of a permanent establishment of an enterprise operated in Germany by a non-resident individual are charged income tax at a minimum rate of 25 per cent. On the other hand, the German tax laws restrict the application of higher rates by strictly limiting the basis for determining the rate applicable to profits derived from German sources—thus excluding any profits derived by those parts of the enterprise which are situated abroad. Moreover, since the minimum rate of 25 per cent is close to the lower end of the progressive tax scale, which ranges from 22 per cent to 56 per cent, Germany is of the opinion that the application of the minimum rate of 25 per cent does not violate the provisions of paragraph 4.
>
> "The *United States* observes that its non-resident citizens are not in the same circumstances as other non-residents, since the United States taxes its non-resident citizens on their worldwide income.

Reservations on the article

"*Australia*, *Canada* and *New Zealand* reserve their positions on this Article.

"*Paragraph 1*

"*France* accepts the provisions of paragraph 1 but wishes to reserve the possibility of granting only to French nationals the exemption, provided for in its domestic laws, of gains from the alienation of immovable property which constitutes, whether in whole or in part, the residence in France of French nationals who are domiciled abroad.

"The *United Kingdom* reserves its position on the second sentence of paragraph 1.

"*Paragraph 4*

"*Belgium* reserves the right to apply the provisions of its internal law for the purpose of taxing the profits of Belgian permanent establishments of companies and associations resident in countries with which it undertakes negotiations, whenever such an attitude is warranted by the general treatment accorded in such countries to permanent establishments of companies and associations resident in Belgium (paragraph 4).

"*Japan* reserves the right not to extend to the permanent establishments of non-residents the benefit of tax incentive measures introduced for national policy objectives.

"*Paragraph 5*

"*France* accepts the provisions of paragraph 5 but wishes to reserve the possibility of applying the provisions in its domestic laws relative to the limitation to the deduction of interest paid by a French company to a foreign parent company."

Article 25

MUTUAL AGREEMENT PROCEDURE

A. GENERAL CONSIDERATIONS

Article 25 of the United Nations Model Convention reproduces article 25 of the OECD Model Convention with one substantive change, namely, the deletion of the second sentence of paragraph 4 of the latter article and its replacement by two new sentences (the second and third sentences) of article 25, paragraph 4, of the United Nations Model Convention.

The mutual agreement procedure is designed not only to furnish a means of settling questions relating to the interpretation and application of the Convention, but also to provide (*a*) a forum in which residents of the States involved can protest actions not in accordance with the Convention and (*b*) a mechanism for eliminating double taxation in cases not provided for in the Convention. It should be clear that the mutual agreement procedure applies in connexion with all articles of the Convention, and, in particular, to article 7 on business profits, article 9 on associated enterprises, article 11 on interest, article 12 on royalties and article 23 on methods for the elimination of double taxation. However, some countries may need to modify this grant of power to their competent authorities in conformity with their domestic laws.

Paragraphs 1 and 2

These paragraphs reproduce the full text of paragraphs 1 and 2 of article 25 of the OECD Model Convention. The Group decided, however, that an alternative time-limit could be left to bilateral negotiations. The following passages of the commentary on article 25, paragraphs 1 and 2, of the OECD Model Convention are therefore relevant.

> "The rules laid down in paragraphs 1 and 2 provide for the elimination in a particular case of taxation which does not accord with the Convention. As is known, in such cases it is normally open to taxpayers to litigate in the tax court, either immediately or upon the dismissal of their objections by the taxation authorities. When taxation not in accordance with the Convention arises from an incorrect application of the Convention in both States, taxpayers are then obliged to litigate in each State, with all the disadvantages and uncertainties that such a situation entails. So paragraph 1 makes available to taxpayers affected, without depriving them of the ordinary legal remedies available, a procedure which is called the mutual agreement procedure because it is aimed, in its second stage, at resolving the dispute on an amicable basis, i.e. by agreement between competent authorities, the first stage being conducted exclusively in the State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) from the presentation of the objection up to the decision taken regarding it by the competent authority on the matter.
>
> "In any case, the mutual agreement procedure is clearly a special procedure outside the domestic law. It follows that it can be set in motion solely in cases coming within paragraph 1, i.e. cases where tax has been charged, or is going to be charged, in

disregard of the provisions of the Convention. So where a charge of tax has been made contrary both to the Convention and the domestic law, this case is amenable to the mutual agreement procedure to the extent only that the Convention is affected, unless a connecting link exists between the rules of the Convention and the rules of the domestic law which have been misapplied.

"In practice, the procedure applies to cases—by far the most numerous—where the measure in question leads to double taxation which it is the specific purpose of the Convention to avoid. Among the most common cases, mention must be made of the following:

"—the questions relating to attribution to a permanent establishment of a proportion of the executive and general administrative expenses incurred by the enterprise, under paragraph 3 of Article 7;

"—the taxation in the State of the payer—in case of a special relationship between the payer and the beneficial owner—of the excess part of interest and royalties, under the provisions of Article 9, paragraph 6 of Article 11 or paragraph 4 of Article 12;

"—cases where lack of information as to the taxpayer's actual situation has led to misapplication of the Convention, especially in regard to the determination of residence (paragraph 2 of Article 4), the existence of a permanent establishment (Article 5), or the temporary nature of the services performed by an employee (paragraph 2 of Article 15).

"As regards adjustments to be made correlatively with the reinstatement of profits in the trading results of associated enterprises under the provisions of paragraphs 1 and 2 of Article 9, there is ground for considering that they may properly be dealt with through the mutual agreement procedure when determining their amount gives rise to difficulty.

"The mutual agreement procedure is also applicable in the absence of any double taxation contrary to the Convention, once the taxation in dispute is in direct contravention of a rule in the Convention. Such is the case when one State taxes a particular class of income in respect of which the Convention gives an exclusive right to tax to the other State even though the latter is unable to exercise it owing to a gap in its domestic laws. Another category of cases concerns persons who, being nationals of one Contracting State but residents of the other State, are subjected in that other State to taxation treatment which is discriminatory under the provisions of paragraph 1 of Article 24.

"It should be noted that the mutual agreement procedure, unlike the disputed claims procedure under domestic law, can be set in motion by a taxpayer without waiting until the taxation considered by him to be 'not in accordance with the Convention' has been charged against or notified to him. To be able to set the procedure in motion, he must, and it is sufficient if he does, establish that the 'actions for one or both of the Contracting States' will result in such taxation, and that this taxation appears as a risk which is not merely possible but probable. Such actions mean all acts or decisions, whether of a legislative or a regulatory nature, and whether of general or individual application, having as their direct and necessary consequence the charging of tax against the complainant contrary to the provisions of the Convention.

"To be admissible objections presented under paragraph 1 must first meet a twofold requirement expressly formulated in that paragraph: in principle, they must be presented to the competent authority of the taxpayer's State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national), and they must be so presented within three years of the first notification of the action which gives rise to taxation which is not in accordance with the Convention. The Convention does not lay down any special rule as to the form of the objections. The competent authorities may prescribe special procedures which they feel to be appropriate. If no special procedure has been specified, the objections may be presented in the same way as objections regarding taxes are presented to the tax authorities of the State concerned.

"The requirement laid on the taxpayer to present his case to the competent authority of the State of which he is a resident (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national) is of general application, regardless of whether the taxation objected to has been charged in that or the other State and regardless of whether it has given rise to double taxation or not. If the taxpayer should have transferred his residence to the other Contracting State subsequently to the measure or taxation objected to, he must nevertheless still present his objection to the competent authority of the State of which he was a resident during the year in respect of which such taxation has been or is going to be charged.

"However, in the case already alluded to where a person who is a national of one State but a resident of the other complains of having been subjected in that other State to an action or taxation which is discriminatory under paragraph 1 of Article 24, it appears more appropriate for obvious reasons to allow him, by way of exception to the general rule set forth above, to present his objection to the competent authority of the Contracting State of which he is a national. Finally, it is to the same competent authority that an objection has to be presented by a person who, while not being a resident of a Contracting State, is a national of a Contracting State, and whose case comes under paragraph 1 of Article 24.

"On the other hand, Contracting States may, if they consider it preferable, give taxpayers the option of presenting their cases to the competent authority of either State. In such a case, paragraph 1 would have to be modified as follows:

" '1. Where a person considers that the actions of one or both of the Contracting States result or will result for him in taxation not in accordance with the provisions of this Convention, he may, irrespective of the remedies provided by the domestic law of those States, present his case to the competent authority of either Contracting State. The case must be presented within three years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention.'

"The time limit of three years [2] set by the second sentence of paragraph 1 for presenting objections is intended to protect administrations against late objections. This time limit must be regarded as a minimum, so that Contracting States are left free to agree in their bilateral conventions upon a longer period in the interests of taxpayers, e.g. on the analogy in particular of the time limits laid down by their respective domestic regulations in regard to tax conventions. Contracting States may omit the second sentence of paragraph 1 if they concur that their respective domestic regulations apply automatically to such objections and are more favourable in their effects to the taxpayers affected, either because they allow a longer time for presenting objections or because they do not set any time limits for such purpose.

"The provision fixing the starting point of the three-year time limit as the date of the 'first notification of the action resulting in taxation not in accordance with the provisions of the Convention' should be interpreted in the way most favourable to the taxpayer. Thus, even if such taxation should be directly charged in pursuance of an administrative decision or action of general application, the time limit begins to run only from the date of the notification of the individual action giving rise to such taxation, that is to say, under the most favourable interpretation, from the act of taxation itself, as evidenced by a notice of assessment or an official demand or other instrument for the

---

[2] The United Nations Model provides that the three-year period could be changed through bilateral negotiations.

collection or levy of tax. If the tax is levied by deduction at the source, the time limit begins to run from the moment when the income is paid; however, if the taxpayer proves that only at a later date did he know that the deduction had been made, the time limit will begin from that date. Furthermore, where it is the combination of decisions or actions taken in both Contracting States resulting in taxation not in accordance with the Convention, it begins to run only from the first notification of the most recent decision or action.

"As regards the procedure itself, it is necessary to consider briefly the two distinct stages into which it is divided.

"In the first stage, which opens with the presentation of the taxpayer's objections, the procedure takes place exclusively at the level of dealings between him and the competent authorities of his State of residence (except where the procedure for the application of paragraph 1 of Article 24 is set in motion by the taxpayer in the State of which he is a national). The provisions of paragraph 1 give the taxpayer concerned the right to apply to the competent authority of the State of which he is a resident, whether or not he has exhausted all the remedies available to him under the domestic law of each of the two States. On the other hand, that competent authority is under an obligation to consider whether the objection is justified and, if it appears to be justified, take action on it in one of the two forms provided for in paragraph 2.

"If the competent authority duly approached recognises that the complaint is justified and considers that the taxation complained of is due wholly or in part to a measure taken in the taxpayer's State of residence, it must give the complainant satisfaction as speedily as possible by making such adjustments or allowing such reliefs as appear to be justified. In this situation, the issue can be resolved without resort to the mutual agreement procedure. On the other hand, it may be found useful to exchange views and information with the competent authority of the other Contracting State, in order, for example, to confirm a given interpretation of the Convention.

"If, however, it appears to that competent authority that the taxation complained of is due wholly or in part to a measure taken in the other State, it will be incumbent on it, indeed it will be its duty–as clearly appears by the terms of paragraph 2–to set in motion the mutual agreement procedure proper.

"A taxpayer is entitled to present his case under paragraph 1 to the competent authority of the State of which he is a resident whether or not he may also have made a claim or commenced litigation under the domestic law of that State. If litigation is pending, the competent authority of the State of residence should not wait for the final adjudication, but should say whether it considers the case to be eligible for the mutual agreement procedure. If it so decides, it has to determine whether it is itself able to arrive at a satisfactory solution or whether the case has to be submitted to the competent authority of the other Contracting State.

"If a claim has been finally adjudicated by a court in the State of residence, a taxpayer may wish even so to present or pursue a claim under the mutual agreement procedure. In some States, the competent authority may be able to arrive at a satisfactory solution which departs from the court decision. In other States, the competent authority is bound by the court decision. It may nevertheless present the case to the competent authority of the other Contracting State and ask the latter to take measures for avoiding double taxation.

"In its second stage—which opens with the approach to the competent authority of the other State by the competent authority to which the taxpayer has applied—the procedure is henceforward at the level of dealings between States, as if, so to speak, the State to which the complaint was presented had given it its backing. But while this procedure is indisputably a procedure between States, it may, on the other hand, be asked:

"—whether, as the title of the Article and the terms employed in the first sentence of paragraph 2 suggest, it is no more than a simple procedure of mutual agreement, or constitutes the implementation of a "pactum de contrahendo" laying on the parties a mere duty to negotiate but in no way laying on them a duty to reach agreement;

"—or whether on the contrary, it is to be regarded (on the assumption of course that it takes place within the framework of a Joint Commission) as a procedure of a jurisdictional nature laying on the parties a duty to resolve the dispute.

"Paragraph 2 no doubt entails a duty to negotiate; but as far as reaching mutual agreement through the procedure is concerned, the competent authorities are under a duty merely to use their best endeavours and not to achieve a result. However, Contracting States could agree on a more far-reaching commitment whereby the mutual agreement procedure, and above all the discussions in the Joint Commission, would produce a solution to the dispute. Such a rule could be established either by an amendment to paragraph 2 or by an interpretation specified in a protocol or an exchange of letters annexed to the convention.

"In seeking a mutual agreement, the competent authorities must first, of course, determine their position in the light of the rules of their respective taxation laws and of the provisions of the Convention, which are as binding on them as much as they are on the taxpayer. Should the strict application of such rules or provisions preclude any agreement, it may reasonably be held that the competent authorities, as in the case of international arbitration, can, subsidiarily, have regard to considerations of equity in order to give the taxpayer satisfaction.

"The purpose of the last sentence of paragraph 2 is to enable countries with time limits relating to adjustments of assessments and tax refunds in their domestic law to give effect to an agreement despite such time limits. This provision does not prevent, however, such States as are not, on constitutional or other legal grounds, able to overrule the time limits in the domestic law from inserting in the mutual agreement itself such time limits as are adapted to their internal statute of limitation. In certain extreme cases, a Contracting State may prefer not to enter into a mutual agreement, the implementation of which would require that the internal statute of limitation had to be disregarded. Apart from time limits there may exist other obstacles such as 'final court decisions' to giving effect to an agreement. Contracting States are free to agree on firm provisions for the removal of such obstacles.

"Finally, the case may arise where a mutual agreement is concluded in relation to a taxpayer who has brought a suit for the same purpose in the competent court of either Contracting State and such suit is still pending. In such a case, there would be no grounds for rejecting a request by a taxpayer that he be allowed to defer acceptance of the solution agreed upon as a result of the mutual agreement procedure until the court had delivered its judgment in the suit still pending. On the other hand, it is necessary to take into account the concern of the competent authority to avoid any divergence or contradiction between the decision of the court and the mutual agreement, with the difficulties or risks of abuse that they could entail. In short, therefore, it seems normal that the implementation of a mutual agreement should be made subject:

"—to the acceptance of such mutual agreement by the taxpayer, and

"—to the taxpayer's withdrawal of his suit at law concerning the points settled in the mutual agreement."

Paragraph 3

This paragraph reproduces article 25, paragraph 3, of the OECD Model Convention. The commentary on that paragraph is therefore relevant:

"The first sentence of this paragraph invites and authorises the competent authorities to resolve, if possible, difficulties of interpretation or application by means of mutual agreement. These are essentially difficulties of a general nature which concern, or which may concern, a category of taxpayers, even if they have arisen in connection with an individual case normally coming under the procedure defined in paragraphs 1 and 2.

"This provision makes it possible to resolve difficulties arising from the application of the Convention. Such difficulties are not only those of a practical nature, which might arise in connection with the setting up and operation of procedures for the relief from tax deducted from dividends, interest and royalties in the Contracting State in which they arise, but also those which could impair or impede the normal operation of the clauses of the Convention as they were conceived by the negotiators, the solution of which does not depend on a prior agreement as to the interpretation of the Convention.

"Under this provision the competent authorities can, in particular:

"—where a term has been incompletely or ambiguously defined in the Convention, complete or clarify its definition in order to obviate any difficulty;

"—where the laws of a State have been changed without impairing the balance or affecting the substance of the Convention, settle any difficulties that may emerge from the new system of taxation arising out of such changes.

"Paragraph 3 confers on the 'competent authorities of the Contracting States', i.e. generally the Ministers of Finance or their authorized representatives normally responsible for the administration of the Convention, authority to resolve by mutual agreement any difficulties arising as to the interpretation of the Convention. However, it is important not to lose sight of the fact that, depending on the domestic law of Contracting States, other authorities (ministry of Foreign Affairs, courts) have the right to interpret international treaties and agreements as well as the 'competent authority' designated in the Convention, and that this is sometimes the exclusive right of such other authorities.

"Mutual agreements resolving general difficulties of interpretation or application are binding on administrations as long as the competent authorities do not agree to modify or rescind the mutual agreement.

"The second sentence of paragraph 3 enables the competent authorities to deal also with such cases of double taxation as do not come within the scope of the provisions of the Convention. Of special interest in this connection is the case of a resident of a third State having permanent establishments in both Contracting States. It is of course desirable that the mutual agreement procedure should result in the effective elimination of the double taxation which can occur in such a situation. An exception must, however, be made for the case of Contracting States whose domestic law prevents the convention from being complemented on points which are not explicitly or at least implicitly dealt with; in such a case, the convention could be complemented only by a protocol subject, like the convention itself, to ratification or approval."

Paragraph 4

This paragraph consists of three sentences, the first of which reproduces the first sentence of article 25, paragraph 4, of the OECD Model Convention, while the second and third sentences constitute new provisions.

With regard to this paragraph the following essential elements in respect of income and expense allocations, including transfer pricing, are to be emphasized:

First, transactions between related entities should be governed by the standard of "arm's length dealing"; as a consequence, if an actual allocation is considered by the tax authorities of a treaty country to depart from that standard, the taxable profits may be redetermined;

Secondly, taxpayers are entitled to invoke the mutual agreement procedure where they consider that such action by one or both of the tax authorities regarding such redetermination is contrary to the arm's length standard;

Thirdly, the implementation of the mutual agreement procedure is delegated to the competent authorities of the treaty countries, with adequate powers to ensure full implementation and with the expectation that such implementation will enable the mutual agreement procedure to be an effective instrument for carrying out the purpose of the treaty. Such delegation includes the establishment of time limits within which matters should be presented by the interested parties to the appropriate competent authority, and hence makes unnecessary the last sentence of paragraph 1 of OECD article 25 dealing with this aspect, except for those countries whose domestic law requires the insertion of the sentence (see the commentary on page 182 of the OECD Model Convention).

In order to assist the competent authorities in applying the mutual agreement procedure, the Group of Experts discussed a number of possible arrangements. The Group stressed that those arrangements were not intended to be exhaustive and could be extended as appropriate in the light of experience.

The procedural arrangements should be suitable to the number and types of issues expected to be dealt with by the competent authorities and to the administrative capability and resources of those authorities. The arrangements should not be rigidly structured but instead should embody the degree of flexibility required to facilitate consultation and agreement rather than hinder them by elaborate procedural requirements and mechanisms. But even relatively simple procedural arrangements must incorporate certain minimum rules that inform taxpayers of their essential rights and obligations under the mutual agreement procedure. Such minimum rules would appear to involve such questions as:

At what stage in his tax matter a taxpayer can invoke action by the competent authority under the mutual agreement procedure;

Whether any particular form must be followed by a taxpayer in invoking action by the competent authority;

Whether any time-limits are applicable to a taxpayer's invocation of action by the competent authority;

If a taxpayer invokes action by the competent authority, whether he is bound by the decision of the competent authorities and whether he must waive recourse to other administrative or judicial processes;

In what manner, if at all, a taxpayer can participate in the competent authority proceedings and what requirements regarding the furnishing of information by a taxpayer are involved.

(a) *Information on adjustments*

The competent authorities should decide on the extent of the information to be provided on adjustments involving income allocation and the time when it is to be given by one competent authority to the other. Thus, the information could cover adjustments proposed or concluded by the tax administration of one country, the related entities involved and the general nature of the adjustments.

Generally speaking, most competent authorities are likely to conclude that the automatic transmittal of such information is not needed or desirable. The competent authority of the country making an adjustment may find it difficult or time-consuming to gather the information and prepare it in a suitable form for transmission. In addition, the other competent authority may find it burdensome merely to process a volume of data routinely transmitted by the first competent authority. Moreover, a taxpaying corporation can usually be counted upon to inform its related entity in the other country of the proceedings and the latter is thus in a position to inform, in turn, its competent authority. For this reason, the functioning of a consultation system would be aided if a tax administration considering an adjustment possibly involving an international aspect were to give the taxpayer as much warning as possible.

Some competent authorities, while not wishing to be informed routinely of all adjustments in the other country, may desire to receive, either from their own taxpayers or from the other competent authority, "early warning" of serious cases or of the existence of a significant degree or pattern of activity respecting particular types of cases; similarly, they may want to transmit such information. In this event, a process should be worked out for obtaining the information. Some competent authorities may want to extend this early warning system to less serious cases, thus covering a larger number of cases.

(b) *Invocation of competent authority consultation at the point of proposed or concluded adjustments*

The competent authorities must decide at what stage the competent authority consultation process may be invoked by a taxpayer and which competent authority a taxpayer should go to in order to initiate that process. For example, suppose an adjustment is proposed by State A that would increase the income of a parent company in State A and the adjustment would have a correlative effect on a related entity in State B. May the company go to its competent authority in State A, asserting that the adjustment is contrary to the treaty, and ask that the bilateral competent authority process commence? (It is assumed, as stated earlier, that if the bilateral competent authority process is properly invoked, the two competent authorities must enter the process of consultation.) As another example, may the related entity in State B invoke its competent authority?

Probably most competent authorities, at least in the early stages of their experience, would prefer that the process not be invoked at the point of a proposed adjustment and probably not even at the point of a concluded adjustment. A proposed adjustment may never result in final action and even a concluded adjustment may or may not trigger a claim for a correlative adjustment; even if it does, the latter adjustment may occur without problems. As a consequence, many competent authorities may decide that the process should not be invoked until the correlative adjustment (or other tax consequence in the second country) is involved at some point.

However, some competent authorities may prefer that the bilateral process be invoked earlier, perhaps at the proposed adjustment stage. Such involvement may make the process of consultation easier, in that the first country will not have an initial fixed position. In such a case the other competent authority should be prepared to discuss the case at this early stage with the first competent authority. Other competent authorities may be willing to let the taxpayer decide, and thus stand ready to have the process invoked at any point starting with the proposed adjustment

In any event, at a minimum, taxpayers must be informed when they can invoke the mutual agreement procedure and which competent authority is to be addressed (presumably it would be the competent authority of the country where the invoking taxpayer resides). Taxpayers should also be informed in what form the request should be submitted, although it is likely that a simple form would normally be suitable.

(c) *Correlative adjustments*

(i) *Governing rule*. It is the general view that a tax treaty should provide that if one country makes an adjustment in the tax liabilities of an entity under the rules governing the allocation of income and expense, thereby increasing the tax liabilities of that entity, and if the effect of this adjustment, when reflected in the tax status of a related entity in the other country, would require a change in the tax liabilities of the related entity, then a correlative adjustment should be made by the second country at the related entity's request if the initial adjustment is in accord with the treaty standard governing allocation of income and expense. The purpose of such a treaty provision is to avoid economic double taxation. It is clear that the key aspect of a treaty provision requiring a correlative adjustment is that the initial adjustment itself must conform to the appropriate arm's-length standard. Such conformity thus becomes for this purpose an important facet of competent authority consultation.

While many countries may be willing to agree that a correlative adjustment should be made, some countries may believe it appropriate to reserve a degree of discretion to the competent authorities, which could then decide that a correlative adjustment need not be made where they conclude that the actual allocations of the related entities which provoked the initial adjustment involved fraud, evasion, intent to avoid taxes or gross abuse in the allocation method utilized. Such countries may take the view that, if a correlative adjustment were required in such situations and the taxpayer were thus given, in effect, an almost automatic guarantee against the consequence of double taxation, the taxpayer would generally have little to lose in initially using clearly improper allocations. Hence, if the competent authorities possess such discretion and there were a risk to the taxpayer of economic double taxation, he would be deterred from taking such action and would be more careful in his allocations. Other countries may feel, however, that the key objective of the treaty should be to avoid double taxation and, hence, matters such as fraud should be left to other provisions of law, although even here they might concede some modicum of discretion to be used in outrageous cases.

Putting such situations to one side, some countries may not desire a provision requiring correlative adjustments but would leave the entire matter to the discretionary agreement of the competent authorities in the view that the requirement of a correlative adjustment is too strong an invitation to a country to make a large number of initial adjustments. Other countries, however, may believe that the constraint that competent authorities must agree that the initial adjustment conforms to an arm's-length standard is itself a sufficient safeguard.

It is recognized that, to be effective, a treaty with a correlative adjustment provision must also provide that any domestic law procedural or other barriers to the making of the correlative adjustment are to be disregarded. Thus, such provisions as statutes of limitations and finality of assessments would have to be overridden to permit the correlative adjustment to be made. If a particular country cannot, through a treaty, override such aspects of its domestic law, this would have to be indicated as an exception to the correlative adjustment provision, although it would be hoped that domestic law could be amended to permit the treaty to operate.

The treaty need not prescribe the method of the correlative adjustment since this depends on the nature of the initial adjustment and its effect on the tax status of the related entity. The method of the correlative adjustment is thus an aspect of the substantive issue underlying the initial adjustment.

(ii) *Competent authority procedure*. Given this correlative adjustment requirement, it is clear that the competent authority process must be available at this point. Thus, if the tax authorities of the second country do not themselves work out the correlative adjustment, the taxpayers should be entitled to invoke the competent authority procedure. Hence as one of the minimum aspects of the competent authority procedure, the competent authorities must establish rules as to which competent authority the taxpayers may go to, i.e., the competent authority of the country in which the related entity seeking the correlative adjustment is situated or the competent authority of the country of the initial adjustment, or both. If a time-limit on the invocation is to be imposed, then the limit must be stated and the stage at which the time begins to run must be defined. In some countries, when a taxpayer invokes the competent authority of its country, that competent authority may be in a position to dispose of the matter without having to consult the competent authority of the other country. For example, the first competent authority may be in a position to handle a matter having potential international consequences that arises from an adjustment proposed by a taxing unit in the country other than the central body. This is, of course, an aspect of domestic law as affected by the treaty.

As another minimum procedural aspect, the competent authorities must indicate the extent to which a taxpayer may be allowed to participate in the competent authority procedure and the manner of his participation. Some countries may wish to favour a reasonable degree of taxpayer participation. Some countries may wish to allow a taxpayer to present information and even to appear before them; others may restrict the taxpayer to presentation of data. Presumably, the competent authorities would make it a condition that a taxpayer invoking the procedure be required to submit to them relevant information needed to decide the matter. In addition, some competent authorities may, where appropriate, require that data furnished by a taxpayer be prepared as far as possible in accordance with internationally accepted accounting standards so the data provided will have some uniformity and objectivity. It is to be noted that rapid progress is being made in developing international accounting standards and the work of competent authorities should be aided by this development. As a further aspect concerning the taxpayer's participation, there should be a requirement that the taxpayer who invokes the competent authority procedure should be informed of the response of the competent authority.

The competent authorities will have to decide how their consultation should proceed once the procedure comes into operation. Presumably, the nature of the consultation will depend on the number and character of the cases involved. The competent authorities should keep the consultation procedure flexible and leave every method of communication open, so that the method appropriate to the matter at hand can be used.

Various alternatives are available, such as informal consultation by communication or in person; meetings between technical personnel or auditors of each country, whose conclusions are to be accepted or ratified by the competent authorities; appointment of a joint commission for a complicated case or a series of cases; formal meetings of the competent authorities in person etc. It does not seem desirable to place a time-limit on when the competent authorities must conclude a matter, since the complexities of particular cases may differ. Nevertheless, competent authorities should develop working habits that are conducive to prompt disposition of cases and should endeavour not to allow undue delay.

An important minimum procedural aspect of the competent authority procedure is the effect of a taxpayer's invocation of that procedure. Must a taxpayer who invokes that process be bound by the decision of the competent authorities in the sense that he gives up rights to alternative procedures, such as recourse to domestic administrative or judicial procedures? If the competent authorities want their procedure to be exclusive and binding, it would be necessary that the treaty provisions be so drawn as to permit this result. Presumably, this may be accomplished under the general delegation in article 25, paragraph 4, by requiring the taxpayer to waive recourse to those alternative procedures. (However, even with this guideline paragraph, some countries may consider that their domestic law requires a more explicit statement to permit the competent authority procedure to be binding, especially in view of paragraph 1 of guideline 25 referring to remedies under national laws and of the present practice under treaties not to make the procedure a binding one.) Some competent authorities may desire that their actions be binding, since they will not want to go through the effort of reaching agreements only to have the taxpayer reject the result if he feels he can do better in the courts or elsewhere. Other competent authorities may desire to follow the present practice and thus may not want to bind taxpayers or may not be in a position to do so under domestic law. This would appear to be a matter on which developing experience would be a useful guide.

A basic issue regarding the competent authority procedure is the extent to which the competent authorities should consider themselves under obligation to reach an agreement on a matter that comes before them. At a minimum, the treaty requires consultation and the obligation to endeavour to find a solution to economic double taxation. But must the consultation end in agreement? Presumably, disagreement would, in general, leave the related entities in a situation where double taxation may result contrary to the treaty, for example, when a country has opposed a correlative adjustment on the grounds that the initial adjustment was not in conformity with the arm's-length standard. On the other hand, an agreement would mean a correlative adjustment made, or a change in the initial adjustment followed then by a correlative adjustment, or perhaps the withdrawal of the initial adjustment. In essence, the general question is whether the competent authority consultation is to be governed by the requirement that there be an "agreement to agree".

It should be observed that, in practice, this question is not as serious as it may seem. The experience of most competent authorities, at least as concerns disputes between developed countries, is that in the end an agreement or solution is almost always reached. Of course, the solution may often be a compromise, but compromise is an essential aspect of the process of consultation and negotiation. Hence, in reality, it would not be much of a further step for competent authorities to decide that their procedure should be governed by the standard of "agreement to agree". However, some countries would consider the formal adoption of such standard as a step possessing significant juridical consequences and hence would not be disposed to adopt such a requirement.

It is recognized that, for some countries, the process of agreement might well be facilitated if competent authorities, when faced with an extremely difficult case or an impasse, could call, either informally or formally, upon outside experts to give an advisory opinion or otherwise assist in the resolution of the matter. Such experts could be persons currently or previously associated with other tax administrations and possessing the requisite experience in this field. In essence, it would largely be the personal operation of these experts that would be significant. This resort to outside assistance could be useful even where the competent authorities are not operating under the standard of an "agreement to agree", since the outside assistance, by providing a fresh point of view, may help to resolve an impasse.

(d) *Publication of competent authority procedures and determinations*

The competent authorities should make public the procedures they have adopted with regard to their consultation procedure. The description of the procedures should be as complete as is feasible and at the least should contain the minimum procedural aspects discussed above.

Where the consultation procedure has produced a substantive determination in an important area that can reasonably be viewed as providing a guide to the viewpoints of the competent authorities, the competent authorities should develop a procedure for publication in their countries of that determination or decision.

(e) *Procedures to implement adjustments*

The competent authorities should consider what procedures may be required to implement the various adjustments involved. For example:

(i) The first country may consider deferring a tax payment under the adjustment or even waiving the payment if, for example, payment or reimbursement of an expense charge by the related entity is prohibited at the time because of currency or other restrictions imposed by the second country.

(ii) The first country may consider steps to facilitate carrying out the adjustment and payment of a reallocated amount. Thus, if income is imputed and taxed to a parent corporation because of service to a related foreign subsidiary, the related subsidiary may be allowed as far as the parent country is concerned, to establish on its book an account payable in favour of the parent, and the parent will not be subject to a second tax in its country on the establishment or payment of the amount receivable. Such payment should not be considered a dividend by the country of the subsidiary.

(iii) The second country may consider steps to facilitate carrying out the adjustment and payment of a reallocated amount. This may, for example, involve recognition of the payment made as a deductible item, even though prior to the adjustment there was no legal obligation to pay such amount. This is really an aspect of the correlative adjustment.

(f) *Unilateral procedures*

The above discussion has related almost entirely to bilateral procedures to be agreed upon by the competent authorities to implement the mutual agreement procedure. In addition, a competent authority may consider it useful to develop certain unilateral rules or procedures involving its relationship to its own taxpayers, so that these relationships may be better understood. These unilateral rules can cover such matters as the form to be followed in bringing matters to the attention of the competent authority; the permission to taxpayers to bring matters to the competent authority at an early stage even where the bilateral procedure does not require consultation at that stage; the question whether the competent authority will raise new domestic issues (so-called affirmative issues) between the tax authorities and the taxpayer if he goes to the competent authority; and requests for information that will assist the competent authority in handling cases.

Unilateral rules regarding the operation of a competent authority would not require agreement to them by the other competent authority, since the rules are limited to the domestic relationship with its own taxpayers. However, it would seem appropriate to communicate such unilateral rules to the other treaty competent authorities, and to avoid wherever possible material differences, if any, in such rules in relation to the various treaties.

C. RESERVATIONS ON ARTICLE 25 OF THE OECD MODEL CONVENTION

"*Canada* and *Portugal* reserve their positions on the last sentence of paragraph 1 as they could not accept such a long time-limit.

"*Canada, Greece, Ireland, Italy, Portugal, Spain* and the

United Kingdom reserve their positions on the second sentence of paragraph 2. These countries consider that the implementation of reliefs and refunds following a mutual agreement ought to remain linked to time-limits prescribed by their domestic laws.

"*Turkey* reserves its position on the second sentence of paragraph 2. Turkey's tax law provides that refunds of tax, like the assessment itself, must be made within a specific period. According to these provisions, if the administration finds an application for repayment acceptable, it must notify the fact to the taxpayer so that he can present his claim within a period of one year of such notification. If the taxpayer exceeds this time limit, his right to claim repayment lapses. The same procedure applies to the enforcement of judgements of courts under which repayments are required to be made. That is why Turkey is obliged to fix a time limit for the implementation of agreed mutual agreement procedures, as is done for all repayments. For this reason Turkey wishes to reserve the right to mention in the text of bilateral conventions a definite time limit as regards their implementation."

Article 26

EXCHANGE OF INFORMATION

A. GENERAL CONSIDERATIONS

Article 26 of the United Nations Model Convention reproduces article 26 of the OECD Model Convention with three substantive changes in paragraph 1, namely the insertion of the phrase "and in particular for the prevention of fraud or evasion of such taxes" in the first sentence, the insertion of the phrase "and where originally regarded as secret in the transmitting State" in the fourth sentence and the addition of a new sentence (sixth and last sentence). The latter sentence is the key to the approach advocated by the Group; it would stress the importance of the competent authorities in implementing fully the provisions on the exchange of information and will give them the necessary authority.

The words "in particular for the prevention of fraud or evasion of such taxes" were inserted at the request of members of the Group, mainly from developing countries, who wanted to emphasize that the exchange of information under article 26 did cover the purpose of preventing fraud or evasion. This insertion is not intended to affect the interpretation of the OECD text of article 26, according to which the exchange of information it provides may be used for the prevention of fraud or evasion, although this is not expressly stated in the article. It is also clear that this exchange of information for the prevention of fraud or evasion is subject to the general condition embodied in the first sentence of paragraph 1, that the taxation involved is not contrary to the Convention.

Since article 26 of the United Nations Model Convention reproduces the substance of all the provisions of article 26 of the OECD Model Convention, the preliminary remarks contained in the commentary on the latter article are relevant. These remarks read as follows:

> "There are good grounds for including in a convention for the avoidance of double taxation provisions concerning co-operation between the tax administrations of the two Contracting States. In the first place it appears to be desirable to give administrative assistance for the purpose of ascertaining facts in relation to which the rules of the Convention are to be applied. Moreover, in view of the increasing internationalisation of economic relations, the Contracting States have a growing interest in the reciprocal supply of information on the basis of which domestic taxation laws have to be administered, even if there is no question of the application of any particular Article of the Convention.
>
> "Therefore the present Article embodies the rules under which information may be exchanged to the widest possible extent, with a view to laying the proper basis for the implementation of the domestic laws of the Contracting States concerning taxes covered by the Convention and for the application of specific provisions of the Convention. The text of the Article makes it clear that the exchange of information is not restricted by Article 1, so that the information may include particulars about non-residents.
>
> "The matter of administrative assistance for the purpose of tax collection is not dealt with in the Article. This matter often forms the subject of a separate agreement, whether bilateral or multilateral, between the Contracting States; alternatively, the provisions on assistance in the field of tax collection may be introduced in the double taxation convention, whenever Contracting States find it preferable.
>
> "Experience in recent years has shown that the text of the Article in the 1963 Draft Convention left room for differing interpretations. Therefore it was felt desirable to clarify its meaning by a change in the wording of the article and its commentary without altering its effects. Apart from a single point of substance the main purpose of the changes made has been to remove grounds for divergent interpretations."

The Group emphasized that in negotiating treaties for the avoidance of double taxation and tax evasion the competent authorities might wish to provide for the exchange of such information as was necessary for carrying out the provisions of the treaty or of the domestic laws of the Contracting States concerning taxes covered by the treaty. In that regard, the Group suggested guidelines for arrangements regarding the implementation of appropriate exchanges of information. Those guidelines are in the form of an inventory of possible arrangements from which the competent authorities under a tax treaty may select the particular arrangements which they decide should be used. The inventory is not intended to be exhaustive nor is it to be regarded as listing matters all of which are to be drawn on in every case. Instead, the inventory is a listing of suggestions to be examined by competent authorities in deciding on the matters they wish to cover.

The Group also emphasized that the term "exchange of information" included an exchange of documents and that, subject to the provisions of paragraph 2 of the article if specifically requested by the competent authority of a Contracting State, the competent authority of the other Contracting State should provide information under that article in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, or writings), to the extent that it could obtain such depositions and documents under the laws and administrative practices applying in respect to its own taxes.

Routine transmittal of information[3]

A method of exchange of information that is in use to a limited extent is that of the routine or automatic flow of information from one treaty country to another. The following are various aspects that the competent authorities should focus on in developing a structure for such routine exchange. In considering routine exchanges of information it should be recognized that some countries not desiring to receive such information in a routine fashion (or unable to receive it routinely because the transmitting countries do not routinely collect such information) may desire to obtain information of this type under a specific request. Hence, in these situations, items mentioned in the present section should be considered as available for coverage under the next section, "Transmittal on specific request".

Items covered

Regular sources of income. The items covered under a routine transmittal or exchange of information may extend to regular sources of income flowing between countries, such as dividends, interest, compensation (including wages, salaries, fees and commissions),

[3] In the following text, "transmitting country" refers to the country transmitting information and "receiving country" refers to the country receiving information.

royalties, rents and other possible items whose regular flow between the two countries is signficant. It should be recognized, however, that at present most countries are not in a position to supply routine information of this type because their tax collection procedures do not provide the needed data.

Transactions involving taxpayer activity. A routine exchange of information may cover certain significant transactions involving taxpayer activity.

(*a*) Transactions relevant to the treaty itself:

Claims for refund of transmitting country tax made by residents of receiving country;

Claims for exemption or particular relief from transmitting country tax made by residents of receiving country.

(*b*) Transactions relevant to special aspcts of the legislation of the transmitting country:

Items of income derived by residents of the receiving country that receive exemption or partial relief under special provisions of the national law of the transmitting country;

(*c*) Transactions relating to activities in the transmitting country of residents of the receiving country:

Opening and closing by receiving country residents of a branch, office etc. in the transmitting country;

Creation or termination by receiving country residents of a corporation in the transmitting country;

Creation or termination by receiving country residents of a trust in the transmitting country;

Opening and closing by receiving country residents of bank accounts in the transmitting country;

Property in the transmitting country acquired by residents of the receiving country by inheritance, bequest or gift;

Ancillary probate proceedings in the transmitting country concerning receiving country residents.

(*d*) General information:

Tax laws, administrative procedures etc. of the transmitting country;

Changes in regular sources of income flowing between countries, especially as they affect the treaty, including administrative interpretations of and court decisions on treaty provisions and administrative practices or developments affecting application of the treaty;

Activities that affect or distort application of the treaty, including new patterns or techniques of evasion or avoidance used by residents of the transmitting or receiving country;

Activities that have repercussions regarding the tax system of the receiving country, including new patterns or techniques of evasion or avoidance used by residents of either country that significantly affect the receiving country's tax system.

General operational aspects to be considered

The competent authorities should consider various factors that may have a bearing on the operational character of the routine exchange, including its effectiveness. For example:

(*a*) Countries that are more interested in receiving information on a specific request basis than on a routine basis, in their consideration of the specific request area should keep in mind items mentioned in this inventory under the heading of routine information;

(*b*) A minimum floor amount may be fixed to limit minor data;

(*c*) The routine source of income items may be rotated from year to year, for example, dividends only in one year, interest in another etc.;

(*d*) The information to be exchanged routinely need not be strictly reciprocal in all items. Country A may be interested in receiving information on some items but not others; the preferences of country B may extend to different items; it is not necessary for either country to receive items in which it is not interested, nor should either country refuse to transmit information on certain items simply because it is not interested in receiving information on those items;

(*e*) While the information to be exchanged on income items may not always be significant in itself as regards the income flows escaping tax, the routine exchange may provide indications respecting the degree to which the capital or other assets producing the income flows are escaping tax;

(*f*) Whether the information on items of income should cover the payee only or also the payer is a further point to be taken into account;

(*g*) Another factor to be considered is whether the information should cover only residents of the receiving country or also those domiciled therein or citizens thereof, or be limited to any of these categories;

(*h*) The degree of detail involved in the reporting, e.g., name of taxpayer or recipient, profession, address etc. may need to be taken into account.

(*i*) The form and the language in which the information should be provided is a further point to be considered.

Factors to be considered by the transmitting country

The transmitting country may wish to give consideration to factors affecting its ability to fulfil the requirements of a routine exchange of information. Such a consideration would presumably lead to a more careful selection of the information to be routinely exchanged rather than to a decision not to exchange information that could be of practical use.

Among the factors to be considered are the administrative ability of the transmitting country to obtain the information involved. This in turn is governed by the general effectiveness of its administrative procedures, its use of withholding taxes, its use of information returns from payers or others and the over-all costs of obtaining the information involved.

Factors to be considered by receiving country

The receiving country may wish to give consideration to factors affecting its ability to use the information that could be received under a routine exchange of information, such as the administrative ability of the receiving country to use the information on a reasonably current basis and effectively to associate such information with its own taxpayers, either routinely or on a sufficient scale to justify the routine receipt of the information.

Transmittal on specific request

A method of exchange of information that is in current use is that of a request for specific information made by one treaty country to another. The specific information may relate to a particular taxpayer and certain facets of his situation or to particular types of transactions or activities or to information of a more general character. The following are various aspects of the question that the competent authorities should focus on in developing a structure for such exchange of information pursuant to specific requests.

Items covered

Particular taxpayers. The information that may be desired from a transmitting country with respect to a receiving country taxpayer is essentially open-ended and depends on the factors involved in the situation of the taxpayer under the tax system of the receiving country and the relationship of the taxpayer and his activities to the transmitting country. A specific enumeration in advance of the type of information that may be within the scope of an exchange pursuant to specific request does not seem to be a fruitful or necessary task. The agreement to provide information pursuant to specific request may thus be open-ended as to the range, scope and type of information, subject to the over-all constraints to be discussed herein.

The request for specific information may arise in a variety of ways. For example:

(*a*) Information needed to complete the determination of a taxpayer's liability in the receiving country when that liability depends on the taxpayer's world-wide income or assets; the nature of the stock ownership in the transmitting country of the receiving country corporation; the amount or type of expense incurred in the transmitting country; the fiscal domicile of an individual or corporation;

(*b*) Information needed to determine the accuracy of a taxpayer's tax return to the tax administration of the receiving country or the accuracy of the claims or proof asserted by the taxpayer in defence of the tax return when the return is regarded as suspect or is under actual investigation;

(*c*) Information needed to determine the true liability of a taxpayer in the receiving country when it is suspected that his reported liability is wrong.

Particular types of transactions or activities. The exchange on specific request need not be confined to requests regarding particular taxpayers but may extend to requests for information on particular types of transactions or activities. For example:

(*a*) Information on price, cost, commission or other such patterns in the transmitting country necessary to enable the tax administration of the receiving country either to determine tax liability in a particular situation or to develop standards for investigation of its taxpayers in situations involving possible under- or over-invoicing of exported or imported goods, the payment of commissions on international transactions and the like;

(*b*) Information on the typical methods by which particular transactions or activities are customarily conducted in the transmitting country;

(*c*) Information on whether a particular type of activity is being carried on in the transmitting country that may have effects on taxpayers or tax liabilities in the receiving country.

Economic relationships between the countries. The specific request may extend to requests for information regarding certain economic relationships between the countries which may be useful to a country as a check on the effectiveness of its tax administration activities, for example:

(*a*) The volume of exports from the transmitting country to the receiving country;

(*b*) The volume of imports into the transmitting country from the receiving country;

(*c*) Names of banks dealing in the transmitting country with branches, subsidiaries etc. of residents of the receiving country.

It should be noted that since items in this category, such as the volume of exports between the countries, are presumably not regarded as secret to the tax authorities in the transmitting country, they may be disclosed generally in the receiving country, as provided in article 26.

Rules applicable to the specific request

The competent authorities should develop rules applicable to the transmission of specific requests by the receiving country and to the response by the transmitting country. These rules should be designed to facilitate a systematic operational procedure regarding such exchange that is both efficient and orderly. While the rules may be general in character in the sense that they set standards or guidelines governing the specific request procedures, the rules should also permit discussion between the competent authorities of special situations that either country believes require special handling.

The rules should pertain to:

(*a*) The specificity of detail required in the request by the receiving country, the form of such request and the language of the request and reply;

(*b*) The extent to which the receiving country must pursue or exhaust its own administrative processes and possibilities before making a specific request; presumably the receiving country should make a *bona fide* effort to obtain the information for itself before resorting to the specific request procedure;

(*c*) The conditions affecting the nature and extent of the response by the transmitting country. This aspect should cover the ability of the transmitting country to provide documentary material when the receiving country needs material in that form for use in judicial or other proceedings, including the appropriate authentication of the documents.

Transmittal of information on discretionary initiative of transmitting country

The competent authorities should determine whether, in addition to the routine and specific request methods of exchange of information under which a transmitting country is automatically transmitting information or systematically responding to specific requests by the receiving country, they desire a transmittal of information on the discretionary initiative of the transmitting country itself. Such a transmittal could occur when, in the course of its own activities, the tax administration of the transmitting country obtains information that it considers would be of importance to the receiving country. The information may relate to facets of a particular taxpayer's situation and the relationship of that situation to his liability in the receiving country or to the liability of other taxpayers in the receiving country. Or the information may relate to a pattern of transactions or conduct by various taxpayers or groups of taxpayers occurring in either country that is likely to affect the tax liabilities or tax administration of the receiving country either in relation to its national laws or to the treaty provisions.

The competent authorities will have to determine, under the standards governing the exchange of information developed pursuant to the treaty, whether it is the duty of a transmitting country affirmatively to develop a procedure and guidelines governing when such information is to be transmitted, whether such transmittal is to be considered by the transmitting country but is fully discretionary, or whether such transmittal need not even be considered by the transmitting country. Even if it is agreed that it is the duty of the transmitting country to develop a system for such transmittal, presumably the decision on when the conditions under that system have been met will rest on the discretionary judgement of the latter country.

Use of information received

The competent authorities will have to decide on the permissible use of the information received. The decisions on this matter basically depend on the legal requirements set forth in article 26 itself. Under the guideline, the extent of the use of information depends primarily on the requirements of national law regarding the disclosure of tax information or on other "security requirements" regarding tax information. This being so, it is possible that the extent of the disclosure or the restrictions on disclosure may vary between the two countries. However, such possible variance need not be regarded as inappropriate or as negating exchanges of information that would otherwise occur if the countries involved are satisfied with such a consequence under article 26 as adopted in their convention.

Recipients of information received through exchange

The competent authorities will have to specify, either in detail or by reference to existing comparable rules in the receiving country, who the qualifying recipients of information in that country are. Under article 26 the information can be disclosed, for example:

(*a*) To administrators of the taxes covered in the convention;

(*b*) To enforcement officials and prosecutors for such taxes;

(*c*) To administrative tribunals for such taxes;

(*d*) To judicial tribunals for such taxes;

(*e*) In public court proceedings or in judicial decisions where it may become available to the public if considered appropriate;

(*f*) To the competent authority of another country (see the section below entitled "Consultation among several competent authorities").

The form in which information is provided

The permissible extent of the disclosure may affect the form in which the information is to be provided if it is to be useful to the receiving country. Thus, if the information may be used in judicial tribunals and if, to be so used, it must be of a particular character or form, then the competent authorities will have to consider how to provide for a transmittal that meets this need. (See also the comment on documents in the section above dealing with rules applicable to the specific request.)

Consultation among several competent authorities

Countries may wish to give consideration to procedures developed by the competent authorities for consultations covering more than the two competent authorities under a particular treaty. Thus, if countries A, B and C are joined in a network of treaties, the competent authorities of A, B and C might desire to hold a joint consultation. This could be desired whether all three countries are directly intertwined, for example, where there are A-B, A-C and B-C treaties, or where one country is a link in a chain but not fully joined, for example, where there are A-B and B-C treaties but not an A-C treaty. Countries desiring to have their competent authorities engage in such consultations should provide the legal basis for the consultations by adding the necessary authority in their treaties. Some countries may feel that article 26 permits joint consultation where all three countries are directly linked by bilateral treaties. However, the guideline does not cover joint consultation where a link in the chain is not fully joined, as in the second situation described above. In such a case, it would be necessary to add a treaty provision allowing the competent authority of country B to provide information received from country A to the competent authority of country C. Such a treaty provision could include a safeguard that the competent authority of country A must consent to the action of the competent authority of country B. Presumably, it would so consent only where it was satisfied as to the provisions regarding protection of secrecy in the B-C treaty.

Over-all factors

There are a variety of over-all factors affecting the exchanges of information that the competent authorities will have to consider and decide upon, either as to their specific operational handling in the implementation of the exchange of information or as to their effect on the entire exchange process itself. Among such over-all factors are:

Factors affecting implementation of exchange of information

(*a*) The competent authorities should decide on the channels of communication for the different types of exchanges of information.

One method of communication that may be provided for is to permit an official of one country to go in person to the other country to receive the information from the competent authority and discuss it so as to expedite the process of exchange of information.

(*b*) Some countries may have decided that it is useful and appropriate for a country to have representatives of its own tax administration stationed in the other treaty country. Such an arrangement would presumably rest on authority, treaty or agreements other than that in the article on exchange of information of the envisaged double taxation treaty (though, if national laws of both countries permit, this article would be treated as covering this topic) and the arrangement would determine the conditions governing the presence of such representatives and their duties. In this regard, it should be noted that it would not seem necessary that the process be reciprocal, so that it would be appropriate for country A to have its representatives in country B but not vice versa if country A considered the process to be useful and country B did not. If arrangements do exist for such representatives, then the competent authorities may want to co-ordinate with those representatives where such co-ordination would make the exchange of information process more effective and where such co-ordination is otherwise appropriate.

(*c*) Some countries may decide it is appropriate to have a tax official of one country participate directly with tax officials of the other country in a joint or "team" investigation of a particular taxpayer or activity. The existence of the arrangement for most countries would presumably rest on authority, treaty or agreements other than that in the envisaged treaty article on exchange of information, although, if national laws of both countries permit, this article could be treated by the countries as authorizing the competent authorities to sanction this arrangement. In either event, if the arrangement is made, it would be appropriate to extend to such an investigation the safeguards and procedures developed under the envisaged treaty article on exchange of information.

(*d*) The process of exchange of information should be developed so that it has the needed relevance to the effective implementation of the substantive treaty provisions. Thus, treaty provisions regarding intercompany pricing and the allocation of income and expenses produce their own informational requirements for effective implementation. The exchange of information process should be responsive to those requirements.

(*e*) The substantive provisions of the treaty should take account of and be responsive to the exchange of information process. Thus, if there is an adequate informational base for the exchange of information process to support allowing one country to deduct expenses incurred in another country, then the treaty should be developed on the basis of the substantive appropriateness of such deduction.

(*f*) The competent authorities will have to determine to what extent there should be cost-sharing or cost-reimbursement with respect to the process of exchange of information.

Factors affecting structure of exchange of information process

(*a*) It should be recognized that the arrangements regarding exchange of information worked out by country A with country B need not parallel those worked out between country A and country C or between country B and country C. The arrangements should in the first instance be responsive to the needs of the two countries directly involved and need not be fully parallel in every case just for the sake of formal uniformity. However, it should be observed that prevention of international tax evasion and avoidance will often require international co-operation of tax authorities in a number of countries. As a consequence, some countries may consider it appropriate to devise procedures and treaty provisions that are sufficiently flexible to enable them to extend their co-operation to multicountry consultation and exchange arrangements.

(*b*) The competent authorities will have to weigh the effect of a domestic legal restriction on obtaining information in a country that requests information from another country not under a similar domestic legal restriction. Thus, suppose country A requests information from country B and the tax authorities in country B are able to go to their financial institutions to obtain such information, whereas the tax authorities in country A are generally not able to go to their own financial institutions to obtain information for tax purposes. How should the matter be regarded in country B? It should be noted that article 26 here permits country B to obtain the information from its financial institutions and transmit it to country A. Thus, Country B is not barred by its domestic laws regarding tax secrecy if it decides to obtain and transmit the information. It thus becomes a matter of discretion in country B as to whether it should respond, and may perhaps become a matter for negotiation between the competent authorities. It should be noted that many countries in practice do respond in this situation and that such a course is indeed useful in achieving effective exchange of information to prevent tax avoidance. However, it should also be noted that country A, being anxious to obtain information in such cases from other countries, should also recognize its responsibility to try to change its domestic laws to strengthen the domestic authority of its own tax administration and to enable it to respond to requests from other countries.

(*c*) In addition to situations involving the legal imbalance discussed above, the competent authorities will have to weigh the effects of a possible imbalance growing out of a divergence in other aspects of tax administration. Thus, if country A cannot respond as fully to a request as country B can because of practical problems of tax administration in country A, then might the level of the process of exchange of information be geared to the position of country A? Or, on the other hand, in general or in particular aspects, should country B be willing to respond to requests of country A even when country A would not be able to respond to requests of country B? This matter is similar to that discussed in the preceding paragraph and a similar response should be noted.

(*d*) It should be noted that article 26 authorizes a transmitting country to use its administrative procedures solely to provide information to the requesting country, even when the person about whom information is sought is not involved in a tax proceeding in the transmitting country. Moreover, the transmitting country can, for the purpose of exchange of information, use its own administrative authority in the same way as if its own taxation were involved.

(*e*) The competent authorities will have to weigh the effect on the process of exchange of information of one country's belief that the tax system or tax administration of the other country, either in general or in particular situations is discriminatory or confiscatory. It may be that further exploration of such a belief could lead to substantive provisions in the treaty or in national law that would eliminate the problems perceived by the first country and thereby facilitate a process of exchange of information. One possible example of this is the treatment of non-permanent residents.

(*f*) The competent authorities will have to weigh the effects that the process of exchange of information may have on the competitive position of taxpayers of the countries involved. Thus, if country A has a treaty with country B providing for exchange of information, country A will have to weigh the effect on the structure or process of that exchange of the fact that country C does not have a treaty with country B, so that firms of country C doing business in country B may be subject to a different tax posture in country B than firms of country A. Similarly, even if a treaty with an exchange of information article exists between countries C and B, if the tax administration of country A has more authority to obtain information (to be exchanged with country B) than does the tax administration of country C, or is otherwise more effective in its administration and therefore has more information, then a similar difference in tax posture may result. As a corollary, it seems clear that the adequate implementation of exchange of information provisions requires a universal effort of tax administrations to obtain and develop under national laws a capacity for securing information and a competence in utilizing information that is appropriate to a high level of efficient and equitable tax administration.

Periodic consultation and review

Since differences in interpretation and application, specific difficulties and unforeseen problems and situations are bound to arise, provision must be made for efficient and expeditious consultation between the competent authorities. Such consultation should extend both to particular situations and problems and to periodic review of the operations under the exchange of information provision. The periodic review should ensure that the process of exchange of information is working with the requisite promptness and efficiency, that it is meeting the basic requirements of treaty implementation and that it is promoting adequate compliance with treaty provisions and the national laws of the two countries.

B. COMMENTARY ON THE PARAGRAPHS OF ARTICLE 26

Paragraph 1

As noted above, this paragraph, while incorporating all the provisions of article 26, paragraph 1, of the OECD Model Convention also contains three additions. The commentary on that paragraph is therefore relevant:

"The main rule concerning the exchange of information is contained in the first sentence of the paragraph. The competent authorities of the Contracting States shall exchange such information as is necessary to secure the correct application of the provisions of the Convention or of the domestic laws of the Contracting States concerning taxes covered by the Convention even if, in the latter case, a particular article of the Convention need not be applied. In order to keep the exchange of information within the framework of the Convention, a limitation to the exchange of information is set so that information should be given only insofar as the national tax in question is covered by the Convention and the taxation under the domestic taxation laws concerned is not contrary to the Convention. An illustration may be cited in this connexion: a request for the imposition of a sales tax need not be complied with by the requested State as it is not covered by the Convention.

"The following examples may clarify the principle dealt with in paragraph 5 above. In all such cases information can be exchanged under paragraph 1.

"Application of the Convention

"(*a*) When applying Article 12, State A where the beneficiary is resident asks State B where the payer is resident for information concerning the amount of royalty transmitted.

"(*b*) Conversely, in order to grant the exemption provided for in Article 12, State B asks State A whether the recipient of the amounts paid is in fact a resident of the last-mentioned State and the beneficial owner of the royalties.

"(*c*) Similarly, information may be needed with a view to the proper allocation of taxable profits between associated companies in different States or the adjustment of the profits shown in the accounts of a permanent establishment in one State and in the accounts of the head office in the other State (Articles 9, 7, 23 A and 23 B).

"Implementation of the domestic laws

"(*a*) A company in State A supplies goods to an independent company in State B. State A wishes to know from State B what price the company in State B paid for the goods with a view to a correct application of the provisions of its domestic laws.

"(*b*) A company in State A sells goods through a company in State C (possibly a low-tax country) to a company in State B. The companies may or may not be associated. There is no convention between State A and State C, nor between State B and State C. Under the convention between A and B, State A, with a view to ensuring the correct application of the provisions of its domestic laws to the profits made by the company situated in its territory, asks State B what price the company in State B paid for the goods.

"(*c*) State A, for the purpose of taxing a company situated in its territory, asks State B, under the convention between A and B, for information about the prices charged by a company in State B, or a group of companies in State B with which the company in State A has no business contacts in order to enable it to check the prices charged by the company in State A by direct comparison (e.g. prices charged by a company or a group of companies in a dominant position). It should be borne in mind that the exchange of information in this case might be a difficult and delicate matter owing in particular to the provisions of subparagraph (*c*) of paragraph 2 relating to business and other secrets.

"The rule laid down in paragraph 1 allows information to be exchanged in three different ways:

"(*a*) on request, with a special case in mind, it being understood that the regular sources of information available under the internal taxation procedure should be relied upon in the first place before request for information is made to the other State;

"(*b*) automatically, for example when information about one or various categories of income having their source in one Contracting State and received in the other Contracting State is transmitted systematically to the other State;

"(*c*) spontaneously, for example in the case of a State having acquired, through certain investigations, information which it supposes to be of interest to the other State.

"The manner in which the exchange of information agreed to in the Convention will finally be effected can be decided upon by the competent authorities of the Contracting States.

"Reciprocal assistance between tax administrations is feasible only if each administration is assured that the other administration will treat with proper confidence the information which it will receive in the course of their co-operation. At the same time maintenance of such secrecy in the receiving Contracting State is a matter of domestic laws. It is therefore provided in paragraph 1 that information communicated under the provisions of the Convention shall be treated as secret in the receiving State in the same manner as information obtained under the domestic laws of that State. Sanctions for the violation of such secrecy in that State will be governed by the administrative and penal laws of that State.

"The information obtained may be disclosed only to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the Convention. This means that the information may also be communicated to the taxpayer, his proxy or to the witnesses. The information received by a Contracting State may be used by such persons or authorities only for the purposes mentioned in paragraph 1. If the information appears to be of value to the receiving State for other purposes than those referred to, that State may not use the information for such other purposes but it must resort to means specially designed for those purposes (e.g. in case of a non-fiscal crime, to a treaty concerning judicial assistance).

"As stated above, the information obtained can be communicated to the persons and authorities mentioned but it does not follow from this that it can be disclosed by them in court sessions held in public or in decisions which reveal the name of the taxpayer. The last sentence of the paragraph, however, opens up this possibility. Once information is used in public court proceedings or in court decisions and thus rendered public, it is clear that from that moment such information can be quoted from the court files or decisions for other purposes even as possible evidence. But this does not mean that the persons and authorities mentioned in paragraph 1 are allowed to provide on request additional information received. If either or both of the Contracting States object to the information being made public by courts in this way, or, once the information has been made public in this way, to the information being used for other purposes, because this is not the normal procedure under their domestic laws, they should state this expressly in their convention."

With regard to the additions to article 26, paragraph 1, of the OECD Model Convention, the Group of Experts observed that the reference to fraud or evasion in paragraph 1 was intended to focus attention on the importance of exchanges of information that would assist the treaty partners in combating such practices. Since a number of countries were concerned with the need for information to assist in the administration of specific statutory provisions against tax avoidance and others were concerned with the need for information to assist in detecting other aspects of tax avoidance, the Group considered it advisable to include the reference in the last sentence of paragraph 1 to exchanges of information regarding tax avoidance where the treaty partners deemed it appropriate. The reference in the same sentence to the consultations aimed at developing appropriate conditions, methods and techniques was designed to enable the treaty partners to work out the modalities for exchanges of information between them.

In the course of the discussion members from developing countries observed that the proliferation of transnational corporations and the ever-growing sophistication and complexity of the forms taken by international business transactions was resulting in increasing tax avoidance and evasion. The view was expressed that such a situation might have reached a point where it could negate completely the effects of treaties for the avoidance of double taxation and raised the question whether steps should be taken outside and in addition to the existing framework of such treaties. One member from a developing country, supported by other members from developing countries, suggested that the quickest and most effective way of ensuring the exchange of information required to combat tax evasion efficiently would be through the conclusion of a multilateral agreement dealing specifically with the exchange of information and mutual assistance in tax administration.

While discussing the problems of tax havens, the Group felt that as a protection against improper manipulation of treaty benefits, consideration should be given in bilateral negotiations to the inclusion of a separate article along the following lines:

> "Each of the Contracting States should endeavour to collect on behalf of the other Contracting State such taxes imposed by that other Contracting State to the extent necessary to ensure that any exemption or reduced rate of tax granted under the treaty by that other Contracting State should not be enjoyed by persons not entitled to such benefits."

Paragraph 2

Since this paragraph reproduces article 26, paragraph 2, of the OECD Model Convention, the commentary on that paragraph is fully relevant:

"This paragraph contains certain limitations to the main rule in favour of the requested State. In the first place, the paragraph contains the clarification that a Contracting State is not bound to go beyond its own internal laws and administrative practice in putting information at the disposal of the other Contracting State. However, types of administrative measures authorised for the purpose of the requested State's tax must be utilised, even though invoked solely to provide information to the other Contracting State. Likewise, internal provisions concerning tax secrecy should not be interpreted as constituting an obstacle to the exchange of information under the present article. As mentioned above, the authorities of the requesting State are obliged to observe secrecy with regard to information received under this article.

"Furthermore, the requested State does not need to go so far as to carry out administrative measures that are not permitted under the laws or practice of the requesting State or to supply items of information that are not obtainable under the laws or in the normal course of administration of the requesting State. It follows that a Contracting State cannot take advantage of the information system of the other Contracting State if it is wider than its own system.

"Information is deemed to be obtainable in the normal course of administration if it is in the possession of the tax authorities or can be obtained by them in the normal procedure of tax determination, which may include special investigations or special examination of the business accounts kept by the taxpayer or other persons, provided that the tax authorities would make similar investigations or examination for their own purposes. This means that the requested State has to collect the information the other State needs in the same way as if its own taxation was involved, under the proviso mentioned in the above paragraph.

"The requested State is at liberty to refuse to give information in the cases referred to in the paragraphs above. However if it does give the requested information, it remains within the framework of the agreement on the exchange of information which is laid down in the Convention; consequently it cannot be objected that this State has failed to observe the obligation to secrecy.

"If the structure of the information systems of two Contracting States is very different, the conditions under subparagraphs (*a*) and (*b*) of paragraph 2 will lead to the result that the Contracting States exchange very little information or perhaps none at all. In such a case, the Contracting States may find it appropriate to broaden the scope of the exchange of information.

"In addition to the limitations referred to above, subparagraph (*c*) of paragraph 2 contains a reservation concerning the disclosure of certain secret information. Secrets mentioned in this subparagraph should not be taken in too wide a sense. Before invoking this provision, a Contracting State should carefully weigh if the interests of the taxpayer really justify its application. Otherwise it is clear that too wide an interpretation would in many cases render ineffective the exchange of information provided for in the Convention. The observations made . . . above apply here as well. The requested State in protecting the interests of its taxpayers is given a certain discretion to refuse the requested information, but if it does supply the information deliberately the taxpayer cannot allege an infraction of the rules of secrecy. It is open to the Contracting States to add further dispensations from the obligation to supply information to the items listed in subparagraph (*c*), for example, information protected by provisions on banker's discretion. It has been felt necessary also to prescribe a limitation with regard to information which concerns the vital interests of the State itself. To this end, it is stipulated that Contracting States do not have to supply information the disclosure of which would be contrary to public policy (ordre public)."

C. OBSERVATIONS ON THE OECD COMMENTARY AND RESERVATIONS ON ARTICLE 26 OF THE OECD MODEL CONVENTION

Observations on the commentary

"*Japan* wishes to indicate that with respect to paragraph 11 above, it would be difficult for Japan, in view of its strict domestic laws and administrative practice as to the procedure to make public the information obtained under the domestic laws, to provide information requested unless a requesting State has comparable domestic laws and administrative practice as to this procedure.

"With respect to paragraphs 14 to 16 above, *Japan* can only supply information obtained through special investigation or special examination as long as such investigation or examination is concerned with taxation in Japan."

Reservations on the article

"*Portugal* reserves the right to apply Article 26 of the 1963 version of the Draft Convention.

"Under the Swiss concept a double taxation convention aims at avoiding international double taxation; the information necessary for the correct application and for the prevention of an abuse of such a convention can be exchanged already within the existing framework of its provisions on the mutual agreement procedure, the reduction of taxes withheld at the source, etc. *Switzerland* considers a particular provision on the exchange of information as unnecessary since even such an express clause could not, according to the purpose of the convention, provide for more than for an exchange of information necessary for the correct application and prevention of an abuse of the convention. Accordingly Switzerland has an express reservation on the Article on the exchange of information.

"The *United States* believes that this Article should apply to all taxes imposed by a Contracting State, not just taxes covered by the Convention."

Article 27

DIPLOMATIC AGENTS AND CONSULAR OFFICERS

A. COMMENTARY ON THE ARTICLE

Article 27 of the United Nations Model Convention reproduces article 27 of the OECD Model Convention. The commentary of that article is therefore relevant:

"The aim of the provision is to secure that diplomatic agents or consular officers shall, under the provisions of a double taxation convention, receive no less favourable treatment than that to which they are entitled under international law or under special international agreements.

"The simultaneous application of the provisions of a double taxation convention and of diplomatic and consular privileges conferred by virtue of the general rules of international law, or under a special international agreement may under certain circumstances, have the result of discharging, in both Contracting States, tax that would otherwise have been due. As an illustration, it may be mentioned that e.g. a diplomatic agent who is accredited by State A to State B and derives royalties, or dividends from sources in State A will not, owing to international law, be subject to tax in State B in respect of this income and may also, depending upon the provisions of the bilateral convention between the two States, be entitled as a resident of State B to an exemption from, or a reduction of, the tax imposed on the income in State A. In order to avoid tax reliefs that are not intended, the Contracting States are free to adopt bilaterally an additional provision which may be drafted on the following lines:

" 'In so far as, due to fiscal privileges granted to diplomatic agents or consular officers under the general rules of international law or under the provisions of special international agreements, income or capital are not subject to tax in the receiving State, the right to tax shall be reserved to the selling State.'

"In many OECD Member countries, the domestic laws contain provisions to the effect that diplomatic agents and consular officers while abroad shall for tax purposes be deemed to be residents of the sending State. In the bilateral relations between Member countries in which provisions of this kind are operative internally, a further step may be taken by including in the convention specific rules that establish, for purposes of the convention, the sending State as the State of residence of the members of the diplomatic missions and consular posts of the Contracting States. The special provision suggested here could be drafted as follows:

" 'Notwithstanding the provisions of article 4 an individual who is a member of a diplomatic mission, consular post or permanent mission of a Contracting State which is situated in the other Contracting State or in a third State shall be deemed for the purposes of the Convention to be a resident of the sending State if:

" '(*a*) in accordance with international law he is not liable to tax in the receiving State in respect of income from sources outside that State or on capital situated outside that State, and

" '(*b*) he is liable in the sending State to the same obligations in relation to tax on his total income or on capital as are residents of that State.'

"By virtue of paragraph 1 of Article 4[4] the diplomatic agents and consular officers of a third State accredited to a Contracting State, are not deemed to be residents of the receiving State if they are only subject to a limited taxation in that State (cf. paragraph 8 of the Commentary on Article 4). This consideration also holds true of the international organisations established in a Contracting State and their officials as they usually benefit from certain fiscal privileges either under the convention or treaty establishing the organisation or under a treaty between the organisation and the State in which it is established. Contracting States wishing to settle expressly this question, or to prevent undesirable tax reliefs, may add the following provision to this Article:

" 'The Convention shall not apply to international organisations, to organs or officials thereof and to persons who are members of a diplomatic mission, consular post or permanent mission of a third State, being present in a Contracting State and

[4] This paragraph will not apply to those bilateral negotiations which omit the second sentence of article 4.

not treated in either Contracting State as residents in respect of taxes on income or on capital.'

"This means that international organisations, organs or officials who are liable in a Contracting State in respect only of income from sources therein should not have the benefit of the Convention.

"Although honorary consular officers cannot derive from the provisions of the Article any privileges to which they are not entitled under the general rules of international law (there commonly exists only tax exemption for payments received as consideration for expenses honorary consuls have on behalf of the sending State), the Contracting States are free to exclude, by bilateral agreement, expressly honorary consular officers from the application of the Article."

B. OBSERVATIONS ON THE OECD COMMENTARY

"*Belgium, France*, the *Netherlands* and *Switzerland* are of the opinion that persons, who are not liable to comprehensive taxation (full liability to tax) or who do not bear on the taxable part of their income a tax which corresponds in percentage terms to the tax to which they would have been liable on their total income if it had not been partly exempt, should not be deemed to be residents."

Commentaries on chapter VII

FINAL PROVISIONS

Articles 28 and 29

ENTRY INTO FORCE AND TERMINATION

Articles 28 and 29 of the United Nations Model Convention reproduce articles 29 and 30 of the OECD Model Convention. The commentary on the latter articles, is therefore relevant:

> "The present provisions on the procedure for entry into force, ratification and termination are drafted for bilateral conventions and correspond to the rules usually contained in international treaties.
>
> "Some Contracting States may need an additional provision in the first paragraph of Article 29 indicating the authorities which have to give their consent to the ratification. Other Contracting States may agree that the article should indicate that the entry into force takes place after an exchange of notes confirming that each State has completed the procedures required for such entry into force.
>
> "It is open to Contracting States to agree that the Convention shall enter into force when a specified period has elapsed after the exchange of the instruments of ratification or after the confirmation that each State has completed the procedures required for such entry into force.
>
> "No provisions have been drafted as to the date on which the Convention shall have effect or cease to have effect, since such provisions would largely depend on the domestic laws of the Contracting States concerned. Some of the States assess tax on the income received during the current year, others on the income received during the previous year, others again have a fiscal year which differs from the calendar year. Furthermore, some conventions provide, as regards taxes levied by deduction at the source, a date for the application or termination which differs from the date applying to taxes levied by assessment.
>
> "As it is of advantage that the Convention should remain in force at least for a certain period, the article on termination provides that notice of termination can only be given after a certain year—to be fixed by bilateral agreement. It is open to the Contracting States to decide upon the earliest year during which such notice can be given or even to agree not to fix any such year, if they so desire."

كيفية الحصول على منشورات الامم المتحدة

يمكن الحصول على منشورات الامم المتحدة من المكتبات ودور التوزيع في جميع انحاء العالم . استعلم عنها من المكتبة التي تتعامل معها أو اكتب الى : الامم المتحدة ، قسم البيع في نيويورك او في جنيف .

如何购取联合国出版物

联合国出版物在全世界各地的书店和经售处均有发售。请向书店询问或写信到纽约或日内瓦的联合国销售组。

HOW TO OBTAIN UNITED NATIONS PUBLICATIONS

United Nations publications may be obtained from bookstores and distributors throughout the world. Consult your bookstore or write to: United Nations, Sales Section, New York or Geneva.

COMMENT SE PROCURER LES PUBLICATIONS DES NATIONS UNIES

Les publications des Nations Unies sont en vente dans les librairies et les agences dépositaires du monde entier. Informez-vous auprès de votre libraire ou adressez-vous à : Nations Unies, Section des ventes, New York ou Genève.

КАК ПОЛУЧИТЬ ИЗДАНИЯ ОРГАНИЗАЦИИ ОБЪЕДИНЕННЫХ НАЦИЙ

Издания Организации Объединенных Наций можно купить в книжных магазинах и агентствах во всех районах мира. Наводите справки об изданиях в вашем книжном магазине или пишите по адресу: Организация Объединенных Наций, Секция по продаже изданий, Нью-Йорк или Женева.

COMO CONSEGUIR PUBLICACIONES DE LAS NACIONES UNIDAS

Las publicaciones de las Naciones Unidas están en venta en librerías y casas distribuidoras en todas partes del mundo. Consulte a su librero o diríjase a: Naciones Unidas, Sección de Ventas, Nueva York o Ginebra.

Printed in U.S.A. Price: $U.S. 14.00 United Nations publication

40316–May 1980–2,900 Sales No. E.80.XVI.3

ST/ESA/102