ST/ESA/250

Department for Development Support and Management Services

International Cooperation in Tax Matters

Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its seventh meeting

United Nations New York, 1997

NOTE

Symbols of United Nations documents are composed of capital letters combined with figures.

The term "country" as used in the text of this report also refers, as appropriate, to territories or areas.

The views expressed in signed papers are those of the individual authors and do not necessarily reflect those of the organization with which they are associated or those of the United Nations.

Papers have been edited and consolidated in accordance with United Nations practice and requirements.

ST/ESA/250

UNITED NATIONS PUBLICATION
Sales No. E.96.XVI.2

ISBN 92-1-159091-4

CONTENTS

CONTENTS (continued)

Part one

REPORT OF THE AD HOC GROUP OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS ON THE WORK OF ITS SEVENTH MEETING

INTRODUCTION

A. Terms of reference

1. The Economic and Social Council, in its resolutions 1980/13 of 28 April 1980 and 1982/45 of 27 July 1982, stated the terms of reference of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, as follows:

(a) Formulation of guidelines for international cooperation to combat international tax evasion and avoidance;

(b) Continuing the examination of the United Nations Model Double Taxation Convention between Developed and Developing Countries and consideration of the experience of countries in bilateral applications of the Model Convention;

(c) Study of possibilities of enhancing the efficiency of tax administrations and formulation of appropriate policy and methodology suggestions;

(d) Study of possibilities of reducing potential conflicts among the tax laws of various countries and formulation of appropriate policy and methodology suggestions.

B. Opening of the meeting

2. The 7th meeting of the Ad Hoc Group of Experts, which was held from 11 to 15 December 1995 at the Palais des Nations, Geneva, was opened on 11 December 1995 by Abdel Hamid Bouab, Officer-in-Charge, Public Finance and Enterprise Management Branch, Division of Public Administration and Development Management, Department for Development Support and Management Services, of the United Nations Secretariat. He noted that the agenda was in part the outcome of the recommendations made by the Group at its 6th meeting and of the deliberations and suggestions of the Steering Committee, the successor to the preparatory subgroup. The Steering Committee met at United Nations Headquarters from 5 to 7 June 1995 to review in advance the drafts of the working and conference papers to be discussed by the Group. Mr. Bouab stressed four areas of special attention. The first concerned the tax treatment of teachers and students. He noted that the Steering Committee had agreed by consensus to recommend that the Ad Hoc Group should consider the possible deletion of article 14, paragraph 1 (c), and of article 20, paragraph 2, of the United Nations Model Double Taxation Convention between Developed and Developing Countries (hereinafter referred to as the Model Convention).

3. The second area concerned the tax treatment of transfer pricing, in particular as it related to the pricing of primary products between related entities, cost-sharing arrangements and the provision of services. He emphasized that transfer pricing was a complex issue, that the views of all countries - developing countries, countries with economies in transition, and economically advanced countries - be taken into account in any consensus on any aspect of that issue.

4. The third area concerned the tax treatment of financial instruments and derivatives. That involved the question of whether the income from a considerable range of financial instruments, many of them "hybrids" having the characteristic of more than one type of instrument, should be treated for tax

purposes as interest, capital gains, business profits or income from other sources. The representative of the Secretary-General stated that the tax treatment of financial instruments and derivatives was an issue that called for increased cooperation between OECD and the United Nations, with a view to working out a common approach.

5. The fourth area concerned the updating of the Model Convention and Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries. The rationale for such a task was the need to update the Model Convention and the Manual in light of the changes made in the OECD Model Convention, developments in the world economy and the emergence of international trade as a primary factor in global development.

6. Mr. Bouab mentioned further that the Ad Hoc Group might wish to consider the possibility of expanding the Group's role to include the provision of technical assistance and support in the areas of tax administration, international taxation, transfer pricing, and negotiation of tax treaties, as recommended by the Steering Committee. Such assistance would help requesting countries to minimize national and international tax evasion and avoidance and would facilitate the resolution of treaty disputes and the negotiation of tax treaties, thus contributing to improving international income allocation and expanded international development.

C. Attendance

7. The following members of the Group attended the 7th meeting: Atef Alawneh (Palestine Authority), Nabawia Sobhi Khaled Allam (Egypt), J. A. Arogundale (Nigeria), Ernst Bunders (Netherlands), Mordecai Feinberg (United States of America), Antonio H. Figueroa (Argentina), Mayer Gabay (Israel), Sergey M. Ignatiev (Russian Federation), Helmut Krabbe (Germany), Daniel Luthi (Switzerland), Reksoprajitno Mansury (Indonesia), John E. A. Mills (Ghana), G. K. Mishra (India), Maria das Graças Oliveira (Brazil), Alvi Abdul Rahim (Pakistan), Juan Lopez Rodriquez (Spain), Alain Ruellan (France), J. Brian Shepherd (United Kingdom of Great Britain and Northern Ireland), Katsumi Shinagawa (Japan), Hillel Skurnik (Finland), Li Yongqui (China). For details, see annex I.A below.

8. The meeting was attended by observers for the following States Members of the United Nations: Australia, Belgium, Brazil, China, Denmark, Israel, Japan, Jordan, Malawi, Malaysia, Malta, Sri Lanka, Turkey, Uganda and Zimbabwe. For details, see annex I.B below.

9. The observers for Palestine also attended the meeting.

10. The meeting was attended by observers for the following international bodies and other institutions: Association de planification fiscale et financiére, Commonwealth of Tax Administrators, International Association of University Presidents, International Bureau of Fiscal Documentation, International Chamber of Commerce, International Fiscal Association, Organization for Economic Cooperation and Development, Universidad Santa María, and Universitat de València. For details, see annex I.C below.

11. The Secretariat gratefully acknowledges the contributions by consultants Peter D. Byrne, Lawrence Lokken and Harold Ullman in preparing documents for submission to the Ad Hoc Group of Experts. For details, see annex I.D. below.

D. Election of officers

12. The Ad Hoc Group of Experts elected Reksoprajitno Mansury (Indonesia) as Chairman and Hillel Skurnik (Finland) as Rapporteur. Mr. Abdel Hamid Bouab served as Secretary and was assisted by Lawrence Lokken (Special Adviser), Peter E. Heijkoop (Assistant Secretary), Peter D. Byrne (Consultant), and Harold Ullman (Assistant to the Secretariat).

E. Adoption of the agenda

13. The Ad Hoc Group of Experts adopted the following substantive agenda for the 7th meeting:

1. Taxation of special categories: teachers and students;

2. Transfer pricing, in particular as it related to pricing of primary products between related entities, cost-sharing arrangements and the provision of services;

3. Tax treatment of new financial instruments (hybrid instruments);

4. Discussion of the draft revision of the United Nations Model Double Taxation Convention between Developed and Developing Countries and of the Manual for the Negotiation of Bilateral Treaties between Developed and Developing Countries;

5. Other topics;

6. Arrangements for the 8th meeting.

F. Documentation

14. To facilitate its work, the group had before it the following documents:

(a) Annotated provisional agenda (ST/SG/AC.8/1995/L.1);

(b) Tax treatment of students and teachers (ST/SG/AC.8/1995/L.2);

(c) Transfer pricing: pricing of primary products between related entities, cost sharing and provision of services (ST/SG/AC.8/1995/L.3);

(d) The globalization of capital markets (ST/SG/AC.8/1995/L.4);

(e) Derivative markets: economic implication for taxation (ST/SG/AC.8/1995/L.5);

(f) Taxation of derivatives and new financial instruments (ST/SG/AC.8/1995/L.6);

(g) Report of the Steering Committee of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (New York, 5-7 June 1995) (ST/SG/AC.8/1995/L.7);

(h) Transfer pricing and taxation of international income in developing countries (ST/SG/AC.8/1995/L.8);

(i) Trends in recently negotiated tax treaties between developed and developing countries (ST/SG/AC.8/1995/L.9).

15. For a list of working papers and conference room papers, see annex II below.

I. TAXATION OF SPECIAL CATEGORIES: STUDENTS AND TEACHERS

16. The Group considered agenda item 1 on the taxation of special categories (students and teachers), which consists of three issues: whether article 14, paragraph 1 (c), should be deleted from the Model Convention, whether article 20, paragraph 2, should be deleted, and whether the United Nations Model Double Taxation Convention between Developed and Developing Countries should contain a separate article on the taxation of visiting teachers and researchers.

A. Article 14 (1) (c)

17. The question of whether to delete or retain article 14, paragraph 1 (c), was discussed at length. The provision allowed remuneration from independent personal services to be taxed in the source country if it exceeded a fixed amount established in bilateral negotiations, even if the taxpayer had no fixed base in that country and regardless of the length of the taxpayer's presence in that country. Many participants argued for deletion, whereas several participants favoured retention.

18. One participant argued that because the provision had been part of the Model Convention for 15 years, deletion of the provision would inappropriately send a signal that the provision should not be included in treaties. Another participant countered that the provision was not a good one and that a negative signal was appropriate.

19. Another participant argued that the provision was important for countries, especially developing countries, that tax primarily or exclusively on the basis of source. Another participant replied that the interests of developing countries were adequately protected by subparagraphs (a) and (b) of Article 14 (1), which allowed taxation in the source country if the taxpayer had a fixed base in that source country or was present in that country for at least 183 days.

20. Many participants noted that a problem with the provision was that the monetary threshold tended to become smaller and smaller over time as a result of inflation. Those arguing for retention suggested that the problem could be addressed by providing for periodic adjustments to the monetary amount. Alternatively, an automatic adjustment mechanism might be developed. Moreover, it was argued, problems with thresholds existed under many provisions, and those problems were not adequate reasons for eliminating the entirety of provisions containing the thresholds.

21. Proponents of deleting the provision noted that, even though it had been part of the Model Convention for 15 years, the provision had found its way into only a tiny minority of treaties concluded between developed and developing countries during that time. The Model Convention, it was argued, should include only provisions on which broad agreement existed, not provisions that might be applicable only to the special situations of a few countries.

22. It was noted that the provision could have the effect of subjecting a non-resident to source-country taxation for services performed on a single day (e.g., in the case of a surgeon imported to perform a single operation). Moreover, the service might be the product of extensive preparation in the service performer's residence country, in addition to the actual rendition in

the source country, in which case it would be inappropriate to allow the source country to tax all of the income.

23. Several participants objected to the consideration of the issue in the context of teachers and students. Because the provision applied to all personal services, they argued that it should be discussed only as part of a general discussion of article 14.

24. After discussion, it was concluded that a majority of the Group, but not a consensus, favoured deletion of article 14, paragraph 1 (c).

B. Article 20 (2)

25. At its June 1995 meeting, the Steering Committee recommended that the Group consider deleting from the Model Convention article 20, paragraph 2, which provided that if a visiting student had income not exempted by paragraph 1 from taxation in the visited country, the student should, in the taxation of the non-exempted income, be entitled to the same exemptions, reliefs, and reductions as were allowed to residents of that country.

26. A participant argued that the provision should be retained because it allowed visiting students to be taxed in the same way as resident students. Another participant responded that such parity was sometimes elusive because a resident student was taxable on all income, whereas a visiting student was taxable only on income from sources in the visited country.

27. A proponent of deleting the provision noted that article 24, paragraph 4 (second sentence), stated that a country is not required to allow to non-residents any personal allowances or other reliefs "on account of civil status or family responsibilities" which might be allowed to residents; article 20, paragraph 2, it was argued, contradicted that provision of article 24.

28. A participant noted that, as an alternative to article 14, paragraph 1 (c), a treaty might provide for exemption in the host State, for the normal duration of the studies, of remuneration not exceeding a certain annual amount, but only to the extent that the remuneration was not also exempted in the other State.

29. After discussion, it was concluded that a majority of the Group, but not a consensus, favoured deletion of article 20, paragraph 2.

C. Article for teachers

30. Several participants argued for the addition to the Model Convention of an article dealing with visiting teachers. Currently, under the Model Convention, visiting teachers were subject to article 14 if the teaching services were performed in an independent capacity; article 15, if the services were dependent; or article 19, if the remuneration was paid by a contracting State. Many treaties have an additional article or paragraph dealing specifically with teachers and, sometimes, researchers, which typically exempted them from taxation in the source country if their stay did not exceed a prescribed length. A participant pointed out that the issue to be addressed by such a provision was limited to the situation in which the visiting teacher was receiving remuneration from a non-governmental agency in the host country. Several participants stated that the issue was of concern to many developing countries.

31. It was noted that articles 14 and 15 commonly did not exempt a visiting teacher's compensation from taxation at source because they generally allowed source taxation of service performers who were present in the host country for more than 183 days, and many teaching assignments exceeded that period of time.

32. A participant contended that in the case of a teacher from a developed country visiting a developing country, the remuneration could be subject to very high rates of tax in the developing country, because the amount would be large in relation to prevailing incomes in the developing country and therefore would be taxed at the top marginal rates.

33. Other participants posed several objections to the addition of an article for teachers or researchers. Some argued that the Model Convention should include only provisions on which broad consensus existed and that the wide range of controversy on the issue at the meeting showed that no such consensus existed on the issue.

34. A participant argued that the addition of a new article might open a Pandora's box, raising the possibility that claims might be made for treaty exemptions for numerous other meritorious groups. Income tax treaties were intended to promote interchange of all sorts, and notwithstanding the importance of cultural services, there was no reason for singling them out for special treatment.

35. Those opposed to the inclusion of a teachers' article generally agreed that the otherwise applicable articles of the treaty provided adequate protection against double taxation. If the host country wanted to provide an incentive to visiting teachers, it could do so unilaterally.

36. Substantially all participants agreed that an article on teachers, if included in the Model Convention, should not have the effect of exempting a teacher from tax both in the home country and in the country visited.

37. A participant suggested a compromise on the issue: that the Model Convention should not be amended to include a provision on visiting teachers but that an addition should be made to the commentary, noting that many treaties contained such articles and providing advice for bilateral negotiations on the subject. Many participants concurred with that suggestion and offered various items of advice for treaty negotiators. The advice might include a warning that a teachers' article should not have the effect of allowing exemption in both the residence country and the host country. Double exemption could be avoided by limiting any exemption at source to income that was taxed in the visiting teacher's country of residence or by restricting it to income that originated outside the source country. The advice might further note the need for a strict time limit on the exemption (e.g., two years), although participants differed over whether a visiting teacher who stayed longer than that period should lose the exemption retroactively from the outset or only prospectively from the end of the exemption period. The advice might also caution that a teachers' article should not allow a teacher to obtain repeated exemptions by making successive visits to the same country. Moreover, the advice might note that the issue might in some instances be covered more appropriately by special agreements defining the right of the host country to tax the teacher's income, rather than being included in a general tax convention. However, it was important for any such special agreement to agree with provisions of the general tax convention or for rules to be provided for resolving any conflicts that might arise.

38. Accordingly, the Group appointed a drafting committee to formulate language for inclusion in the commentary on the Model Convention. After being discussed and amended, the following inclusion was adopted by the Group:

No special Model Convention provision has been made regarding remuneration derived by visiting professors and other teachers. In the absence of a special provision, articles 14, 15, 19 or 23 of the Model Convention, depending on the circumstances, would apply. Many bilateral conventions, however, contain rules of some kind or other concerning such persons, the main purpose of which is to facilitate cultural relations and the exchange of knowledge by providing for a limited tax exemption in the host country for visiting teachers. Sometimes, tax exemption is already provided under domestic taxation laws, which many consider to be the preferred way of solving double taxation problems of visiting teachers.

Notwithstanding the applicability of articles 14, 15, 19 and 23 to prevent double taxation, some countries may wish to include an article on teachers. The variety of domestic tax rules in different countries, on the one hand, or the absence of such rules, on the other, constitute an impediment to a specific provision on teachers in the Model Convention. If, however, in bilateral negotiations the Contracting States choose to include a provision relating to visiting teachers, the following issues should be considered in preparing such a provision:

(a) The purpose of a tax treaty generally is to avoid double taxation, and double exemption of teachers is not desirable;

(b) It is advisable to limit benefits for visits of a maximum duration (normally two years), and the time limit should be subject to expansion in individual cases by mutual agreement between the competent authorities of the Contracting States. It should be determined whether income from visits exceeding the time limit should be taxable as of the beginning of the visit or merely from the date beyond the expiration of the time limit;

(c) Whether benefits should be limited to teaching services performed at certain institutions "recognized" by the Contracting State in which the services are performed;

(d) Whether, in the case of visiting professors and other teachers who also do research, to limit benefits remuneration for research performed in the public (vs. private) interest;

(e) Whether an individual may be entitled to the benefits of the article more than once.

II. TRANSFER PRICING

39. The Secretary introduced the subject of transfer pricing, which he characterized as one of the most important and challenging items on the agenda for the meeting. He noted that OECD had considered the matter at length over several years and that the Steering Committee, at its June 1995 meeting, had identified five issues for consideration at the meeting of the Group:

(a) Administrative capabilities for dealing with transfer pricing issues;

(b) Assistance by developed countries to developing countries on transfer pricing enforcement;

(c) Treatment of finished goods versus primary goods;

(d) Exchange of information;

(e) Mechanisms for correlative adjustments.

The Steering Committee agreed that consideration of transfer pricing issues by the Group was important in order to ensure that the interests of both developing and developed countries were adequately represented in any international consensus on those issues.

40. A representative of OECD summarized for the Group the history of the organization's consideration of transfer pricing, which began with a report issued in 1979 and culminated most recently with the issuance in 1995 of the OECD transfer pricing guidelines. A description of the differences between the 1979 report and the 1995 guidelines was distributed to members of the Group. Also, copies of the 1995 guidelines were made available to interested persons. OECD intends to supplement the guidelines with additional chapters on, among other things, transfer pricing of intangibles and cost contribution arrangements. OECD is also studying the related issue of arbitration. Before completing the guidelines, OECD held informal discussions with several non-member countries, and after the guidelines were issued, it organized several seminars to present them to non-member countries. Other meetings would be held with non-member countries on the subject. Also, certain OECD members that had actively participated in the transfer pricing project did so with great concern for preserving their tax bases as source countries and as producers of primary products.

41. A participant noted that at the Steering Committee's June 1995 meeting, reservations were expressed about the effects of cost-sharing arrangements in developing countries. Often, it was argued, new technology was not transferred to developing countries until decades after it had been conceived, and the effect of cost sharing of research and development expenses could be to allocate portions of such expenses to developing countries when any benefits to those countries from the research and development were very remote in time. Other participants pointed out that the problem arose only if cost sharing was done incorrectly. Under a proper application of cost sharing, expenses should be allocated to a particular country only to the extent appropriate to reflect the benefits of the expenditures in that country.

42. Various participants urged that transfer pricing should not be viewed as an issue of contention between developed and developing countries. The basic problem - enforcing the arm's length principle - was faced by all countries.

Moreover, many developing countries were highly developed in certain aspects of their economies (e.g., manufacturing for export) and thus encountered the same difficulties in that area as the developed countries.

43. Several participants noted a need for study of the connections between customs valuations and transfer pricing for income tax purposes. For example, conflict sometimes arose between customs officials who wanted to maximize the value of goods as they entered the country and a tax administration desiring to minimize the transfer price by which the goods were imported.

44. Participants also argued that the Group should work with OECD on transfer pricing, taking the OECD's work as a starting point and identifying areas in which the Group's concerns differed from those addressed by OECD and in which work needed to be done by the Group.

45. Proposals for an international body to deal with transfer pricing were debated at length. In the relevant paper prepared for the Group (ST/SG/AC.8/1995/L.8), it was proposed that an international organization should undertake the following:

(a) Develop a uniform set of transfer pricing principles to be adopted by all countries participating in the initiative;

(b) Formulate regulations and forms so that a firm doing business in two or more participating countries could file one form allocating its income among the countries;

(c) Assemble a group of experts to provide advice to countries and assist in the resolution of disputes.

46. A few participants supported item (c) of the proposal in principle. They pointed out that in many developing countries, transfer pricing schemes practised by multinationals were not well understood by tax administrators and that those countries often lacked the audit and other resources required to enforce transfer pricing rules. An international body for providing advice and assistance in the resolution of disputes, they hoped, would help developing countries deal with those problems.

47. Most participants expressed scepticism about the proposal. Enshrining a common set of transfer pricing principles in binding rules or regulations could be perceived as a derogation from national sovereignty. Moreover, acceptance of the idea might not be politically feasible at any time in the foreseeable future, because it represented a great leap from the present situation. The experience of the European Union in its development of a multilateral convention between the member States of the Union on arbitration of tax disputes relating to transfer pricing, which became effective as from the beginning of 1995, more than 20 years after work on it began, was cited as evidence of the slowness with which new initiatives were accepted in that context. A single return dividing a firm's income among participating countries was feasible only if there was great similarity from country to country in the measurement of income, as well as in transfer pricing rules, and that that similarity did not widely exist.

48. A participant suggested that the inclusion of arbitration clauses in bilateral treaties was a more practical approach to the resolution of transfer-pricing disputes between countries. A supporter of the concept of an international body for dispute resolution responded that such a body might not

be much different from arbitration, except that it would provide an ongoing mechanism, rather than requiring a separate arbitration panel for each case.

49. Other participants pointed out that the needs of many developing countries in that area went beyond dispute resolution and that if a country lacked the resources required to develop transfer-pricing cases, there would be no disputes to resolve. They concluded that it was more important for an international body to provide technical assistance and training to the tax administrations of countries without expertise and resources in that area. One participant suggested that it should first be determined whether OECD could and would provide leadership on training. Another participant suggested that the need of developing countries was for information relevant to transfer prices reported by companies, as well as capabilities for processing the information.

50. It was suggested that a drafting committee should be appointed to develop proposals on activities to be undertaken by the Group with regard to transfer pricing. Although some participants suggested that the plenary session had to provide more guidance on the question before a drafting committee could work productively on the matter, the Group agreed to the formation of a drafting committee. The committee was asked to consider three items:

(a) OECD guidelines on transfer pricing;

(b) A framework to enhance administrative capacity in the developing countries and countries with economies in transition;

(c) A framework for dispute resolution.

The drafting committee formulated the following recommendations, which were discussed, amended and then adopted by the Group:

(a) With regard to the OECD guidelines: The OECD effort to develop guidelines for transfer pricing has been comprehensive and sustained. It would be futile - indeed, counterproductive - to undertake an independent effort. This is especially true in light of the fact that developed and developing countries' interests rarely differ in this area; and where they potentially differ, an attempt has been made in the OECD guidelines to address the concerns of capital-importing and primary material-exporting countries. It is proposed, therefore, that interested parties study the OECD guidelines with the express intention of focusing on issues that are of particular importance to developing countries. This may include the issue of coordination between customs and tax authorities on valuation of products. Where, however, after such study, additional work in areas such as primary products is necessary, the Ad Hoc Group of Experts is the appropriate body to undertake the work.

(b) With regard to administrative capacity: There is consensus that developed countries and international organizations such as the United Nations and OECD, as well as private sector organizations, need to redouble their efforts to assist in a coordinated way developing countries in their effort to build capacity in the area of transfer-pricing control, which may consist of training, seminars, and other mechanisms of experience-sharing. However, it is emphasized that the exchange of information under tax treaties, exchange-of-information agreements, and other international agreements can assist countries in application of the arm's length principle and be a vehicle to enhance the control of transfer pricing and the avoidance of international double taxation.

(c) With regard to dispute resolution: Greater cooperation must be a goal of the Ad Hoc Group of Experts and other multilateral institutions. Resolution of transfer-pricing disputes may increase international investment by assuring investors that they will not be subject to double taxation because of inconsistent and incorrect transfer prices imposed by different countries. So far, most countries have refused to cede their authority to any sort of arbitration that is outside the formal jurisdiction of the countries involved. It is proposed that the experience of such arbitrations, where they are authorized, be studied. It may be appropriate in the future for the Ad Hoc Group of Experts to initiate study of bilateral or multilateral approaches to dispute resolution (e.g., mandatory arbitration, voluntary arbitration or mediation). At present, countries may consider, in bilateral negotiations, an arbitration provision or other dispute resolution provision within the mutual-agreement procedure article.

III. TAXATION OF NEW FINANCIAL INSTRUMENTS

51. The subject of new financial instruments was introduced by the Special Adviser to the Secretary. He pointed out that those instruments could be divided into three groups: debt instruments (including bonds issued at a discount); derivatives; and hybrid instruments in which derivatives were embedded in debt or equity instruments. Derivatives, in turn, came in three principal varieties: options; forwards (including exchanged-traded futures and privately negotiated forward contracts); and other contracts based on option and forward concepts, including swaps of various kinds (interest rate swaps, currency swaps, and equity swaps), caps, floors, and collars.

52. Derivatives and other new financial instruments presented a host of tax problems. When a debt instrument was issued at a discount, interest on the instrument consisted, in whole or in part, of accrual of the discount, but if interest income was taxed only when paid (e.g., as under a withholding tax scheme for interest paid to foreign persons), the use of discount bonds, instead of interest-bearing, bonds tended to defeat, or at least defer, the tax. Also, because derivatives could be combined in ways that mimicked the economic behaviour of non-derivative instruments (e.g., a bond, plus a package of options, could have the same economic consequences as ownership of a share of stock), derivatives could be used by taxpayers to avoid unwanted tax consequences. In other words, if the tax rules for various types of investment vehicles were not completely consistent, taxpayers could use derivatives to choose the tax treatment they most desired; moreover, achieving complete consistency was difficult, if not impossible, because various instruments differed in ways traditionally considered highly relevant to taxation (e.g., the predictable returns of a debt instrument versus the unpredictable returns on most equity investments).

53. On the other hand, tax rules could upset economically valuable uses of derivatives. Derivatives were commonly used to hedge business and financial risks (e.g., an interest rate swap might be used to transfer away the interest-rate risk under a borrowing obtained at a variable rate), and a perfect hedge before taxes might be a highly imperfect hedge after taxes if the taxation of the hedge was not coordinated with the taxation of the transaction or investment giving rise to the risk being hedged. Miscoordination could result if the hedge and the hedged activity or investment were subject to differing characterizations (e.g., ordinary income versus capital gain) or if there were timing discrepancies (e.g., one was taxed on a realization basis, while the other was taxed on an accrual basis).

54. Derivatives and other new financial instruments also raised many issues under treaties. It was unclear in many instances whether income from the instruments was subject to the article on business profits, the article on interest, the article on capital gains, or the article on other income. The answers to those issues often depended on the nature of the particular instrument, the characterization of the instrument under the national law of the taxing country, and unresolved questions of treaty interpretation.

55. Representatives of OECD described activities of that organization with respect to those new financial instruments. Over a period of several years, OECD had collected information on the taxation of financial instruments under the laws of its member States. In 1994, a report was issued, and a working group was convened to continue consideration of the matter. Currently, the working group was examining the taxation of hedging, global trading, and

financial innovation. It had nearly reached a consensus on transfer pricing and other issues raised by the practice of global trading (trading by companies and financial institutions with offices in several countries that shared responsibility for the management of a single portfolio throughout each 24-hour period). The working group was also examining the issue of whether payments under equity swaps should, under any circumstances, be taxed as dividends.

56. Several of the participants commented that, before the Group could make any meaningful contribution on issues relating to derivatives and innovative financial instruments, the members of the Group had to expand considerably their understanding of those instruments. Mr. Bouab responded that consideration of the issues at the meeting was only introductory and was not intended to produce any concrete results.

IV. REVISION OF THE DRAFT MODEL CONVENTION

57. Before the Group began its discussion of the revision of the Model Convention, the Special Adviser to the Secretary summarized the document entitled "Trends in recently negotiated tax treaties between developed and developing countries" (ST/SG/AC.8/1995/L.9) which compared more than 50 tax treaties concluded during the past 10 years with the United Nations Model Convention and the OECD Model Convention. The study was initiated as a result of decisions made by the Steering Committee at its June 1995 meeting. Because of the relatively brief time available for its completion, the study was somewhat less encompassing than might be desired. Emphasis was placed on the treaties of a small number of developed countries and developing countries (selected largely at random), in order to make it possible to isolate trends in their treaty policies. A consequence of the small sample is that treaty policies of some countries may have escaped notice.

58. The treaties were compared article by article. Frequently occurring divergences from the Model Conventions were described in a summary that began the paper. More complete comparisons of the treaties with the Model Conventions make up the remainder of the paper. Many of the trends identified in the summary were reflected in the draft revision of the United Nations Model Convention. In addition to the trends in treaty provisions corresponding to provisions of the Model Convention, the study identified emerging practices in the inclusion of provisions not contained in the Model Convention, including provisions on treaty abuse, branch profits taxes, and partnerships and other transparent entities.

59. Several participants expressed appreciation for the document and identified areas for further review. One participant noted that the document did not survey tax-sparing credit provisions, which appeared in a large number of treaties between developed and developing countries. Another noted that alternative B of article 8 of the United Nations Model Convention, allowing source country taxation of profits from international shipping, appeared in some form in many treaties made by countries in South-East Asia, and that that did not appear in the study, probably because of the small number of treaties from those countries included in the study.

60. A representative of the World Bank noted that the Bank had a database containing the text of 1,300 bilateral tax conventions, which it believed included substantially all conventions in existence. It was agreed that the Bank would utilize the database to provide the Secretariat with a comprehensive survey of the use in tax treaties between developed and developing countries of the unique provisions of the United Nations Model Convention.

61. The Secretary noted that the United Nations also published tax treaties, and that the publication programme would be strengthened if member States submitted to the Secretariat copies of their newly concluded bilateral tax treaties, as they took effect, in all of the languages in which they were drafted. The participants agreed to do so.

62. In its consideration of the draft United Nations Model Convention, the Group noted that the environment in which tax treaties were negotiated was dynamic and ever-changing. That was exemplified by the experience of OECD, which adopted a model convention in 1963, revised it in 1977, and updated it in 1992, 1994, and 1995, with the intention of continuing the updating process indefinitely. An updated United Nations Model Convention would be a major

contribution, because the Model was widely used in treaty negotiations. The draft update presented to the meeting (ST/SG/AC.8/1995/WP.9) was to a large extent inspired by the OECD changes and by provisions commonly appearing in treaties concluded between developing and developed countries.

63. A participant explained that the OECD changes were the result of extensive deliberations which occurred over many years and involved wide participation by member countries. Apparently simple changes were often the result of lengthy discussions and compromise. The experience of OECD suggested that the Group might expect to reach agreement on a comprehensive revision of the United Nations Model Convention only after a reasonable period of consultation.

64. Several participants, agreeing with those observations, suggested that the Group should focus on particular issues, selecting those issues of greatest interest in negotiations of treaties between developed and developing countries. Participants also urged that all States Members of the United Nations should be asked to suggest issues to be the focus of the Group's efforts.

65. The participants generally agreed that the updating process was too complex to be done in plenary session and that a steering committee should be organized to work on the issues and report to a future meeting of the Group. The participants debated whether the work should be done by one committee or several, but they ultimately agreed to assign the work to one steering committee.

66. The Secretary noted that much work had already been done on updating the Model Convention and that reactions to the draft update had been received from several countries and international organizations. The reactions indicated that the draft revisions were on the right road and were well advanced, although the reactions also raised important issues that might require considerable study and analysis. The Secretary suggested that the Steering Committee should meet at least once, perhaps twice, before the next meeting of the Group and that members of the Group should, at that meeting, provide guidance for the Steering Committee's work.

67. The participants debated whether the goal of the updating should be a new United Nations Model Convention or the issuance of supplements to the existing Model Convention, as agreement is reached on particular changes to the Model Convention. Proponents of the former view noted that, because the Model Convention was widely used in treaty negotiations, a fully updated version was important to the very reason for having a United Nations Model. Proponents of the latter approach argued that achieving agreement on a fully updated Model was such a large task that work on it would likely continue over many years without completion. The consensus of the Group was that no decision should then be made on the issue and that the Steering Committee should remain open to either approach as it proceeded with its work. The Steering Committee might, for example, choose to focus on a limited number of issues, particularly issues of special relevance to treaties between developed and developing countries. Also, a participant noted that the Group had produced many documents since the issuance of the 1980 Model and that the Steering Committee might find much material useful to its work in those documents.

68. Various participants suggested issues that might be considered by the steering committee early in its deliberations, including the articles on interest, dividends, royalties, and capital gains; the force of attraction principle (art. 7, para. 1); allocation of expenses to permanent establishments

(art. 7, para. 3); tax sparing credit; limitation of benefits provisions; transfer pricing; and teachers.

69. Several participants noted that the 1980 United Nations Model Convention was out of print and suggested that, in view of the lengthy process probably necessary to update it, it would be useful to have it reprinted.

V. EXPANSION OF THE GROUP'S ROLE RELATING TO TECHNICAL ASSISTANCE IN INTERNATIONAL TAXATION

70. The Secretary introduced the subject of the possible expansion of the role of the Ad Hoc Group of Experts to include the provision of technical assistance in international taxation. Although the Group had thus far been primarily a policy-making body, it had often been requested to provide technical assistance in the areas of tax administration, international taxation, and negotiation of tax treaties. Such assistance could help developing countries enhance their capacity-building in negotiating tax treaties, generate additional revenues for socio-economic growth, and facilitate the resolution of treaty disputes. The Department for Development Support and Management Services of the United Nations Secretariat and other groups had offered technical assistance, including training seminars, and any efforts of the Group in that area should be coordinated with those other efforts. Pursuant to requests made at the 6th meeting of the Group, the Secretariat had served as a clearing-house for the exchange of information on tax conventions and had stood ready to provide assistance in international taxation matters.

71. The Secretary referred to the "Proposal concerning the possible expansion of the role of the Ad Hoc Group of Experts on International Cooperation in Tax Matters" (ST/SG/AC.8/1995/WP.4), which was prepared by the Secretariat in response to a request of the Steering Committee at its June 1995 meeting. The proposal was to convene five annual interregional workshops, commencing in 1997, to promote worldwide development of expertise in international taxation, with special emphasis on the prevention of tax evasion and avoidance and of double taxation. The workshops, to be held at United Nations Headquarters and in Africa, Asia, Europe, and Latin America, would each be attended by about 35 participants from all regions. Governments might send additional participants at their own expense.

72. The workshops, organized under the auspices of the Group, would consist of lectures, training, and practical guidance based on case studies. They would be conducted by members of the Group, together with international tax experts from the International Monetary Fund, OECD, regional and subregional fiscal organizations, and universities with international tax programmes. Each workshop would also provide a forum for the exchange of experience among tax administrators from various regions. Participants would be expected subsequently to act as trainers, passing along knowledge acquired at the workshops to their colleagues in the tax administrations of their respective countries. The workshops would be conducted in the appropriate combination of English, French, and Spanish, depending on the linguistic knowledge of the participants.

73. Several participants expressed support for the proposal. They noted the need for coordination with the assistance efforts of other organizations.

VI. PREPARATIONS FOR THE EIGHTH MEETING

74. The Group discussed the agenda for its next meeting, agreeing by consensus on the following items:

(a) Update of the United Nations Model Convention and the Manual for the Negotiations of Bilateral Tax Treaties between Developed and Developing Countries;

(b) Financial instruments;

(c) Transfer pricing;

(d) Tax havens, including exchanges of information.

75. Several participants argued that the consideration of financial instruments and transfer pricing should be focused on particular issues within those broad categories. It was agreed that the Steering Committee should have the authority to identify issues within those categories to be discussed at the 8th meeting. Transfer pricing of primary products was mentioned as a possible item of discussion, but it was agreed that the Steering Committee's discretion should not be limited by that suggestion.

76. The Group tentatively selected the period 15-19 December 1997 as the time for its next meeting.

Annex I

LIST OF PARTICIPANTS

A. EXPERTS

Mr. Atef Alawneh
Deputy Minister
Palestinian Authority
Ministry of Finance
P.O. Box 795
Ramallah
Telephone: (972-2) 998-5881/2/3/4
Facsimile: (972-2) 998-5880

Ms. Nabawia Sobhi Khaled Allam
Senior Tax Expert
General Directorate of International Tax Agreements
General Tax Administration
5 Hussein Hegazi Street
Lazoughli Square
Cairo
Egypt
Telephone: (20-2) 355-7027
Facsimile: (20-2) 355-7994

Mr. J. A. Arogundale
Director
Collection, Computerization and International Tax
Directorate of Collection, Computerization and International Tax
Federal Inland Revenue Service
9th Floor, St. Nicholas Building
8/10 Catholic Mission Street
Lagos
Nigeria
Telephone: (234-1) 263-4329
Facsimile: (234-1) 263-0680

Mr. Ernst Bunders
Deputy Director for International Fiscal Affairs
Ministry of Finance
International Tax Policy and Legislation Directorate
POB 20201
2500 EE The Hague
Netherlands
Telephone: (31-70) 342-8243
Facsimile: (31-70) 342-7938

Mr. Mordecai Feinberg
United States Department of the Treasury
Office of Tax Analysis
International Taxation Division
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220
United States of America
Telephone: (202) 622-0474
Facsimile: (202) 622-0605

Mr. Antonio Hugo Figueroa
National Director of Taxes
H. Yrigoyen 250 250
Buenos Aires
Argentina
Telephone: (54-1) 349-6970
Facsimile: (54-1) 349-6967

Mr. Mayer Gabay
Former Civil Service Commissioner
Ministry of Finance
14 Jabotinski Street
Jerusalem 92142
Telephone: (972-2) 669-761
Facsimile: (972-2) 630-389

Mr. Sergey M. Ignatiev
Deputy Minister of Economy of the Russian Federation
Novy Arbat 19
103025 Moscow
Russia
Telephone: (70-95) 203-8025
Facsimile: (70-95) 203-8017

Mr. Helmut Krabbe
Chief of the Section on Multilateral International Tax Matters and Double Taxation with Member States of Economic Commission
Bundesministerium der Finanzen
D-5300 Bonn
Germany
Telephone: (49-228) 682-4860
Facsimile: (49-228) 682-4420

Mr. Daniel Luthi
Vice Director
Federal Tax Administration
Eigerstrasse 65
CH-3003 Berne
Switzerland
Telephone: (41-31) 322-7136
Facsimile: (41-31) 322-7349

Mr. Reksoprajitno Mansury
Assistant Minister of Finance for Revenue Affairs
Ministry of Finance
J.L. Lapangan Banteng Timur 2
P.O. Box 4126
Jakarta
Indonesia
Telephone: (62-21) 384-6814
Facsimile: (62-21) 345-3710

Mr. John Evans Atta Mills
Commissioner of Internal Revenue Service
Off Kimbu Road
P.O. Box 2202
Accra
Ghana
Telephone: (233-21) 664-938
Facsimile: (233-21) 667-0699

Mr. G. K. Mishra
Member, Central Board of Direct Taxes
Department of Revenue
Ministry of Finance
North Block
New Delhi
India
Telephone: (91-11) 301-3356
Facsimile: (91-11) 301-5473

Ms. Maria das Graças Patrocínio Oliveira
Ministério da Fazenda
Secretaria da Receita-Federal-Coordenaçao-Geral
do Sistema de Tributaçao
Esplanada dos Ministérios, Bloco P, 9o Andar, Sala 922
70048903 Brasilia DF
Brazil
Telephone: (55-61) 314-2947
Facsimile: (55-61) 226-7802

Mr. Alvi Abdul Rahim
Chairman
Central Board of Revenue
C.D.A. Block No. 3
Islamabad
Pakistan
Telephone: (92-51) 820-114
Facsimile: (92-51) 821-527

Mr. Juan López Rodriguez
Tax Coordinator
International Tax Relations Department
Ministerio de Economia y Hacienda
Alcalá 5, 1 planta
28014 Madrid
Spain
Telephone: (34-1) 532-0935
Facsimile: (34-1) 532-3926

Mr. Alain Ruellan
Administrateur Civil
Chef du Bureau E2
Ministère de l'Economie et des Finances
Service de la Législation Fiscale
139, rue de Bercy
Télédoc 568
75572 Paris Cedex 12
France
Telephone: (33-1) 4024-9210
Facsimile: (33-1) 4628-7021

Mr. John Brian Shepherd
Assistant Secretary (retired)
International Division
Inland Revenue
Strand Bridge House
138-142 Strand
London WC2R 1HH
United Kingdom
Telephone: (441-71) 438-6762
Facsimile: (441-71) 438-6396

Home address:

6 Greenway
Berkhamsted
Herts HP4 3JD
United Kingdom
(44-1442) 866-484
(44-1442) 866-484

Mr. Katsumi Shinagawa
Section Chief
International Tax Affairs Division
Tax Bureau
Ministry of Finance
3-1-1 Kasumigaseki, Chiyoda-ku
Tokyo 100
Japan
Telephone: (81-3) 3581-4111 ext. 2453
Facsimile: (81-3) 5251-2121

Mr. Hillel Skurnik
Director of Treaty Affairs
Ministry of Finance
P.O. Box 286
SF 00171 Helsinki
Finland
Telephone: (358-0) 160-3169
Facsimile: (358-0) 160-4747

Mr. Li Yonggui
Chief Economist
Member of the Directors-General Committee
State Administration of Taxation
No. 68 Zaolinqianjie, Xuanwu District
Beijing
China
Telephone: (86-10) 326-6836 ext. 2065
Facsimile: (86-10) 347-1315

B. GOVERNMENTAL OBSERVERS

AUSTRALIA
Mr. Ken Allen
Assistant Commissioner
International Tax Division
Australian Taxation Office
2 Constitution Avenue
Canberra A.C.T. 2601
Telephone: (06) 21-61155
Facsimile: (06) 21-61509

BELGIQUE
Mr. G. Daumerie
Directeur Général de l'Administration des contributions directes
Ministère des Finances
CAE - Tour Finances Boîte 32
Boulevard du Jardin Botanique
1010 Bruxelles
Telephone: (02) 210-2447
Facsimile: (02) 210-2264

BRAZIL
Ms. Clarice Milman Ribenboim
Secretaria da Receita Federal
Av. Presidente Antonio Carlos
375-térrio-Plantao Fiscal
Rio de Janeiro
Telephone: (021) 240-2831
Facsimile: (021) 240-2831

CHINA
Mr. Sun Yugang
Assistant to Mr. Li Yonggui
State Administration of Taxation
No. 68 Zaolinqianjie, Xuanwu District
Beijing 10053
Telephone: (86-10) 326-6836 ext. 2065
Facsimile: (86-10) 347-1315

DENMARK
Mr. Erik Jorgensen
Head of Section
Danish Ministry of Taxation
Slotsholmsgade 12
DK-1216 Copenhagen K
Telephone: (45-33) 923-392
Facsimile: (45-33) 149-105

ISRAEL
Mr. Meir Kapota
Senior-Deputy Director
Economy and State Revenue Department
Ministry of Finance
Hakiria
Jerusalem
Telephone: (972-2) 317-575 (ext. 228)
Facsimile: (972-2) 317-553

JAPAN
Mr. Toshitake Kurosawa
Deputy Director of the International Tax Affairs Division
Tax Bureau
Ministry of Finance
3-1-1 Kasumigaseki, Chiyoda-ku
Tokyo 100
Telephone: (81-3) 3581-9328
Facsimile: (81-3) 5251-2121

JORDAN
Mr. Ahmad Abu Al-Homous
Assistant General Director of the Tax Department
for Legal and Auditing Affairs of Jordan
Amman

MALAWI
Mr. Y. D. Chimombo
Commissioner of Taxes
P.O. Box 162
Blantyre
Telephone: (265) 620-277
Facsimile: (265) 620-202

MALAYSIA
Ms. Nik Esah bte Nik Mahmood
Assistant Director General
Director General of Inland Revenue
Department of Inland Revenue
International Tax Division
12th Floor, Block 11
Government Buildings Complex
Jalan Duta
50600 Kuala Lumpur
Telephone: (60-3) 651-7101
Facsimile: (60-3) 253-9884

Mr. Mohd. Saian bin Hj. Mohd. Ridzuan
Assistant Director General
Director of Inland Revenue
Department of Inland Revenue
Investigation and Intelligence Division
International Tax Division
12th Floor, Block 11
Government Buildings Complex
Jalan Duta
50600 Kuala Lumpur
Telephone: (60-3) 651-7101
Facsimile: (60-3) 253-9884

MALTA
Mr. Vincent Galea
Permanent Secretary
Ministry for Economic Services
Valletta

Mr. Albert Mifsud
Director General (Inland Revenue)
Ministry of Finance
Floriana

SRI LANKA
Ms. Dayani de Silva
Adviser, Fiscal Policy
Ministry of Finance Planning, Ethnic Affairs and National Integration
Secretariat Building
Colombo 1
Telephone: (941) 421-255
Facsimile: (941) 449-823

Mr. D. S. Weeraratne
Commissioner-General
Department of Inland Revenue
Sir Chittampalam Gardiner
Mawathd
Colombo 2

TURKEY
Mr. Baran Demir
Head of Department
Ministry of Finance
Gelirler Genel Mudurlugu
06100 Ulus/Ankara
Telephone: (90-312) 311-4534
Facsimile: (90-312) 311-4510

UGANDA
Mr. Patrick Ocallap
Acting Commissioner
Tax Policy Department
P.O. Box 8147
Kampala
Telephone: (256-41) 234-824

ZIMBABWE
Mr. G. T. Pasi
Deputy Commissioner of Taxes
Department of Taxes
P.O. Box CY 693 Causeway
Head Office, Fourth Floor
Anlaby House, Baker Avenue
Harare

C. OTHER OBSERVERS

1. <u>Palestine</u>

Mr. Nasser Tahboub
Director General of VAT and Excises
Ministry of Finance
Palestinian Authority
P.O. Box 795
Ramallah
Telephone: (972-2) 998-5880/4
Facsimile: (972-2) 438-6865

2. <u>International bodies</u>

Association de planification fiscale et financière
Mr. Robert Roy
Conseiller Spécial et Directeur des
Relations Gouvernementales
445 Boulevard Saint-Laurent
Bureau 300
Montréal (Québec) H2Y 2Y7
Canada
Telephone: (514) 866-2733
Facsimile: (514) 866-0113

Commonwealth Association of Tax Administrators (CATA)
Mr. S. I. Chelvathurai
Executive Director
Marlborough House
Pall Mall
London SW1Y 5HX
United Kingdom
Telephone: (44-71) 747-6473
Facsimile: (44-71) 930-0827

International Association of University Presidents
Mr. Stephen R. Crow
Associate Professor of Taxation
Department of Accountancy
School of Business
California State University, Sacramento
Sacramento, CA 95819-6088
United States
Telephone: (916) 278-7129
Facsimile: (916) 278-5793

International Bureau of Fiscal Documentation (IBFD)
Mr. W. F. G. Wijnen
Director of Research
Sarphatistraat 600
1000 HE Amsterdam
Netherlands
Telephone: (31-020) 626-7726
Facsimile: (31-020) 622-8658

International Chamber of Commerce
Mr. Peter Baumgartner
Deputy Secretary General
Federation of Swiss Industrial Holding Companies
Luisenstrasse 38, Postfach 209
3000 Bern
Switzerland
Telephone: (41-31) 352-7788
Facsimile: (41-31) 352-3255

Mr. Mark V. Föllmi
Vice President, Tax Services Group
Union Bank of Switzerland
Bahnhofstrasse 45
CH-8021 Zurich
Switzerland
Telephone: (41-1) 234-2366
Facsimile: (41-1) 234-2044

International Fiscal Association
Mr. Yvon de Coulon
Deloitte & Touche Experts
20, rue de Pré-Bois
Case postale 718
CH-1215 Geneva
Switzerland
Telephone: (41-22) 788-0246
Facsimile: (41-22) 788-0316

Organization for Economic Cooperation and Development (OECD)
Mr. Jeffrey Owens
Head of the Fiscal Affairs Division
Directorate for Financial, Fiscal and Enterprise Affairs
2, rue André Pascal
75775 Paris Cedex 16
France
Telephone: (33-1) 4524-9108
Facsimile: (33-1) 4524-7852

Mr. Jacques Sasseville
Principal Administrator
Directorate for Financial, Fiscal and Enterprise Affairs
2, rue André Pascal
75775 Paris Cedex 16
France
Telephone: (33-1) 4524-9107
Facsimile: (33-1) 4524-7852

Mr. Achim Pross
Consultant
2, rue André Pascal
75775 Paris Cedex 16
France
Telephone: (33-1) 4524-9108
Facsimile: (33-1) 4524-7852

Universidad Santa María
Mr. Francisco Garcia Arjona
Attorney-at-Law
Profesor de Derecho Financiero
Coordinador del Post-Grado en Tributación
Quinta Alfa
Calle Buena Vista
Prados del Este
Caracas 1080
Venezuela
Telephone: (58-2) 977-2741
Facsimile: (58-2) 977-2741

Universitat de València
Mr. Francisco Garcia Prats
Professor de Dret Financer i Tributari
Avinguda Blasco Ibañez s/n
46010 València
Spain
Telephone: (346) 386-4460
Facsimile: (346) 386-4443

D. CONSULTANTS

Mr. Peter D. Byrne
Deputy Director
International Tax Program
Harvard University
Pound Hall 400
Cambridge, MA 02138
United States
Telephone: (617) 495-4406
Facsimile: (617) 495-4406

Mr. Lawrence Lokken
Hugh F. Culverhouse Eminent Scholar in Taxation
University of Florida
College of Law
Graduate Tax Program
320 Holland Hall
P.O. Box 117627
Gainesville, FL 32611-7627
United States
Telephone: (904) 392-1081
Facsimile: (904) 392-7647

Mr. Harold Ullman
Attorney-at-Law
Curtis, Mallet-Prevost, Colt & Mosle
101 Park Avenue
New York, NY 10178-0061
United States
Telephone: (212) 696-6000
Facsimile: (212) 697-1559

E. UNITED NATIONS

Mr. Abdel Hamid Bouab
Officer-in-Charge
Public Finance and Enterprise Management Branch
Division of Public Administration and Development Management
Department for Development Support and Management Services
Secretary of the Ad Hoc Group of Experts
United Nations
1 United Nations Plaza
Room DCI-950
New York, NY 10017
United States
Telephone: (212) 963-8406
Facsimile: (212) 963-2916

Mr. Peter E. Heijkoop
Economic Affairs Officer
Public Finance and Enterprise Management Branch
Division of Public Administration and Development Management
Department for Development Support and Management Services
United Nations
1 United Nations Plaza
Room DCI-944
New York, NY 10017
United States
Telephone: (212) 963-8415
Facsimile: (212) 963-2916

Ms. Lorraine Ruffing
Chief, Accounting Section
Division for Transnational Corporations and Investment
United Nations Conference on Trade and Development (UNCTAD)
Palais des Nations
CH-1211 Geneva 10, Switzerland

Annex II

LIST OF DOCUMENTS

ST/SG/AC.8/1995/L.1	Annotated provisional agenda
ST/SG/AC.8/1995/L.2	Tax treatment of students and teachers
ST/SG/AC.8/1995/L.3	Transfer pricing: pricing of primary products between related entities, cost-sharing and provision of services
ST/SG/AC.8/1995/L.4	The globalization of capital markets
ST/SG/AC.8/1995/L.5	Derivative markets: economic implication for taxation
ST/SG/AC.8/1995/L.6	Taxation of derivatives and new financial instruments
ST/SG/AC.8/1995/L.7	Report of the Steering Committee of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (New York, 5-7 June 1995)
ST/SG/AC.8/1995/L.8	Transfer pricing and taxation of international income in developing countries
ST/SG/AC.8/1995/L.9	Trends in recently negotiated tax treaties between developed and developing countries
ST/SG/AC.8/1995/WP.1	List of documentation
ST/SG/AC.8/1995/WP.2	List of participants
ST/SG/AC.8/1995/WP.3	Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries
ST/SG/AC.8/1995/WP.4	Proposal concerning the possible expansion of the role of the Ad Hoc Group of Experts on International Cooperation in Tax Matters
ST/SG/AC.8/1995/WP.5	Programme of work
ST/SG/AC.8/1995/WP.6	Suggested commentary of Task Force on Treatment of Teachers and Students
ST/SG/AC.8/1995/WP.9	United Nations Model Double Taxation Convention Between Developed and Developing Countries
ST/SG/AC.8/1995/WP.10	Draft report
ST/SG/AC.8/1995/WP.11	Draft report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

ST/SG/AC.8/1995/CRP.1	Taxation of Students, Teachers and Other Categories
ST/SG/AC.8/1995/CRP.2	The Taxation of Students and Teachers
ST/SG/AC.8/1995/CRP.3	Article 20 of the United Nations Model Double Taxation Convention: Payments Received by Students
ST/SG/AC.8/1995/CRP.4	The Arm's Length Principle in Swiss Fiscal Law (An Extract)
ST/SG/AC.8/1995/CRP.5	Tax Treatment of New Financial Instruments Hybrid Instruments in Indonesia
ST/SG/AC.8/1995/CRP.6	Update of the United Nations Model Convention on Double Taxation Between Developed and Developing Countries (Suggestions from the Argentinian Expert)
ST/SG/AC.8/1995/CRP.7	Tax Treatment of Financial Instruments and Derivatives
ST/SG/AC.8/1995/CRP.8	Taxation of the New Financial Instruments Relevance of Tax Conventions
ST/SG/AC.8/1995/CRP.9	Taxation of Teachers and Researchers' Salaries
ST/SG/AC.8/1995/CRP.10	List of Participants of the Steering Committee Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, New York, 5-7 June 1995
ST/SG/AC.8/1995/CRP.11	Draft Update of United Nations Model Convention and Agenda Items
ST/SG/AC.8/1995/CRP.12	Draft Update of United Nations Model Convention
ST/SG/AC.8/1995/CRP.13	Overview of OECD Work on the Taxation of Innovative Financial Transactions
ST/SG/AC.8/1995/CRP.14	Committee on Fiscal Affairs of the Organization for Economic Cooperation and Development
ST/SG/AC.8/1995/CRP.15	ICC Comments on the Revision of the United Nations Model Tax Convention Between Developed and Developing Countries and Related Issues
ST/SG/AC.8/1995/CRP.16	ICC Comments on Transfer Pricing
ST/SG/AC.8/1995/CRP.17	ICC Comments on Multinational Enterprises: Charges for Intra-Group Services
ST/SG/AC.8/1995/CRP.18	Update of the United Nations Double Taxation Convention Between Developed and Developing Countries (Suggestions from the experts from Indonesia)

ST/SG/AC.8/1995/CRP.19	Note prepared by the OECD Secretariat on OECD work on transfer pricing for information
ST/SG/AC.8/1995/CRP.20	Note prepared by United Kingdom Inland Revenue on Tax Treatment of Students and Teachers
ST/SG/AC.8/1995/CRP.21	Note prepared by Meir Kapota, Ministry of Finance, Israel, on Capital Gains Tax on the Sale of Securities that are traded over the Israeli Stock Exchange
ST/SG/AC.8/1995/CRP.22	OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations

Part two

SELECTED PAPERS PRESENTED TO THE MEETING

TRANSFER PRICING: PRICING OF PRIMARY PRODUCTS BETWEEN RELATED ENTITIES, COST SHARING AND PROVISION OF SERVICES*

1. In their publication "Guidelines for tax treaties between developed and developing countries" (ST/ESA/14) of 1974, the Group of Experts commented "... transfer pricing is an issue of primary importance, both to developed and to developing countries, in connection with the proper international treatment of multinational corporations and their complex network of subsidiaries and branches".

2. The intervening 20 years have done nothing to call that assessment into question. And the Group has judged it timely to address the matter of guidelines once more with the twofold objective of taking into account the considerable amount of study that the member States of the Organisation for Economic Cooperation and Development (OECD) have devoted to the issue over the years and of sensitizing developing countries in particular to the latest thinking and to new ways in which the old question can arise. In particular the Group puts stress on the importance of establishing double taxation conventions for the contribution they can make through exchange of information (art. 26) to finding appropriate solutions to both old and new problems of transfer pricing. As one representative commented, "The starting point ... has been that transfer pricing problems should be dealt with in an international context. Difficulties in this field can ... not be resolved unilaterally, without causing double taxation." Annex I sets out in an aide-memoire a list of the practical methods that are in use for valuation purposes.

A. Pricing of primary products between related entities

3. One of the most tangible manifestations of the internationalization of economies is the creation of multinational enterprises, sometimes of considerable size, which bring together directly or indirectly associated enterprises and answer a need for rational economic behaviour and a coherent approach by markets. Such international groups thus have a tendency to become true entities from the economic standpoint.

4. Tax authorities may have a natural inclination to consider only those entities or those parts of a multinational enterprise that are located in their territory and to want to deal with them in isolation, without taking into account the fact that they are part of a larger group which may have its own interests. This approach is natural and legitimate as long as borders exist between States and the payment of taxes in one State rather than another is therefore of some consequence. It may require the group to disregard economic logic and to focus instead on whether their internal transactions are in compliance with the tax regulations of the States in which they are established.

5. This is the basis for a common abuse of transfer pricing, growing out of the fact that prices can be agreed among members of a group of associated enterprises, something which would not have occurred if the enterprises were unrelated or if related enterprises maintained arm's length prices.

6. The prices charged in respect of transactions of all kinds between connected companies in a multinational group (transfer prices) will not

---

* The original text of this working paper, prepared by the Steering Committee of the Group, was issued as document ST/SG/AC.8/1995/L.3.

necessarily represent the result of market forces but, for a host of reasons, may diverge from those which would have been agreed between unrelated parties engaged in the same, or similar, transactions under the same, or similar, conditions. For example, the prices charged for raw materials or semi-finished products, or for the sale or licensing of patents and know-how, or for establishment costs, may be set below "market" levels to assist a subsidiary in achieving optimal production levels, effect market entry or overcome tariff barriers. The use of transfer pricing by multinationals will impact on the allocation between countries of their overall profits, and prices can be manipulated to minimize or avoid tax by diverting profits into tax havens, or to low tax rate countries, or to countries where unutilized losses are stored. The prices used therefore will not necessarily produce a figure of profit or loss in a particular jurisdiction which is considered appropriate by that tax authority.

Some domestic law approaches

7. In the course of discussion, two participants noted that the domestic tax legislation in their respective countries contained provisions whereby profits or losses could be adjusted to reflect an arm's length price. This was the price that might have been expected if the parties to the transaction had been independent persons dealing with each other in a normal commercial manner, unaffected by any special relationship between them. For example, in the case of one developed country, the principal provision stipulated that (with respect to associated persons) if the actual price for which goods or services were sold was not considered to be an arm's length price, then the computation of income, profits and losses for tax purposes might be adjusted as if the transaction had taken place on an arm's length basis. A further provision enabled the tax authority to obtain information in relation to specific transactions. The legislation defined the transactions governed by the legislation to include letting and hiring of property, grants and transfers of rights, interests or licences and the giving of business facilities of whatever kind. Loan interest, patent royalties, management fees and payments for services were deemed thus to be within the scope of the legislation as well as payments for goods. Contributions by a subsidiary towards costs incurred by a parent company were similarly covered.

8. By contrast, other participants explained that the domestic law contained no provisions explicitly directed at transfer pricing in terms. Nevertheless, they were enabled to take action to counter it under general provisions underlying the overall approach to the application of tax law.

9. One participant noted that in his country the major principle was expressed in an article of a tax act which stated: "Profit is the amount of the total benefits that are derived from a business, under whatever name and in whatever form"; that was connected with another article which read: "In determining profit, the following may not be deducted: direct and indirect distributions of profit, regardless under what name and in what form they have been made". The provision enabled the revenue authorities and the courts to adjust reported taxable income of corporations, if they found that transactions with related persons contained an element of distribution of profit. The system was very flexible: there were no detailed rules, which were often very difficult to comply with or to enforce. The country's view was that standard rules could not do justice to the factual situation. The main guidance for the tax inspectors were the OECD reports on transfer pricing.

10. The representative of another country noted that, mainly owing to the fact that it still had a classic system of taxing the profits earned by corporate

enterprises and distributed to their shareholders (under which distributed profits were doubly taxed) there existed a large body of case law on this point. Shareholders were in fact often inclined to minimize taxes by artificially increasing the remuneration for personal functions and the interest rate on loans they had granted to the company, or by borrowing funds from the company at too low an interest rate or by using the equipment of the company (flats, cars, planes, etc.) on privileged terms.

11. For about 30 years, the relevant juridical fact which entitled tax authorities to adjust taxable profits had been the so-called hidden or disguised profit distribution. Such a distribution depended on three conditions:

(a) The value of the reciprocal performances (goods or services against cash or a claim) was not balanced;

(b) The beneficiary was the shareholder (parent company) or any other person directly or indirectly controlled by the same shareholder;

(c) The discrepancy between the value of the goods sold or the services performed and the remuneration received was recognizable by the executives involved at the time the transaction took place.

12. The country concerned, Switzerland, noted that these principles of domestic tax law had been applied by the High Court in four decisions given on transfer pricing across the national border. Those concerned, in one case, the resale price method; in two cases, the application of the cost-plus method; and in one case, the application of general principles of the separate entity approach. The major points of all four cases are summarized in annex II.

Approach of the United Nations and OECD Models

13. The OECD Model Double Taxation Convention of 1977 and the United Nations Model Double Taxation Convention of 1980 treat the subject of transfer pricing in identical terms in their article 9, "Associated enterprises". The commentaries on this article annexed to the model conventions develop the same arguments in the same terms. The intent of the commentaries is to define the situation of "parent and subsidiary companies and companies under common control", but they do not go into the details of application to a given type of product or service.

14. Paragraph 1 of article 9 gives a competent authority the possibility of adjusting transfer prices if they are not in conformity with the arm's length principle. Paragraph 2 deals with the corresponding adjustment by the other competent authority and states that the competent authorities shall if necessary consult each other. This, however, gives no guarantee to taxpayers that double taxation will not occur, because there is no obligation for the competent authorities to reach agreement.

Some detailed studies

15. Questions regarding the details of the application of the arm's length approach to a given type of product or service have been the subject of lengthy examination by the OECD Committee on Fiscal Affairs throughout the years.

16. The main document is "Transfer prices and multinational enterprises" (1979). That report elaborated on the broad principles set out in the OECD Model Tax Convention and set out guidelines for establishing transfer prices

consistent with the arm's length standard. It provided that the transfer price charged in a transaction between associated enterprises (the "controlled transaction") should be the price that would have been charged by independent enterprises engaged in the same or similar transactions (the "uncontrolled transaction") under the same or similar circumstances in the open market.

17. The 1979 report was supplemented in 1984 by a report entitled "Three taxation issues" which considered, successively, the ways in which a multinational enterprise may be relieved from "economic double taxation" when transfer prices are adjusted by tax authorities; transfer pricing in the particular sector of banking; and issues related to the allocation of management and service costs for tax purposes.

18. The experts noted that events had moved on, and that once again the Committee on Fiscal Affairs had the issue of transfer pricing under scrutiny and that a further report, which would update the 1979 report and respond to developments since 1979, was in preparation. The Group welcomed that development unreservedly, noting that it was a common experience that transfer pricing cases were becoming more complex and difficult. This reflected a growing complexity in the real world of business. Multinational enterprise groups themselves were becoming increasingly integrated, there was an accelerated globalization of the world economy, trade barriers were being reduced and there had been an observable rise in intra-group transactions involving intangible property. Those new developments had led to difficulties in applying the arm's length standard and led to a demand for its relevance and appropriateness to be re-evaluated.

19. The Group looked forward to the appearance of the new report, but in the meantime had taken the opportunity to update its own contribution to the debate by focusing on the aspects that were especially relevant as between developed and developing countries.

<u>Interests of developing and developed countries distinguished</u>

20. The participants identified three particular areas as being of overriding concern to developing countries: they were the three identified in the title, namely primary products (as opposed to finished goods), cost-sharing arrangements and the provision of services. There was a common linking theme: many developing countries saw themselves as involved in an unequal contest with multinational enterprises (as compared, for example, to tax administrations of developed countries) because they were deficient in the basic information they needed in order to fight a case. The Group looked for some practical solutions.

<u>Primary products</u>

21. The Group considered first some problems posed in the sphere of extractive industries such as copper, nickel, bauxite and aluminum. While it was accepted that some indication of a world market price might be established for these commodities traded on recognized metal exchanges, even this information had to be identified and assembled, which could be a laborious activity. And when it was available, it went only part of the way to a solution in a given case. For one thing, a single price could not be apt in a situation where it was possible to trade in wholly raw material or in a whole range of partly processed material. The bauxite example was a case in point. No one primary producing country was likely to be able to arm itself with sufficient information to argue a complete range of cases. And the question arose of whether some research institutions might not need to be established, perhaps at a regional level to

compile data which could then be made available to all subscribing States in the region.

22. A further example examined was that of tropical hardwoods, where for a number of years there had been some difficulty in establishing a properly external comparable market price. This could and did lead to a State fixing a minimum export price for the purpose of domestic control, which was itself lower than it should have been, with the result that transfer pricing manipulation was, in effect, created by the Government's own action in determining a price in error.

B. Cost-sharing arrangements

23. Developing countries perceive themselves to be particularly at-risk in respect of payments of royalties and technical fees. Determining an appropriate transfer price for different types of goods and services can sometimes be difficult, but perhaps one of the most complex areas of transfer pricing arises when intellectual property is owned and developed by one company in the group but the benefits of such property accrue to other group companies as well. The Group recognized that cost-sharing arrangements could be very helpful in this respect. In general, it might be expected that the costs incurred in developing intellectual property under such an arrangement would be apportioned on the basis of the benefits that each participant in the arrangement could be expected to receive from the exploitation of such property. The Group noted that some tax authorities had formal rules governing cost-sharing arrangements. Others preferred to look at each arrangement on the basis of its own facts and circumstances.

C. Provision of services

24. Here the Group considered that the central principle was that costs incurred to benefit associated enterprises should be borne by those enterprises. The general rule to be followed was that prices performed between associated enterprises should be those which would be paid between unrelated parties. Unrelated parties would trade with each other under the proviso that they could profit from their transactions. Therefore a charge for the services, including a profit element, would in general be appropriate. If open market prices for the services rendered could not be found, the most common way to determine the price to be charged was to apply a cost-plus approach, i.e., the price for the services consisted of the costs plus an appropriate profit mark-up, the mark-up being dependent on the entrepreneurial risks involved for the provider of the services.

25. The developing countries considered that, while they were comfortable with that exposition of the theory, they felt themselves to be, once again, severely disadvantaged by their relative lack of access to relevant information to challenge whatever figure the multinational enterprises cared to show in the accounts for tax purposes.

26. One developing country went so far as to propose the creation of a multilateral international clearing-house for information: but the view of a majority of the Group was that it was most important that the existing bilateral provision for information exchange in the double taxation conventions should be made to operate as effectively as possible. If each tax authority were to tax an equitable share of profit, economic double taxation were to be eliminated and

international tax avoidance by means of non-arm's-length transfer pricing challenged, it was essential that administrations acted in cooperation rather than on a unilateral basis. In the absence of an international consensus on how to deal with transfer pricing there could be increased uncertainty for business and a consequent disruption of international trade. The Group thought that there was a case for the extended use of simultaneous examinations as a means of obtaining information on the activities of multinational groups, and necessary for determining appropriate transfer prices and to eliminate loss of revenue earnings from abusive transfer pricing practices. The Group also remained committed to improving the full range of competent authority procedures in order to reach agreements that would eliminate economic double taxation.

D. The Arbitration Convention

27. The Group took note of a new development. In 1990, members of the European Community (EC) signed a multilateral Convention on the Elimination of Double Taxation in Connection with the Adjustment of Profits of Associated Enterprises - the "Arbitration Convention". Once all signatories had ratified, the Convention would come into operation and would seek to prevent economic double taxation arising when transfer pricing adjustments were made in one member State while the other member State involved did not make a corresponding adjustment. The Convention would seek to achieve this by giving a company a right of appeal to the competent authority, if the company believed that the taxing authority had not observed the "arm's-length" standard. The relevant competent authority might then resolve the case by mutual agreement or, if agreement could not be reached, the Convention required the competent authorities to set up an Advisory Commission which would reach a decision on how to eliminate the double taxation. Unless they came to their own agreement, the States concerned were obliged to follow that opinion. The Group further noted that provision for binding arbitration had been included in certain recent bilateral Double Taxation Conventions. But in the absence of any experience of arbitration in practice, the Group deferred expressing an opinion on its value.

THE ARM'S LENGTH PRINCIPLE: SOME PRACTICAL METHODS OF TRANSFER PRICING

A. Comparable uncontrolled prices

28. Making a judgement whether a particular transfer price conforms to the arm's length principle would ideally require direct reference to prices in comparable transactions between enterprises independent of each other or between the group and unrelated parties. This method is frequently referred to as the "comparable uncontrolled price" method and in principle it is the most appropriate to use and in theory the easiest. In practice, however, it often happens that such evidence is not available, or it is impracticable to collect it together, or there is argument about whether the prices quoted are comparable or not. Other methods may therefore need to be used to obtain an arm's length price.

B. Cost-plus and resale methods

29. There will be many cases where no useful evidence of uncontrolled transactions will be available because, for example, the goods or services etc. which are supplied are so special to the group that there is no open market in them and they are not supplied to independent enterprises. This may be particularly the case for example for semi-finished products or in relation to transfers of technology. In other cases the transactions within the group may not be satisfactorily comparable with those between the group and independent third parties, for example, because they take place at a different stage in the chain of production or distribution or because the independent third party is too small a customer to claim the discounts for volume which an entity within the group might be big enough to achieve if it were independent. In such circumstances it will often be necessary, in order to establish an arm's length price, to use either the cost-plus method or the resale method, the cost-plus method starting from the cost of providing the goods or services etc. and adding whatever cost and profit mark-up is appropriate, and the resale price method starting from the final selling price and subtracting the cost and an appropriate profit mark-up.

C. Other methods

30. The complexities of real life business situations may put many conceptual and practical difficulties in the way of the application of the methods referred to above. A mixture of these methods, or other methods still, may sometimes therefore have to be used. Any method which is used will involve problems of judgement and the evaluation of evidence and it has to be recognized that the object of using it is to produce a figure which is acceptable for practical purposes. Experience shows that the difficulties can in general be satisfactorily dealt with and acceptable prices agreed.

D. "Global" methods

31. Proposals for radical reformulations of the approach to intra-group transfer pricing which would move away from the arm's length approach towards so-called global or direct methods of profit allocation, or towards fixing transfer prices by reference to predetermined formulae for allocating profits between affiliates, are not endorsed in this report. The use of such alternatives to the arm's length principle is incompatible in fact with articles 7 and 9 of the OECD Model Double Taxation Convention. Such methods would necessarily be arbitrary, tending to disregard market conditions as well as the particular circumstances of the individual enterprises and tending to ignore the management's own allocation of resources, thus producing an allocation of profits which may bear no sound relationship to the economic facts and inherently running the risk of allocating profits to an entity that is in truth making losses (or possibly the contrary). A number of such methods are sometimes advocated, allocating profits in some cases in proportion to their respective turnovers or to their respective labour forces, or by some formula taking account of several such criteria. They are all however to some degree arbitrary. For example, it does not follow that profit is uniformly related to cost at all stages in an integrated production and marketing process. Indeed the problem of allocating costs could well be no easier than in using the cost-plus method to arrive at arm's length price. Nor does it follow that labour costs are the same for the same labour in different countries, or that profits are necessarily related to any simple combination of such factors. To allocate profits by such methods in a way that reduced the arbitrariness of the results to a negligible degree would necessitate a complex analysis of the different functions of the various associated enterprises and a sophisticated weighing up of the different risks and profit opportunities in the various stages of manufacturing, transportation, marketing and so on. Nor would the information necessary for such an assessment be readily available or, in many cases, available at all. The need would be for full information about the total activities of the whole multinational enterprise. While the widest range of such information may be available to the tax authorities in the country of the parent company, in a group even those tax authorities will be limited to some extent in the information which they can compile. The tax authorities of the country in which a subsidiary is situated will on the other hand be in no position to acquire even this amount of information without imposing on the enterprise itself a possibly intolerable administrative burden, or a similar burden on the tax authorities of the parent company's country if they seek to get the information by way of exchange of information provisions under double taxation agreements. Nor can it be generally assumed that the tax authorities of the country of the subsidiary should in any case be entitled to quite such a wide range of information about the group's world-wide activities. In practice moreover the information may simply not be available to those authorities. Even if the information were available, however, the varied activities of any multinational enterprise and the varied circumstances and situations in which they are carried on must make it impracticable for the tax authorities of the country in which one subsidiary is situated to judge in any satisfactory manner the profitability of any of the other parts of the group situated elsewhere. Moreover, problems would still arise in the comparison of figures produced in different countries by different accounting methods and different legal requirements. Another major disadvantage of any attempt to use such global methods of profit allocation as an alternative to the arm's length principle is that their uncoordinated use by the tax authorities of several countries would involve the danger that, overall, the enterprise affected would suffer double taxation of its profits. This is not to say, however, that in seeking to arrive at the arm's length price in a range of transactions, some regard to the total

profits of the relevant enterprise may not be helpful, as a check on the assessment of the arm's length price, or in specific bilateral situations where other methods give rise to serious difficulties and the two countries concerned are able to adopt a common approach and the necessary information can be made available.

E. Minor adjustments and substitution of methods

32. The starting-point for scrutinizing transfer prices would frequently be the appearance of a discrepancy between the profits returned by an associated enterprise and those which might be expected to be made by comparable enterprises in the uncontrolled situation. Since the assessment of an arm's length price depends very often on careful judgement and the resolution of many, perhaps conflicting, considerations by negotiation between the tax authorities and the enterprise concerned, it follows that if the prices actually paid can be substantiated by acceptable evidence as being arm's length prices, there would be no justification for seeking to make merely minor or marginal adjustments to them for tax purposes. Similarly a tax authority should hesitate to disturb without good reason a pricing arrangement reasonably and consistently operated between associated enterprises if it is also reasonably and consistently operated in comparable dealings with independent parties. Moreover, as a general principle, tax authorities should base their search for an arm's length price on actual transactions and should not substitute hypothetical transactions for them, thus seeming to substitute their own commercial judgement for that of the enterprise at the time when the transactions were concluded (though there may be some circumstances where the form of transaction has effectively to be ignored).

F. Safe havens

33. At this point it may be helpful to consider whether limits of tolerance could be formulated in advance by tax authorities and made known to enterprises by what are sometimes known as safe haven rules, indicating that prices falling within certain ranges would be accepted without question. The report makes no recommendation on this topic. While such an approach may be useful to both taxpayers and tax authorities within a particular country in minimizing disputes over the determination of a proper arm's length price, such safe havens are likely to be arbitrary since they will rarely fit exactly the varying circumstances even of enterprises in the same trade or business. The minimization of this arbitrariness would be difficult and would involve a considerable expenditure of skilled labour in collecting, collating and continuously revising a pool of information about prices and pricing developments. Another point is that safe havens in one country may create difficulties in other countries and further problems would arise if it were a question of seeking to fix a safe haven range of prices acceptable to a number of countries. In any event, it would be necessary to revise periodically the range of prices or rates of interest to reflect changes in market conditions. Moreover, the general use of safe haven ranges for tax purposes could affect the prices charged in the open market. More important perhaps in practice they could open an undesirable scope for tax avoidance.

Annex II

SWITZERLAND: SOME HIGH COURT DECISIONS

34. A 1947 decision concerned the Swiss permanent establishment of a foreign company of the watch industry. Although the production was sold to independent wholesale dealers operating in the country of the head office, all goods were billed at cost to a related company of the same country acting as an intermediary. Since in the relevant commercial years export prices for watches were officially fixed (war economy) and no export permission was granted if the official prices were not paid by the final wholesale import dealers, the entire difference between the at-cost price and the official price was at first sight considered as a disguised transfer of profits. This appeared to be self-evident since the related intermediary did in fact receive from the final wholesale import dealers the official Swiss export price. The adjustment was, however, reduced by 10 per cent of the actual final turnover to remunerate the functions of the intermediary. (Unfortunately, it is not clear what the real functions of the intermediary were. This was most probably the first time where the resale price method had been applied by the country of production.)

35. A 1973 decision concerned the Swiss permanent establishment of a foreign press news corporation. The taxpayer handed in, for taxation purposes, the balance sheet and profit and loss account of the whole company. The overall result was negative and there was no suitable indication to appraise the permanent establishment's receipts. The tax authority applied therefore the instruction of 1960 and taxed 10 per cent of the administrative and other expenses incurred by the Swiss permanent establishment. Arguments of the taxpayer in order to obtain a set-off adjustment for numerous items of free-of-charge news received by the company were not accepted, because in a cost plus taxation concept this would not have had the result expected by the taxpayer. Furthermore nothing proved that the respective receipts were connected with the permanent establishment's functions.

36. A 1979 decision concerned a Swiss company acting as an international agent for the account of its 14 shareholders, all of them being wholesale import merchants of sports' articles in their respective countries. The taxpayer's policy was to charge such amounts as to cover all administrative and other general expenses without realizing any profit. The tax authorities considered that the taxpayer acted as a service company and applied the instruction of 1959. Therefore, a net profit of 10 per cent on all expenses incurred by the Swiss company was taxed. The taxpayer opposed this measurement of the taxable profit and claimed a mark-up on the much lower amount of salaries alone or even just a fair remuneration of the company's capital stock. The taxpayer suggested also the alternative of setting-off, against the original adjustment, the value of all services received free of charge from the shareholders in relation to its marketing and other commercial functions.

37. It was considered that in a system which worked on a riskless cost-sharing basis there was no reason to calculate the assessment basis by reference to costs that were not incurred by the Swiss taxpayer. The other claims of the taxpayer were also rejected since in practice the mere sum of the salaries has up to now never been taken as an assessment basis. The remuneration of the capital stock was rejected too, as it was unsuitable to measure the actual value of the functions performed. (It may seem surprising that the value of the transactions involved was not taken as a basis for calculating the agent's reward.)

38. Another 1979 decision concerned a permanent establishment of a foreign company. The Swiss permanent establishment had taken over all assets of a related Swiss company to continue the former commercial activity of that related company. Its balance sheet showed, however, an allotted capital, granted by the foreign head office, which had supposedly been entirely financed by interest-bearing advances coming from the parent company. It was not clear whether the foreign head office had more than purely formal functions. Since the Swiss permanent establishment paid to its head office a 5 per cent interest on the allotted capital, the tax authorities considered that such an interest was incompatible with general principles of taxation. Thus the interest on allotted capital was taxed as profit. The taxpayer did not contest the adjustment but required the deduction of an even higher amount to take into account the whole interest and various legal charges incurred by the head office for the benefit of this sole permanent establishment. Since the information on the direct connection between the activity in Switzerland and the charges incurred in the country of the head office was doubtful, the tax authorities refused the supplementary deductions claimed by the taxpayer.

THE GLOBALIZATION OF CAPITAL MARKETS*

INTRODUCTION

39. Capital markets are in the process of rapid evolution. Capital flows - which were formerly directed towards banks and controlled by Governments - are now held by individuals, institutions or private mutual funds and can circulate freely and instantaneously to projects which will yield the maximum profit. Electronic computerized data transmission now gives them an unprecedented mobility on all the financial markets on the planet. Moreover, the volume of such flows has grown - tripling or increasing tenfold in the past few years - mainly as a result of the success of mutual funds, whose assets often exceed those of many Governments.

40. We will examine, in turn, the current evolution of capital markets and the attempts made by Governments and international organizations to regulate them, as well as the political and economic consequences of the globalization of capital movements. Lastly, we will consider the future prospects in an attempt to find an answer to the fundamental question: Will the sole purpose of the globalization of capital markets be speculation, or can this globalization be mobilized to promote economic growth, social progress and development?

I. CURRENT EVOLUTION OF CAPITAL MARKETS

A. Previous situation

41. In the past, rivalries between nations were resolved by means of armed conflicts in which empires or ideologies clashed. Today, the wars being waged seem increasingly to be removed from the principal events taking place on the economic and financial front.

42. During the cold war, the super-Powers provided assistance in the form of official financial flows or subsidies to centralized economic systems and developing countries whose survival they ensured. Today, these flows and subsidies have been considerably reduced or have even, in some cases, disappeared, giving way to the laws of the market place which govern growth, development, employment or decline.

B. Current situation

43. Today, the main problem facing Governments is how to attract new investment with a view to creating jobs and promoting sustained economic growth. Governments compete for capital. To this end, nations vie with each other through variations in their interest rates or their rates of exchange, and through the competitiveness of their markets. The world has become capitalist and the ever-increasing financial movements can reward savings and productivity and thus strengthen a country's economy. Conversely, foreign capital can also abandon an economy or withdraw abruptly if an unfavourable fiscal policy drives it away. Speculators may attack a weak currency to weaken it still further. Capital movements may penalize unproductive expenditure and thus help to destroy a country's economy. Governments and heads of enterprises therefore strive to

---

* The original text of this paper, prepared by the United Nations Secretariat, was issued as document ST/SG/AC.8/1995/L.4.

attract this capital by offering it favourable conditions and to utilize it more productively than their rivals.

44. With the end of the cold war, official subsidies and other financial flows dried up in countries such as the Democratic People's Republic of Korea, Myanmar and Cuba, while investors preferred to steer their capital to countries where the climate was more favourable to them, such as the Republic of Korea, the Taiwan province of China and other emerging countries. Capital has thus become more mobile and more difficult to stabilize and control.

C. Demand for capital

45. During the 1990s, over 50 developing countries have created capital markets. During this period, 3 billion people have freed themselves from Marxist or government-controlled economies. These countries need capital to get their new market economies to take off. In Asia and Latin America, economies are in a state of full expansion; they must establish infrastructures and find capital to sustain their economic growth. After a period of recession, the United States of America, Europe and Japan also need capital to finance their expansion, create jobs, make good their budget deficits and privatize their State enterprises.

46. In the face of this increased demand for capital, the competition has become increasingly fierce. In order to attract these financial flows and pay a return on them without overburdening the costs of production, some countries have had to resort to lowering wages or extending the working hours. Moreover, the increasing budget deficits of the United States, Europe and Japan have triggered an additional demand for capital. The financing of these deficits has reduced the amount available to sustain the economy at the very time when it is emerging from the recession of the late 1980s. The indices already show the importance of these demands for capital: interest rates in Europe are rising while inflation is declining. Loans are becoming increasingly expensive and risk breaking the recent cycle of recovery.

47. The countries with economies in transition are also seeking capital. The dearth of capital had already led to the fall of the Soviet empire, which had been unable either to create sufficient capital or to utilize it effectively. China and India have appealed to the capital markets in order to avoid a recession.

48. In South Africa, reforms became essential when the international embargo, including the embargo on capital, led to the country's paralysis. Lastly, Argentina, abandoning its government-controlled policy, has now opened its frontiers to capital imports and has privatized its national companies (railways, highways, ports, and so on), thus bringing about the economic expansion of the country following the investment of $10 billion raised on the international capital market.

49. All these countries are feverishly engaged in establishing a complete capital market infrastructure. The first countries to achieve this will have the benefit of direct and preferential access to international investors. In this context, many countries are planning to establish derivative markets, including futures markets and options, which will allow improved coverage of risks related to stocks and shares, bonds and exchange rates. Thailand, for example, will shortly establish a currency and interest-rate futures market.

D. Supply of capital

50. Private capital is offered on the world investment market for the purchase of bonds and shares in companies and is outside government control. Where does this capital come from? Who owns or manages it? The capital comes mainly from mutual funds, pension funds or insurance funds, and, thanks to a worldwide network of computerized communications, it circulates freely in search of the maximum profits. In some cases, the managers come from Wall Street and have become international celebrities. In others, they are obscure managers of institutions such as the New York State Teachers' Pension Fund or the Robeco group in the Netherlands. More often, they are the managers of investment funds such as the Pacific Investment Management Company in California, which controls assets amounting to over $55 billion.

51. The assets of institutional investors amount to approximately $8,000 billion in the United States and $6,000 billion in Europe. At present, these funds have invested less than 1 per cent in the emerging markets. All projections indicate that investment in these markets will increase to 5-10 per cent of the total assets in the next 10 years. These investors are now convinced that the emerging markets offer higher returns than those of the industrialized countries and that the risk can be controlled by a policy of diversification. There is therefore a unique opportunity during which countries seeking capital will have access to the resources of the industrialized countries.

52. On the other hand, it will be noted that some traditional capital-exporting countries have become debtors. For instance, Saudi Arabia's petrodollars have dried up. The former Federal Republic of Germany, which in 1989 exported capital amounting to $80 billion, has been importing it in the amount of $20 billion a year since its reunification with the former German Democratic Republic.

E. Volume of capital movements

53. According to estimates, the volume of mobile international capital now amounts to $3,000 billion. This volume has tripled in three years. It currently represents three quarters of the total of the national budgets of the seven major industrial countries in the world (G-7). Moreover, capital flows to the emerging countries exceeded $200 billion in 1994, whereas they amounted to only $80 billion in 1989 (fig. I). Private capital accounts for the whole of this increase.

54. While bank loans are regulated and require guarantees from Governments, the International Monetary Fund or the World Bank, private capital circulates and can be invested almost freely.

Figure I. Capital flows to emerging countries

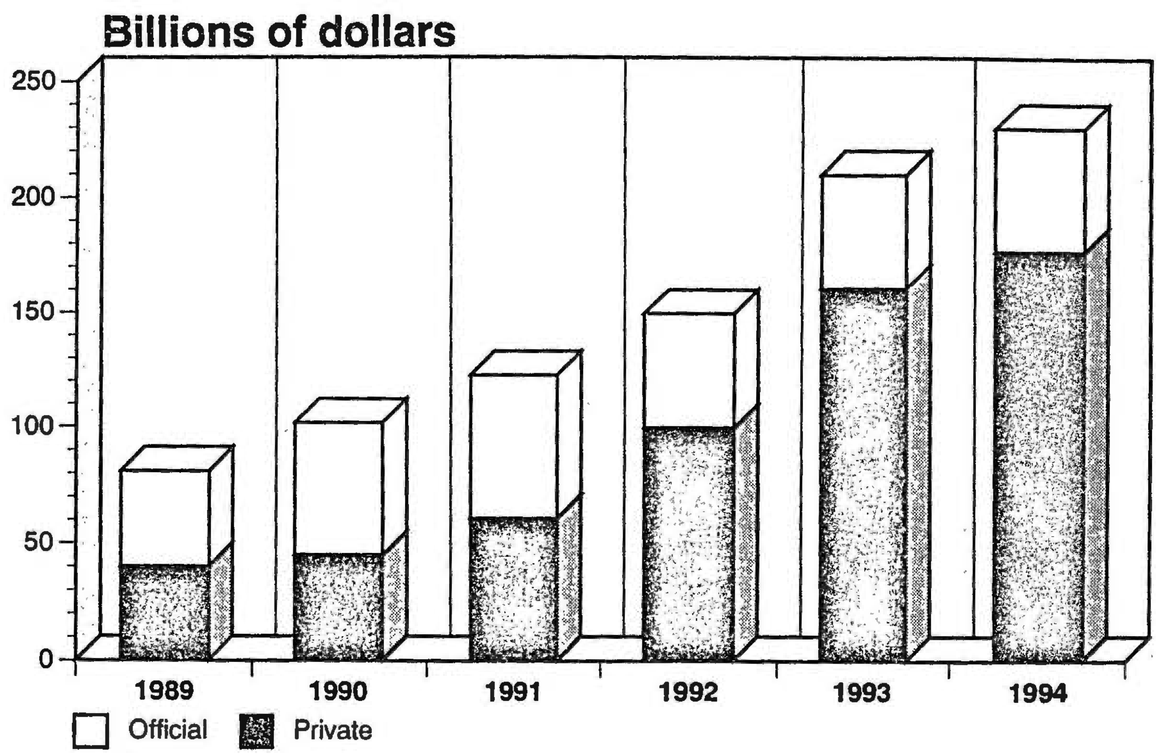
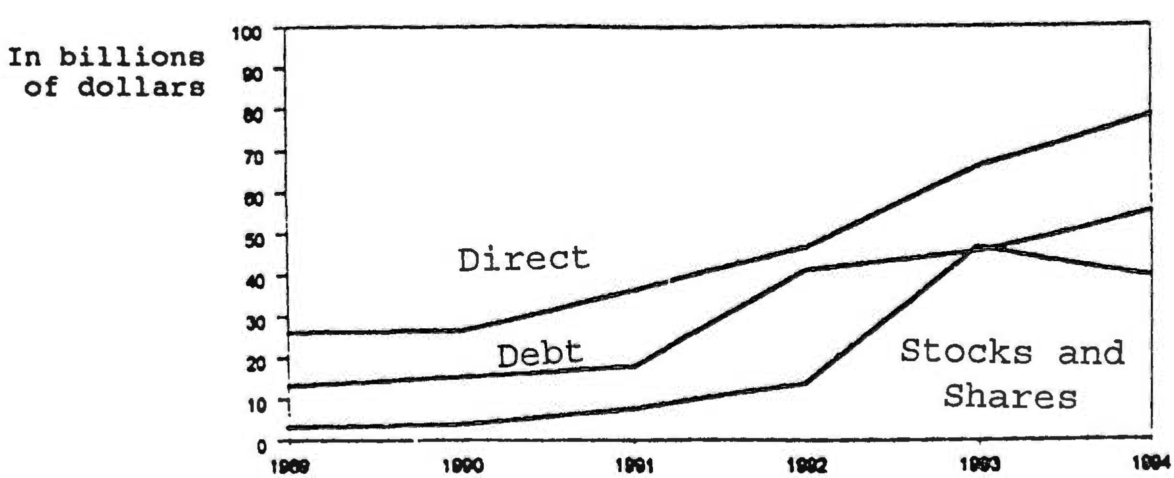


Figure II. Private capital to the emerging countries



55. The composition of capital has also evolved in recent years (fig. II). Capital is composed of direct investments, in which the purchaser retains control of the investment, loans - either bank loans or secured loans - and stocks and shares. Capital movements on the stock market have increased very rapidly and now amount to approximately $50 billion a year.

II. ATTEMPTS AT REGULATION

56. The free circulation of capital outside government control has led to the transfer of the concept of power, traditionally invested in Governments, to private holders of capital. This development explains the inability of central banks to curb the speculations which have recently attacked the value of the yen, the dollar and the European currencies. Governments have thus seen their ability to control their budgets and their capital reduced. Their fiscal resources appear to be reduced in relation to private capital and no longer allow them to make the necessary investments. The same applies to the international financial institutions, the World Bank and the International Monetary Fund, which are financed by Governments.

57. In contrast, multinational financiers, managers of private funds and directors of companies or banks tend to become increasingly powerful. Governments urge them to steer their clients' investments towards their countries: the emergence of private capital as a leading actor on the international scene marks a great turning point in the evolution of world financial management. After the Second World War, it was generally believed that Governments were responsible for the allocation of resources. Today, it is the markets which have taken over this role, thus confirming the decline in State-control or New Deal trends.

58. Moreover, until the early 1980s, Governments endeavoured to regulate the international monetary system and capital movements for fear of losing their natural capital and control over domestic economic policy.

59. Attempts at authoritarian regulation have, however, failed, as is evidenced by the collapse of the economies of totalitarian regimes and the difficulties encountered by welfare States since the late 1980s. In different ways, they are the root cause of the disasters experienced by the Soviet Union and the budgetary collapse of the West.

60. Those countries which have attempted to impose severe restrictions on capital movements have generally had to recognize the fluidity of the financial markets, which have moved towards more welcoming political centres, thus creating an offshore industry which still exists. Governments have been compelled to reduce the barriers to capital movements and, in particular, to reduce the amount of tax deducted at source on foreign investments.

61. The liberalization of trade has been accompanied by a liberalization of capital exchanges. According to some financial circles, the world capital markets have become "the International Monetary Fund of the 1990s".

62. From the standpoint of Governments responsible for controlling emerging markets, the question of the taxation of capital flows is extremely important. Such taxes can be useful if they are used to build a market infrastructure. Too high a rate of taxation, however, would drive investors away. The key is to find a proper balance which takes account of the experience of other countries. Brazil, for example, has just imposed a tax of 1 per cent on foreign investments and this has apparently not reduced the flow of capital.

III. CONSEQUENCES OF THE GLOBALIZATION OF CAPITAL MARKETS

A. Beneficial economic consequences

63. The globalization of capital has beneficial characteristics in many respects. In order to attract the capital necessary for their development, national economies must become, or remain, open to foreign investment and must adopt responsible fiscal and monetary policies.

64. A fully developed financial market also makes it possible to steer investments towards the most useful projects, and thus to acquire the indicators essential to a market economy. This development will be achieved more rapidly if foreign investors have access to the domestic market. Since Brazil opened the BOVESPA stock exchange to foreign investors, the volume of transactions has increased tenfold. Besides contributing capital, global markets also permit the transfer of essential technology which makes it possible to develop a financial market architecture.

65. The majority of Governments have made economic stability one of their highest priorities. Thus, the lowering of customs barriers has introduced competition into previously protected markets. If Governments impose excessive regulations or too high a rate of taxation, if public expenditure is too high in relation to revenue, and if the central banks destroy too many liquid assets, foreign capital will not be attracted or it will be withdrawn if it is already there. International mutual funds have become a strategic weapon in the arsenal of democracies.

B. Adverse consequences

66. The play of market forces may, however, also have adverse consequences. The decision makers and controllers of capital, indeed, turn away from States which are experiencing serious budget deficits or whose budgets are burdened by considerable social expenditure. Deficits and the absence of economic and financial reforms may dissuade capital from investing in the countries in question. The gap between rich and poor may therefore widen in the face of the exigencies of this Social Darwinism and the rigid rules of capitalist disciplines.

67. The threats confronting the welfare States do not, however, come only from abroad. Sweden, for example, owing to its generous social expenditure, currently has such a large deficit that some of its major industrial enterprises are considering moving their businesses abroad; the same applies to the United States, where the return to economic growth has given rise to fears of too rapid expansion and renewed inflation. The bond market has reacted, interest rates have risen and the currency has depreciated. In Mexico, following the assassination of the presidential candidate, capital has fled for fear of an unfavourable political climate. In China and Viet Nam, on the other hand, capital has flooded in too rapidly, bringing in its train a rise in inflation and the overvaluation of the currency.

68. Lastly, it is believed that, if Governments reduce taxes on capital movements, create offshore markets and establish a stable and convertible currency, private capital will flow in.

C. Domestic savings

69. Domestic savings are clearly the alternative solution to the call for foreign capital. Savings have, however, decreased in recent years, since prosperity has placed more consumer goods on the market. Traditionally, it was national savings that supplied the economy with investments which ensured growth and employment.

70. Today, however, Governments have difficulty in keeping these reduced savings within the country. For example, the United States is the largest exporter of capital in the world, despite a considerable budget deficit which the use of domestic savings would help to clear or to reduce; the United States deficit, however, is financed mainly by foreign capital. In Chile, Australia and Mexico, Governments have established mandatory savings plans. Since the restructuring of the pension system, the State has encouraged the development of private pensions, which have increased the rate of savings and are invested mainly in the stock market.

IV. CONCLUSIONS

71. The globalization of capital markets and the growth of trade will help to create new surpluses which could meet the world demand for capital. However, these financial resources, in search of an attractive rate of remuneration, will be invested in countries which achieve a fundamental balance in their public finances and introduce economic and financial measures aimed at reducing budget deficits and current payments, the rationalization and privatization of public enterprises, the development of private savings and of the capital market, and the liberalization of trade.

72. During the past decade, a growing number of developing countries, emerging countries and economies in transition have introduced the reforms necessary for the restoration of financial equilibrium. However, the need to attract external financial flows which could contribute to the creation of jobs and the growth of their economy required, in particular, in the context of the globalization of capital markets, a greater effort in favour of national capital markets. The development of such markets, combined with national capacity-building and the establishment of institutions connected to the international financial centres, would help to enhance the effectiveness of financial mediation in the allocation of resources, to channel external flows, and to increase and diversify the volume of medium- and long-term financial resources necessary for the economic development of these countries. Lastly, these flows, both internal and external, cannot fail to constitute a source for the mobilization of additional financial resources through appropriate taxation.

DERIVATIVE MARKETS: ECONOMIC IMPLICATION FOR TAXATION*

INTRODUCTION

73. The present report presents the economic theories that explain the role of derivatives markets and their implications for taxation. Derivatives are financial agreements whose returns are linked to, or derived from, the performance of some underlying asset, such as bonds, currencies and commodities; derivatives include forward contracts, futures, swaps and options.

74. Derivatives markets are an integral part of the financial system. They play an increasingly important role in contemporary financial markets through three key economic functions. The first is risk management. Derivative securities provide a mechanism through which investors, corporations and countries can efficiently hedge themselves against financial risks. Hedging financial risks is similar to purchasing insurance; hedging provides insurance against the adverse effect of variables over which businesses or countries have no control. The second function is called price discovery. The ability of derivatives markets to provide information about market-clearing prices is an integral component of an efficient economic system. Futures and option exchanges widely distribute equilibrium prices that reflect demand and supply conditions. Knowledge of these prices is essential in order for investors, consumers and producers to make informed decisions. The third function is providing transactional efficiency. Derivatives lower the costs of transacting in financial markets. As a result, investments become more productive and lead to a higher rate of economic growth. Therefore, derivatives bring important social benefits and contribute positively to economic development.

75. These benefits explain the enormous growth in derivatives markets, which at the latest count, amount to more than $35 trillion, not far behind the total value of securities in the world, $48 trillion. Most of this growth has occurred in the last 10 years. In addition, the recent growth in international capital flows to emerging markets suggests that derivatives markets are likely to play an important supporting role in developing economies.

76. Because these financial instruments have developed rapidly, prevailing tax rules are ill-equipped to cope with the tax problems presented by derivatives. Tax legislation now lags behind the rapid developments of commercial uses of derivatives. This has led to uncertainties in domestic and international tax treatment, which is unsatisfactory for both taxpayers and tax administrators.

77. In this context, the role of legislators and regulators is to provide a supervisory tax environment that will support a controlled growth in derivatives. In particular, this report shows that derivatives accelerate the need to harmonize tax regulations.

78. This report emphasizes the economic functions of derivatives and their implications for taxation. Many other issues arise when evaluating derivatives markets, but are outside the scope of this study. A companion report will separately analyse legal and tax issues raised by derivatives markets.

---

* The original text of this paper, prepared by Professor Philippe Jorion, consultant to the Department for Development Support and Management Services of the United Nations Secretariat, was issued as document ST/SG/AC.8/1995/L.5. Views expressed are those of the author and do not necessarily reflect those of the United Nations.

79. The report is structured as follows. Section I provides an overview of global capital markets. We describe the evolution of world stock markets and recent trends in international capital movements. These trends strongly suggest that the financial markets of developing countries are poised for long-term growth, and that derivatives markets will be essential to support this growth.

80. Section II provides an introduction to derivatives and reviews the evolution of derivative securities markets. We also briefly explain the mechanics of fundamental derivative securities. Demonstrating the economic equivalence between positions in derivatives and those in underlying cash securities is essential for taxation purposes.

81. Section III provides a comprehensive analysis of the economic role of derivatives markets. Derivatives lead to better allocation of capital within a country and to an increased accumulation of capital, which is essential to economic growth. We describe the usefulness of financial risk management systems and explain why businesses hedge financial risk. We also show how derivatives markets provide highly visible prices that can serve as benchmarks of value.

82. Section IV turns to the subject of the taxation of derivative securities. Tax neutrality implies that transactions with similar economic purposes should be taxed equally. Taxation should not penalize the use of derivatives relative to underlying cash markets. This section explores the implications of using derivatives to hedge commercial positions and to implement synthetic investment. Withholding taxes are also addressed. Another issue is whether derivatives can be viewed as potential sources of taxation revenues.

83. Finally, section V summarizes the main results and provides some concluding comments.

I. THE GLOBALIZATION OF CAPITAL MARKETS

A. Trends in recent capital flows

84. Since the 1980s, international capital markets have undergone unprecedented changes. The increased liberalization of financial markets has led to a sharp growth in the flows of cross-border investments. From the investors' viewpoint, this growth has been spurred by the search for higher returns and diversified investments. From the recipients' viewpoint, the growth has been spurred by the pressing need for capital, which is now viewed as an essential tool for long-term economic growth.

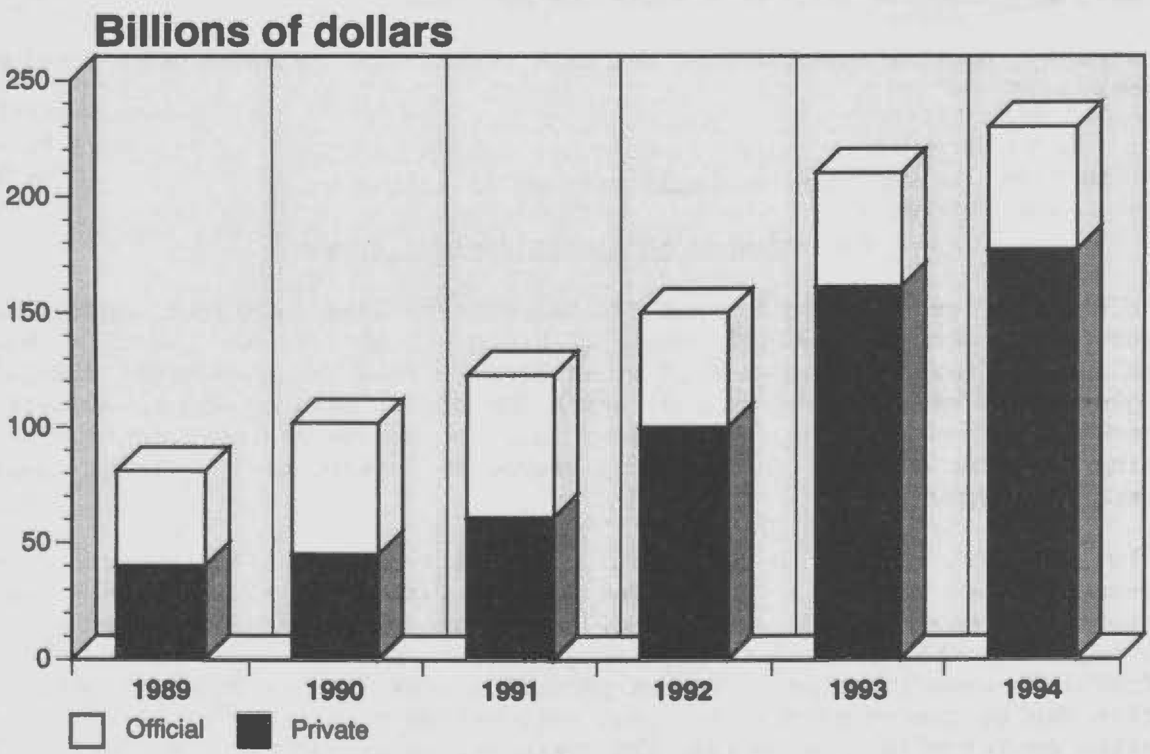
85. Let us first examine the viewpoint of investors. In recent years, there has been a marked change in the perception of mutual funds and pension funds investors, who have become convinced of the benefits accruing from foreign investing. A number of studies have shown that investing in foreign stocks is beneficial because it helps to reduce portfolio risk. These diversification benefits can be traced to the fact that national stock markets often follow different cycles - in other words, the correlations across national markets are much lower than typical correlations within markets. These arguments have been forcefully conveyed to United States of America pension funds, for instance, which have now invested $300 billion of their assets in foreign securities. This represents 8 per cent of their total assets of $4,000 billion, up from 4.5 per cent at the end of 1992. It has been reported that most United States pension funds have a target of 15-20 per cent for international investments.

This implies a further capital flow of $300 billion for United States pension funds only. Extrapolating this trend to all global investors implies capital flows of hundreds of billions of dollars.

86. From the current viewpoint of developing countries, these prospective capital flows are essential to their economic development. During the 1990s, more than 50 developing countries have created capital markets. During this period, 3 billion people have abandoned communism or command-based economies. Across the globe, eastern Europe, Asia, Latin America and much of Africa need capital to start or expand their market economies. There is also an increased realization that countries are now competing for a limited pool of global capital. China alone, for example, estimates that it will need to raise $1,000 billion in capital to satisfy its planned demand for energy over the next 20 years. Paradoxically, developed economies such as the United States and those of Europe also badly need capital to finance their public sector deficits.

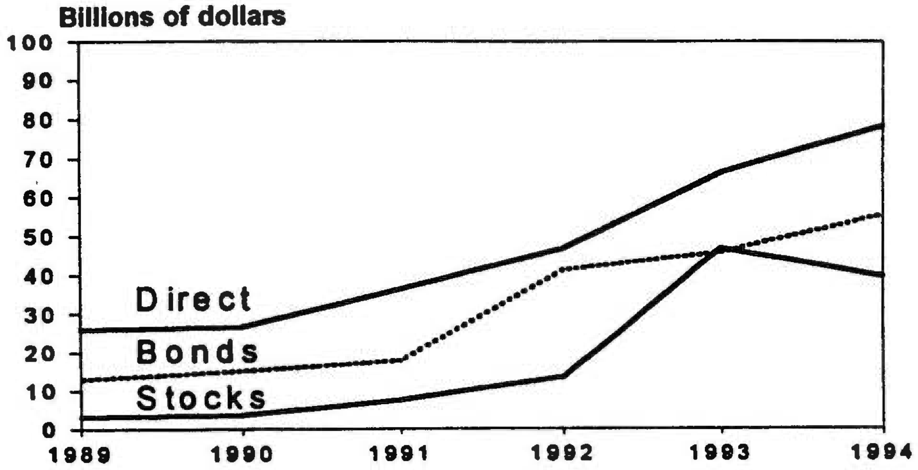
87. These trends are reflected in the changing composition of capital flows into emerging markets. Figure I breaks down these flows into private and official flows. Official flows represent official assistance programmes; private flows represent bank loans, direct investment and portfolio flows. Over the past five years, the growth of capital flows into emerging stock markets has been truly remarkable. Capital inflows have increased from $80 billion to more than $200 billion in 1994. The remarkable aspect of this growth is that it has been exclusively driven by private capital flows.

Figure I. Capital flows into emerging markets



88. The structure of private capital flows is presented in figure II. As of the end of 1994, direct investment (where the owner maintains some control over the corporation, typically defined as more than 10 per cent ownership) accounted for $80 billion. Debt inflows amounted to $55 billion. The fastest growth occurred in equity investments, which amounted to $40 billion last year.

Figure II. Private capital flows into emerging markets



89. In the near future, these flows are likely to slow down following the loss of investors' confidence due to the Mexican economic crisis. However, unless the Mexican crisis extends to many other countries, this slow-down is likely to be only temporary. Institutional investors are still targeting higher allocations to emerging markets, and developing countries still need capital.

B. Trends in global capital markets

90. Tables 1 and 2 present a summary of stock markets in developed and emerging economies. As of the end of 1994, the total capitalization of equities in developed economies was about $12,800 billion. In emerging economies, the total value of equity markets was only $970 billion.

91. The tables also compare the extent of development of the stock market in relation to the economy as measured by the gross domestic product (GDP). These numbers are aggregated in table 3, which compares stock market capitalization and GDP across broad geographical regions. For the United States, the ratio of stock market size to GDP is 77 per cent. This figure is higher is Japan, at 89 per cent, and lower in Europe, at 46 per cent. Nevertheless, the table shows that the relative size of stock markets is much lower for emerging countries, at only 29 per cent of GDP, and it is bound to increase in the future.

Table 1. Global stock markets, developed markets: market value, GDP and derivatives

	Stock market capitalization	Annual GDP	Introduction of stock index futures
	Billions of dollars		
Austria	26.9	181	August 1992
Belgium	80.9	211	September 1993
Denmark	50.8	134	December 1989
Finland	26.7	84	May 1988
France	441.8	1 253	August 1988
Germany	473.2	1 713	November 1990
Ireland	12.5	22	January 1990
Italy	158.6	1 008	December 1994
Netherlands	210.3	314	May 1987
Norway	34.1	98	September 1992
Spain	105.1	478	January 1992
Sweden	122.8	186	April 1987
Switzerland	254.9	234	November 1990
United Kingdom	1 147.1	941	May 1984
Australia	208.2	284	February 1983
Hong Kong	245.2	105	May 1986
Japan	3 747.9	4 216	September 1988
New Zealand	17.3	44	September 1991
Singapore/Malaysia	269.9	50	March 1993
Canada	303.3	588	May 1987
United States	4 900.0	6 378	April 1982
Memorandum items:			
Europe	3 145.6	6 859	
Pacific	4 488.6	4 699	
North America	5 203.3	6 966	
Total	12 837.6	18 523	

Source: Morgan Stanley Capital International for market values (December 1994), International Monetary Fund for GDP (1993) and Futures Magazine for date of introduction of stock index futures.

Table 2. Global stock markets, emerging markets: market value, GDP and derivatives

	Stock market capitalization	Annual GDP	Introduction of stock index futures
	Billions of dollars		
Taiwan, Province of China	160.2	..	
Republic of Korea	125.1	331	
Thailand	79.7	111	1995
India	65.4	263	
Philippines	30.2	54	
Indonesia	22.2	145	
China	19.3	545	
Pakistan	7.7	48	
Sri Lanka	1.7	10	
Brazil	111.5	468	February 1986
Mexico	83.1	376	
Chile	44.9	44	April 1991
Argentina	18.7	256	
Colombia	11.4	46	
Peru	5.3	41	
Venezuela	3.3	59	
South Africa	137.9	117	1987
Nigeria	2.0	37	
Zimbabwe	1.3	6	
Turkey	15.2	126	
Portugal	11.2	79	
Greece	8.0	73	
Jordan	2.8	6	
Poland	1.5	86	
Hungary	0.7	36	1995
Memorandums items:			
Far East Asia	511.5	1 507	
Latin America	278.2	1 291	
Africa	141.2	160	
Europe/Middle East	39.4	406	
Emerging markets	970.3	3 364	

Source: International Finance Corporation for market values (December 1994), International Monetary Fund for GDP (1993) and Futures Magazine for date of introduction of stock index futures.

Table 3. Global stock markets and GDP

	Stock market capitalization	Annual GDP	Ratio: stock/GDP
	Billions of dollars		(percentage)
Europe	3 146	6 859	45.9
Pacific (excluding Japan)	741	483	153.4
Japan	3 748	4 216	88.9
Canada	303	588	51.6
United States	4 900	6 378	76.8
Emerging	970	3 364	28.8
World	13 808	21 887	63.1

Source: Author's calculations.

92. Along with this growth of primary capital markets, equities, bonds and loans, derivatives have enjoyed immense success in the last 10 years. Table 1 shows that, without exception, all stock markets in developed countries have an associated derivatives market in stock index futures. Outside the United States and the United Kingdom of Great Britain and Northern Ireland, most of these markets have been created in the last five years. Table 2 also shows that these instruments are severely lacking in emerging markets.

93. Investors, used to efficient derivatives markets in developed countries, will surely require derivatives in emerging markets to better manage financial risks. As an example of the integral role that derivative securities now play in world markets, some large international investment firms will invest in only those government bonds on which futures contracts are available. They rely on the futures markets to help assure accurate pricing and as a risk management tool. Therefore, it can be expected that derivatives will experience an explosive growth in emerging markets. We now turn to a more formal analysis of derivatives markets.

II. THE DERIVATIVES MARKETS

94. Derivatives instruments have enjoyed enormous success because they allow users to disaggregate financial risks, to bear those they can manage and transfer those they are unwilling to bear. Derivatives are particularly effective risk management instruments. For taxation purpose it is essential to review the economic function of basic derivatives instruments.

A. Definition of derivatives

95. Derivatives are defined as contracts whose value "derives" from some underlying asset, such as stocks, bonds, currencies or commodities. In their purest form, derivatives include forward contracts, futures, swaps and options. These are private contracts. In contrast with a stock, issued by a company and purchased by an investor, a derivative contract is created out of thin air, and is just a private agreement between a buyer and a seller that specifies how the value of the contract evolves over time. Thus, it is a zero-sum game. Every dollar, or billion dollars, lost by one party is gained by the other.

96. Because the term "derivatives" is so general, it is very important to distinguish between different sectors of the market. Derivatives can be traded either on organized exchanges with a physical location where all trades occur, or over a decentralized network of financial institutions called the over-the-counter (OTC) market.

97. In addition, some securities such as collateralized mortgage obligations (CMOs) and "structured notes" are sometimes defined as derivatives. The mortgage market is very large, reaching $3 trillion in the United States, and is fast expanding in other countries as a means to securitize home-owner loans. Although the pay-offs on these securities is linked to some underlying variable, the primary function of the securities is to raise capital, unlike derivatives whose primary function is risk management. Therefore, such securities are not covered in this report.

98. In the United States, a wide variety of contracts are traded on organized exchanges. For instance, wheat futures are traded on the Chicago Board of Trade (CBOT), currency contracts are traded on the Chicago Mercantile Exchange (CME) and stock options are traded on the Chicago Board Options Exchange (CBOE). These are all accessible to individual investors through any broker. The OTC market includes all major commercial and investment banks, and is accessible only to large corporations or investors.

B. Basic derivatives instruments

99. There is a whole array of instruments called derivatives, but the majority constitute variations on three basic instruments: forwards/futures, swaps and options. For tax purposes, it is essential to analyse the economic relationship between the positions in these derivatives and those in the underlying assets.

1. Forwards/futures

(a) Forward contracts

100. Forward contracts are private agreements to exchange a given asset at a fixed point in the future. The terms of the contract are the quantity, date and price at which the exchange will be carried out. This price, called the forward rate, can be computed in relation in the spot rate, which is the cash price of the asset for immediate delivery. Forward contracts are traded on OTC markets and generally held until expiration. Box 1 shows how forward contracts are constructed and priced.

Box 1. Pricing forward contracts

To understand the economic implication of a forward contract, consider an agreement to buy one share (S) of International Business Machines Corporation (IBM) in one year. Assume the current price of IBM is $100, and the annual interest rate (i) is 10 per cent. Assume also that IBM pays no dividends. An investor has two alternatives, which are economically equivalent: (a) buy one share of IBM (convert $100 into one share) and hold for one year or (b) enter a forward contract to buy IBM in one year. The forward rate is set so that the initial value of the contract is zero. Since the contract costs nothing, the whole amount of $100 can be invested to earn $10 interest.

After one year, the two alternatives lead to a position in one share of IBM. Therefore, their initial cost must be identical. This implies that the forward price (F) for IBM must be $110.

A "synthetic" purchase of an asset

$$\begin{tikzcd} \text{DOLLARS NOW} \arrow[r, "i = 10 \text{ per cent}"] \arrow[d, Rightarrow, "S\ \$100"'] & \text{DOLLARS IN FUTURE} \arrow[d, "F\ \$110"] \\ \text{IBM SHARE NOW} \arrow[r, Rightarrow] & \text{IBM SHARE IN FUTURE} \end{tikzcd}$$

Such a transaction, however, has far-reaching consequences for taxes. It converts capital gains into income, and unrealized gains into realized gains.

Assume first that the IBM share is sold at the end of the year for $115. Then path (a) will generate a $15 capital gain on IBM; but path (b) creates two operations: a loan with $10 in interest, and a gain on the forward purchase of $115-$110, or $5. From an economic viewpoint, that is, without taxes, it is not important how the $15 total gain is generated. However, the tax system may tax the interest and capital gain at a different rate, thus creating distortions in the economic equivalence. Further, if IBM is not sold at the end of the year, the interest earnings under path (b) would still be taxed as ordinary income, whereas no tax would be due under path (a).

(b) <u>Futures contracts</u>

101. Futures contracts are akin to forward contracts, but are standardized and negotiable. In contrast to forwards, which are tailored to customers' needs, futures have a limited choice of expiration dates and trade in fixed contract sizes. In addition, futures offer standardization of counterparty risk, owing to the fact that an independent clearing-house acts as an intermediary in all trades. This standardization ensures an active liquid market for futures contracts. Liquidity refers to the ability to trade easily a security. As a result, few futures contracts are held until expiration. For instance, an investor who purchased a futures contract can go back to the exchange before expiration and sell the same contract, thus offsetting the initial position. Futures contracts are traded exclusively on organized exchanges.

2. Swaps

102. Swaps are agreements between two companies to exchange cash flows in the future according to a prearranged formula. Swaps can involve interest rate swaps, where fixed rate debt is exchanged for floating rate debt, or currency swaps, where one currency is exchanged against another.

103. Payments for interest rate swaps involve the exchange of interest at regular intervals. Since the notional amount is generally the same for the two sides of the swap, there is no need to exchange principal. Moreover, interest payments are generally netted against each other. For instance, in a $100 million fixed-for-floating swap, a firm would agree to receive a fixed rate of 10 per cent against a floating payment indexed to the London interbank offered rate (LIBOR). If LIBOR was currently 8 per cent, the firm would receive $10 million, and pay $8 million, for a net payment of $2 million only. Swaps may also involve lump-sum payments to compensate for an imbalance in the value of interest flows being exchanged.

104. These netting arrangements decrease the possible losses in case of default, and are now spreading to currency swaps. In the example in box 2, the Bank receives 500 million yen and pays $9 million. The net payment, at the current rate of 100 yen/dollar, would be $4 million. This netting arrangement effectively blurs the distinction between interest payments in different currencies.

105. Because swaps involve a series of future payments, they can be regarded and valued as portfolios of forward contracts. Thus they create taxation problems similar to those encountered for forward contracts.

Box 2. A currency swap

Consider two institutions that wish to borrow in different currencies. IBM, for instance, wishes to raise 10,000 million yen ($100 million at the rate of 100 yen/dollar) over 10 years; the World Bank wishes to raise $100 million over the same period in United States dollars. Respective capital costs (percentages) are given below.

	Yen	Dollar
World Bank	5.0	9.5
IBM	6.5	10.0

Note that the World Bank has access to cheaper capital in the two markets: it has an "absolute" advantage, using the parlance of international trade. However, perhaps because the World Bank has easier access to the yen market, the World Bank has a "comparative" advantage in issuing yen-denominated debt. Relative to IBM, its funding costs are 1.5 per cent cheaper in yen, and only 0.5 per cent cheaper in dollars. This provides the basis for a swap that will be to the mutual advantage of both parties. If both institutions issue funds in their final desired currency, the total cost will be 9.5 per cent (World Bank) + 6.5 per cent (IBM) = 16.0 per cent. In contrast, the total cost of raising capital where each has a comparative advantage is 5.0 per cent (World Bank) + 10.0 per cent (IBM) = 15.0 per cent. The gain to both parties from entering a swap is 16.0 per cent - 15.0 per cent = 1.0 per cent. For instance, the swap described below would split the benefit equally between the two parties.

Swap payments

Yen debt		Swap		Dollar debt
		5 per cent (yen)		
5 per cent (yen)		⇐		10 per cent (dollars)
←	World Bank		IBM	→
		9 per cent (dollars)		
		⇒		

The Bank issues yen debt at 5.0 per cent, then enters a 10-year swap whereby it promises to pay 9.0 per cent in dollars in exchange for receiving 5.0 per cent interest payments in yen. Its effective funding cost in dollars is therefore 9.0 per cent, which is less than the 9.5 per cent it would have paid in dollars. This example illustrates how institutions use swaps to lower funding costs. Since 1981, the World Bank estimates that swaps have saved $845 million in borrowing costs.

3. Options

106. Options are instruments that give their holder the right to buy or sell an asset at a specified price on or before a specified expiration date. Options to buy are call options; options to sell are put options. Because options confer a right, but not an obligation, the buyer of the option will exercise the option only if it creates a profit at expiration.

107. Since the value of an option at expiration cannot be negative, buying an option must entail an upfront payment, much like an insurance "premium". In contrast, the seller of an option receives the premium, and faces the possibility of having to make a payment in the future. Options are traded both on exchanges or OTC markets and involve either cash instruments or futures as

underlying assets. Options on interest rates are called caps or floors, and their combinations, collars.

108. Options are fundamental instruments - the "quarks" of finance - which can serve as building blocks for nearly any financial contract. Options are also very important because they appear, or hide, in many common assets such as mortgages, common stocks and convertible debt.

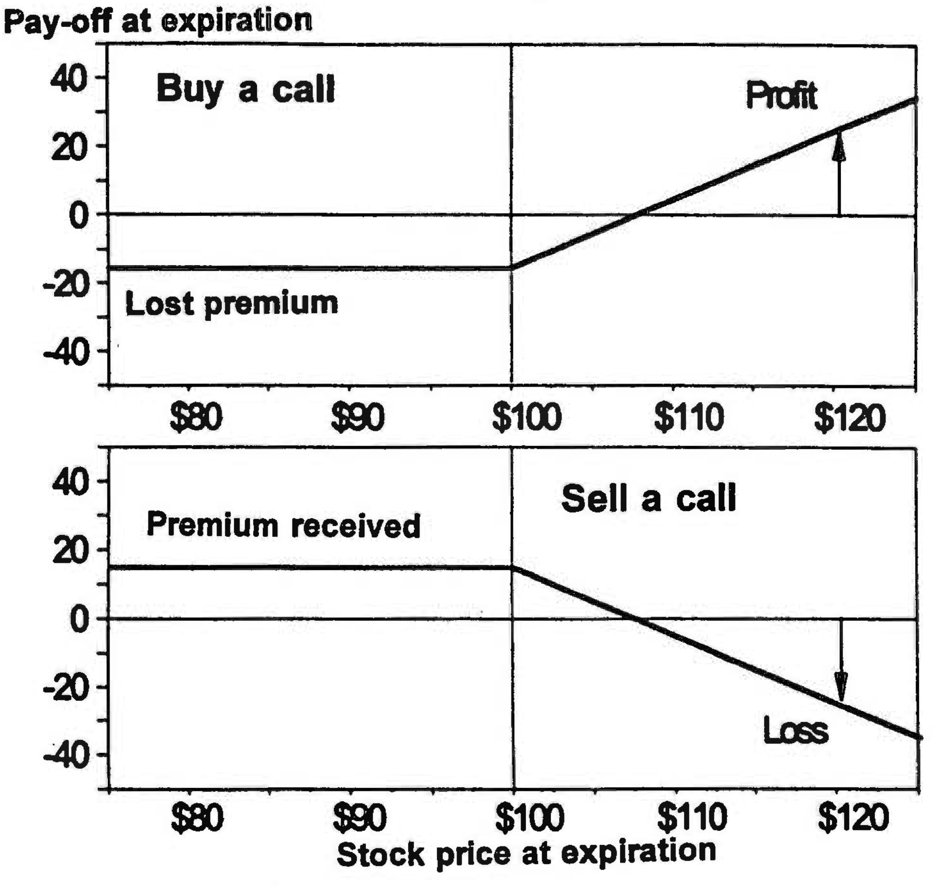
109. To see how an option works, take an option on a share of IBM, which trades at $100, with a delivery price of $100 in one year. If IBM stays below $100, the holder of the call will not exercise, since the option is not profitable. In contrast, if IBM goes to $120, the holder will exercise the right to buy at $100. He will pay $100 and acquire the stock now worth $120, for an unrealized profit of $20.

110. More generally, instead of actually buying the asset, it is sufficient to define a pay-off at expiration. For instance, the contract can specify that it will pay $20 if IBM trades at $120, and so on. The latter method is called cash settlement, and is much easier to implement for some assets. Imagine for example an option on a basket of a hundred stocks, such as the Standard and Poor's (S&P) 100 option traded on CBOE. It would be difficult to take delivery of all these stocks. Instead, cash settlement simply realizes the profit from the exercise without there having to be physical ownership of the underlying asset. From a tax viewpoint, however, cash settlement creates a realized profit.

111. Figure III displays the pay-off at expiration from a call option on IBM stock. The horizontal axis represents the future value of the stock price; the vertical axis plots the dollar pay-off at expiration. The top panel shows the pay-off from buying a call option, and the bottom panel shows the pay-off from selling a call option. Let us say that the market determines that the option premium is $15. This is a "sunk" cost, that is, payable whatever happens later.

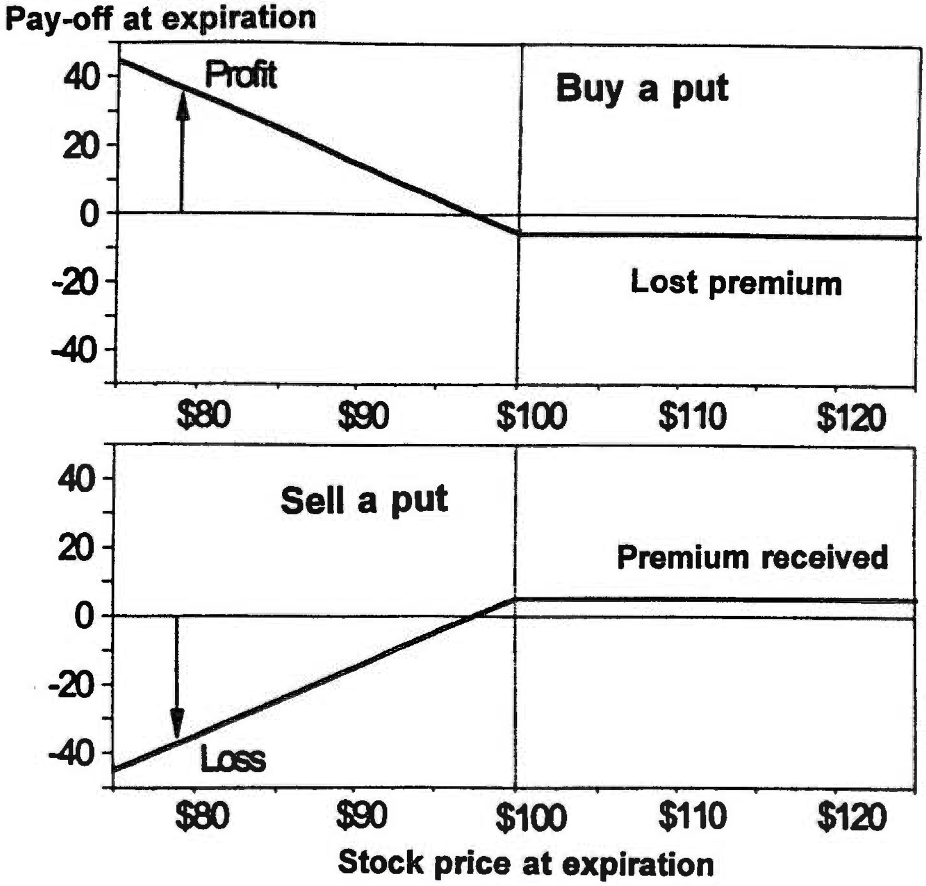
112. If prices stay lower than $100, the option will not be exercised, and its cost is the (future) value of $15. Only if prices were to go above $100 would the buyer exercise. Also note that the sum of pay-offs from buying the call and selling the call is zero, since options are private contracts. The summation of the two panels is identically zero.

Figure III. A call option



113. Next, figure IV displays the pay-off at expiration from a put option on the stock of IBM. Here, the option will be exercised if the stock price moves below $100. Thus large profits or losses occur on the down side.

Figure IV. A put option



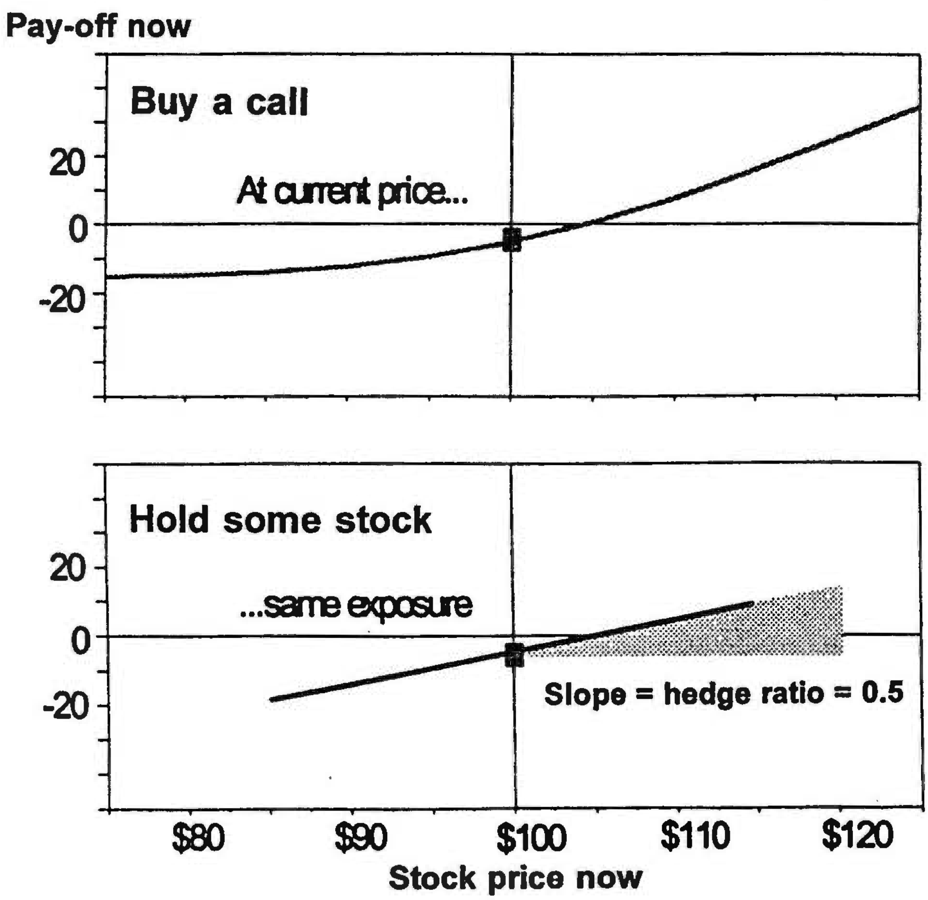
114. The graphs are instructive for a number of reasons. First, they show that positions in forward contracts or in underlying cash markets can be replicated by combinations of positions in options. For instance, buying a call and selling a put with the same strike prices and expiration are equivalent to a position in the underlying asset. This is because the combination provides the same potential for profit on the upside and for loss on the downside as holding the asset. However, even though the positions are economically equivalent, the problem is that they may be taxed differently, therefore creating opportunities for tax arbitrage.

115. The graphs also show that selling options is similar to selling insurance. The seller collects the premium, which can be profitable until a large movement occurs. Thus option values are greatly affected by the extent to which prices oscillate around their average value, that is, their volatility. Options are therefore bets on volatility.

116. When evaluating options, the issue is whether the premium is fairly priced. A major breakthrough in finance theory occurred when Professors Black and Scholes discovered a valuation formula that allowed traders to price options easily and accurately. In addition, their analysis revealed how options could be replicated by a policy of dynamic trading in the underlying asset.

117. They showed that holding a call option is equivalent to holding a fraction of the underlying asset, where the fraction dynamically changes over time. This is illustrated in figure V, which displays the current value of a call as a function of the current price. Before expiration, the value of the call is a smooth increasing function of the current stock price, and will converge to the broken lines in figure III at expiration of the contract.

Figure V. Dynamic replication of a call option



118. By dynamic hedging, the purchase of the call can be replicated by a partial position in the underlying asset. The size of the position increases when the stock price increases. It decreases as the stock price falls, as in a graduated stop-loss order. The fraction to hold is also called the hedge ratio, or "delta" (Δ), of the option. This dynamic equivalence, however, is only valid if the model and assumptions used to create the hedge ratio are correct.

119. To summarize, derivatives can generally be replicated by taking positions, either static or dynamic, in underlying cash markets. Table 4 summarizes the economic equivalence between derivatives contracts on foreign currencies and cash markets. Note that the static equivalences are perfect, except for tax consideration.

Table 4. Economic equivalence: currency derivatives

Derivative		Position in foreign currency (FC)		Position in domestic currency (DC)
Buy forward contract	=	Buy spot contract Invest FC	+ +	 Borrow DC
Buy currency swap	=	Buy spot contract Invest FC bond	+ +	 Borrow DC bond
Buy currency option	=	Buy FC in amount Δ (dynamically changing)	+	Borrow DC
Buy call, sell put	=	Buy FC	+	Borrow DC

C. Growth of derivatives markets

120. Financial innovations have been occurring for several thousand years in parallel with economic development. The earliest type of financial agreement that we know of is a loan from one person to another; without loans, separating the production decision from the consumption decision is possible only through storing goods. A loan allows more efficient use of resources, and makes both parties share the risk of crop failure. Without this arrangement, the farmer might be reluctant to commit all of his capital to farming. This financial contract thus provides a risk-sharing arrangement, which is beneficial to all involved parties. In market-based economies, financial innovations such as derivatives can be viewed as mechanisms to allocate capital efficiently and share risks.

121. The earliest options were listed on the Amsterdam Stock Exchange, opened in 1611, which was the first true market for financial securities. A major step in the evolution of derivatives markets was the opening of commodity futures exchanges in Chicago and New York during the nineteenth century. By the 1840s, Chicago had become a commercial centre for mid-western farm States. To facilitate trading in agricultural products, CBOT was established in 1848. Commodity exchanges greatly lowered the costs of aggregating, transporting, storing and processing commodities. Initially, the main purpose of CBOT was to establish quality and quantity standards for grain contracts, but this soon turned to creating contracts for delivery in the future.

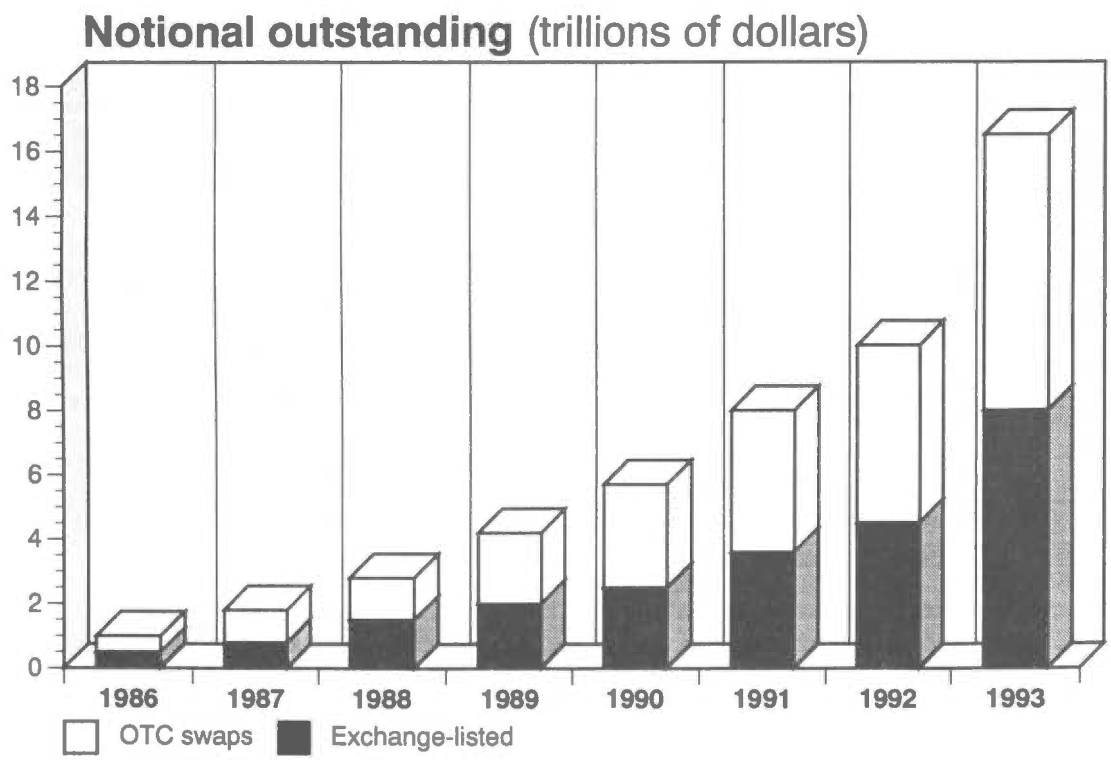
122. CBOT established general rules that formed the foundation of trading practices, which are still largely followed nowadays. For example, traders were able to offset contracts. This meant that traders did not have the obligation to deliver the grain; they could eliminate this obligation by simply selling

contracts they had previously bought. A further major development occurred in 1981, when cash settlement was allowed in the United States. Cash delivery implies that if a futures contract is held to maturity, the trader who purchased it will simply receive the difference between the spot and futures prices, paid in cash, instead of the underlying asset.

123. The 1970s witnessed further fundamental developments in derivatives markets. CME and CBOT launched futures on financial instruments at a time of increased volatility in exchange rates and interest rates. Stock options were also introduced for the first time by CBOE. Merton Miller, a recipient of the Nobel prize in economics, has called financial futures the "most significant financial innovation of the last twenty years".

124. These financial futures and options were the impetus for the explosive growth in derivatives. Futures and option exchanges are now sprouting all over the world. Figure VI displays the growth of derivatives markets from 1986 to 1993, the last year for which full data were available for OTC derivatives. The graph shows the dollar value of outstanding (existing) positions in exchange-traded derivatives and OTC swaps. From 1986 to 1993, the market grew from $1 trillion to more than $15 trillion. Most of the recent growth in futures volume has occurred outside the United States.

Figure VI. Growth of derivatives



125. The activity of these markets can also be expressed in terms of daily trading volume. About 450 million contracts are traded daily on organized exchanges. To give an idea of the amounts involved, the dollar value of the transaction volume on most stock index futures is now greater than the total volume in underlying stocks. In the OTC market, the daily trading volume is now more than $15 billion.[1]

126. Table 5 presents the latest estimates of the size of the total derivatives markets. The table is more complete than the previous graph, because it also includes OTC forwards and options. As of June 1994, derivatives markets amounted to about $35 trillion. In comparison, the total value of the stock, bond and cash markets was about $48 trillion. Thus derivatives are now about as important as the primary securities markets.

Table 5. Size of the global derivatives market
(Billions of dollars)

Exchange-traded derivatives	
Futures	
Interest-rate futures	6 440
Stock-index futures	150
Currency futures	28
Options	
Interest-rate options	3 390
Stock-index options	390
Currency options	250
Individual stock options	50
Total exchange-traded	10 698
Over-the-counter derivatives	
Forwards	
Currency forwards	9 000
Interest-rate forwards	3 500
Options	
Interest-rate options	2 000
Currency options	800
Swaps	
Interest-rate swaps	8 000
Currency swaps	1 100
Total OTC	24 400
Total derivatives	35 098
Conventional securities	
Bonds	18 600
Cash	15 500
Stocks	13 700
Total securities	47 800

Source: Author's calculations and Wall Street Journal, 25 August 1994. Data as of June 1994, except for OTC derivatives, which are recorded as of December 1993.

127. The growth of derivatives markets can be explained by two views. One is that innovation is a response to changes in the tax code and regulation. Another view is that it makes markets more complete by increasing the

opportunities for risk-sharing among investors. A study of recent innovations (Finnerty, 1988) categorized risk reallocation as a primary factor responsible for the financial innovation in a majority of cases. As can be seen from table 6, tax and regulatory reasons were a primary factor in a minority of cases.

Table 6. Factors behind introduction of derivatives

Instrument	Risk reallocation	Increased volatility	Technological innovation	Regulatory
Stock options	x		x	
Interest-rate futures	x	x	x	
Interest-rate swaps	x	x		x
Interest-rate options	x	x		
Currency futures	x		x	
Currency swaps	x	x		x
Options on futures	x	x	x	
Stock-index futures	x	x	x	

128. According to the risk-sharing viewpoint, three factors can be viewed as responsible for the growth of the derivatives market:

(a) Increased volatility in the world economy. In the 1970s and 1980s, financial asset prices became quite volatile. This was due to various factors, such as the breakdown of the fixed exchange rate system, the oil shocks, excess government spending and inflationary policies. These fundamental imbalances created a need for derivative products, which then took a permanent place in the panoply of financial instruments;

(b) Technological innovation. Technological changes have arisen from advances on two fronts: physical equipment and academic work in finance theory. On the one hand, the advent of cheaper communications and computing power has led to financial innovations, such as global 24-hour trading and on-line risk management systems. On the other hand, breakthroughs in modern finance theory have allowed institutions to create new instruments and better understand the dynamic management of financial risks. Such an instrument, for instance, is the celebrated Black-Scholes model (Black and Scholes, 1973), which is used to price and hedge options;

(c) Political developments. In the 1960s, Governments were viewed as the principal vehicle for economic growth. Widespread dissatisfaction with these policies led to major political changes in the 1970s. Those changes created a worldwide movement towards market-oriented policies and deregulation of financial markets.

III. THE ECONOMIC ROLE OF DERIVATIVES

129. The present section discusses the economic benefits of derivatives markets. We will show that derivatives markets, as part of an efficient capital market, help to stimulate economic growth and should be strongly encouraged.[2]

A. Derivatives markets and economic growth

130. As part of well-functioning capital markets, derivatives markets help to promote economic growth. Efficient capital markets ensure that resources are efficiently allocated to their most productive uses. In turn, productivity improvements are primary factors in long-term economic growth. Indeed, the empirical evidence points to a positive relationship between growth and indicators of financial development.[3]

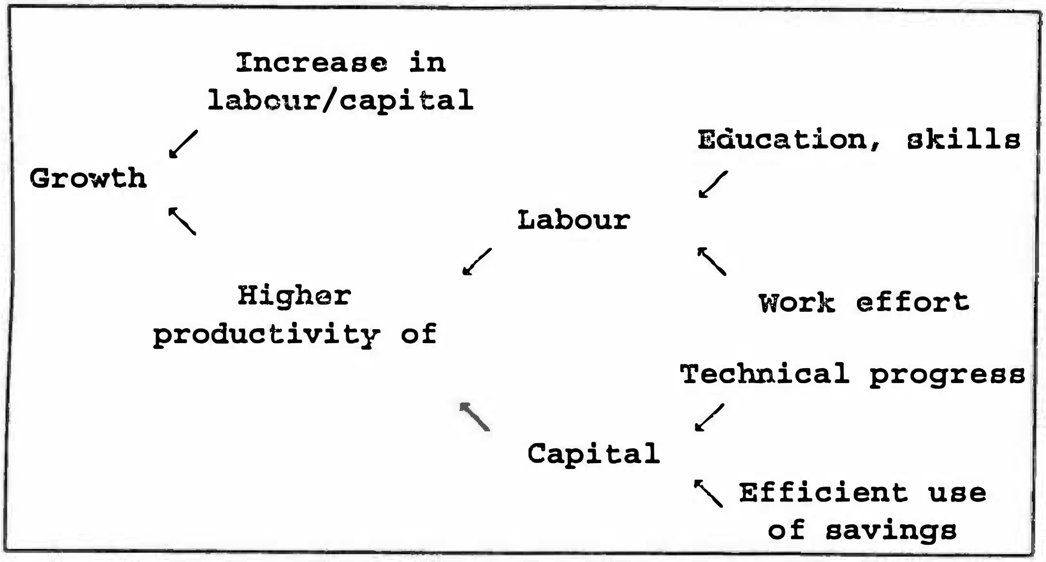
1. Finance and economic growth

131. Consider the case of Hong Kong, Japan, the Republic of Korea and Singapore. Over the last decades, these countries' growth rates in per capita income have been among the world's highest, yet they have poor land and mineral resources. The biggest difference between rich and poor countries is the efficiency with which they have used their resources. The financial system's contribution to growth precisely lies in its ability to increase efficiency.

132. Figure VII describes the factors driving economic growth. About half a country's output growth can be traced to increases in the stock of labour and capital. The other half is explained by higher productivity. More productive labour is due to better education, skills and work effort. More productive capital is due to technological development and more efficient use of capital. This is why finance is a key aspect of economic growth.

133. In a recent study, King and Levine (1993a, 1993b) analysed the effect of financial markets, using measures of intermediation (the size of commercial bank credit relative to central bank credit) and asset distribution (the relative size of credit going to private enterprises as opposed to the public sector). They found that high levels of financial development were strongly related to the growth rate of physical capital, and to efficiency. Furthermore, finance led economic growth. For a broad cross-section of countries over the period 1960-1989, they found that the level of financial development measured as of 1960, was among the most important forecasting variables for growth, coming only after secondary school enrolment. Difference in financial systems can explain differences in real growth rates of 1 per cent per annum.

Figure VII. Components of economic growth



134. An efficient financial system is critical to ensuring that prudent macroeconomic policies will translate into sustained economic growth. The architecture of a financial system for emerging economies generally proceeds along a three-step path comprising:

(a) An efficient banking system that provides a payment system as an artery for any market economy;

(b) A secondary market in financial assets, money market instruments, bonds and equities that provides a means to identify the cost of capital and to allocate capital among competing uses;

(c) A regulatory framework that ensures that capital markets function efficiently.

135. Once these steps are in place, trading in derivative instruments can take place. To price and hedge these instruments require a liquid market for the underlying asset. Most emerging economies are still in the process of building this architecture, and therefore have no derivatives markets. However, with stock markets developing rapidly all over the world, derivatives markets should be established soon. The contribution of derivatives markets to economic growth is detailed next.

2. Effects on the allocation of capital

136. Derivatives markets have a positive effect on the allocation of capital. Suppose for instance that a firm has developed a new product that might find a profitable market. In addition to the business risk of the project, the firm also faces substantial financial risks, owing to movements in inflation, in future interest payments, and possibly in foreign exchange rates. Derivatives may increase the willingness of entrepreneurs to invest in risky projects by providing them with an opportunity to be protected against financial risks. In addition, the price discovery function of derivatives markets leads to better,

more informed capital decisions. Therefore capital is directed towards more efficient uses.

3. Effects on the accumulation of capital

137. Derivatives markets also have a positive effect on the accumulation of capital. The economic growth of a country is driven by productivity improvements resulting from capital investment. In a closed economy, the total pool of investment derives from national savings. However, investment will be less than savings because of frictions, or costs, in the financial system. Reducing these frictions leads to a higher level of investment and, ultimately, of economic growth. Also, in an open economy, derivatives markets may increase the inflows of foreign capital, given that some market risks can be easily hedged, and thus lead to a higher level of investment.

138. Admittedly, there are some costs incurred in establishing derivatives markets, because productive resources are diverted to running the exchanges, executing trades and keeping records. These costs, however, must be balanced against the benefits of derivatives trading.

139. Because derivatives involve very low transaction costs, they raise the net amount of capital that can be invested in productive resources. For instance, investors may want protection against a decline in the market; instead of selling stocks, they can simply sell index futures contracts, at much lower cost. Lower transaction costs increase the net pool of savings.

140. Derivatives markets are also beneficial because of their risk-sharing function. Derivatives, for instance, help to lower the cost of raising capital. Suppose that a firm hires an investment bank to raise capital through a bond issue. The bank establishes a public offering price and underwrites the total issue, that is, commits to selling the entirety of the bonds at a fixed price. The firm then receives the proceeds from the sale minus an underwriting fee; this fee compensates for transaction costs, as well as for market risks of holding an inventory of bonds. The risk, however, can be effectively hedged through selling bond futures, thereby lowering underwriting fees to issuing corporations. This increases the pool of capital available to corporations.

B. Economic functions of derivatives

141. Derivatives markets provide three essential economic functions: risk management, price discovery and transactional efficiency. The first function refers to the ability of traders to offset financial risks through derivatives. The second refers to the better allocation of resources in the economy that is created by the wide availability of an equilibrium price that serves as a measure of value. The third function refers to the increased efficiency of transacting through derivatives. Derivatives markets reduce the costs of trading and raising capital, thereby enhancing their risk management and price discovery functions. Because of these low costs, investors can hedge financial risks efficiently, or implement "synthetic" investments with derivatives.

1. Risk management

142. Derivatives markets are important because they provide the possibility of effective risk management through hedging.[4] Hedgers use derivative contracts to

shift unwanted price risk to others - speculators who willingly assume risks in order to make profits, or traders with different risk profiles. Markets provide mechanisms to exchange not only products, but also risks. Without derivatives markets, these risks could not be managed efficiently, and the cost of risk to society would be higher. As a result, we would all be worse off.

143. In other words, derivatives are innovations in risk management, not in risk itself. Risk exists because there is uncertainty in the world. Derivatives are sometimes considered harmful instruments because they are associated with gambling. This comparison, however, is misleading, because gambling entails the assumption of newly created risks (such as in roulette and poker). In contrast, speculation entails the assumption of existing risks (such as drought and inflation risk) and must be viewed as the necessary concomitant of hedging.

144. The unbundling of risk allowed by derivatives has led to efficient risk management techniques. Risk management involves the structuring of financial contracts to produce gains (or losses) that counterbalance the losses (or gains) arising from movements in financial prices. Thus the purpose of risk management is to stabilize total profits.

145. Movements in exchange rates, for instance, affect firms involved with international trade or utilizing international financing. Consider a manufacturer of Côte d'Ivoire who finances a new investment with a franc loan. Assume that, because of barriers to trade, revenues are primarily determined in the domestic currency, the Communauté africaine financière (CFA) franc. This manufacturer has exposure to currency movements. If the local currency depreciates, profits will be adversely affected; this is because revenues will stay constant in the local currency, whereas costs will be higher owing to the higher value of franc payments. As a result, the manufacturer may go bankrupt for reasons that have nothing to do with the business.

146. In the absence of views on financial markets, there are many arguments why financial risks should be hedged. In general, hedging is useful when agents are risk-averse or when there are "frictions" (costs or taxes) in capital markets.

Risk-aversion

147. Hedging may be useful if corporations or investors prefer stable profits. Managers, for instance, may have a substantial amount of capital tied to the firm, either through ownership or through compensation plans where bonuses depend on profits. If risk-averse, they will try to hedge financial risks to reduce the volatility of firm profits. Whether this benefits shareholders is another question, especially if shareholders can diversify across many stocks and therefore do not worry as much about firm-specific risk as about market-wide risk.

148. Hedging may also be beneficial to countries that depend heavily on exports of a small number of commodities. Chile, Zambia and Zaire, for instance, rely heavily on copper exports. These countries are not well diversified, and could experience large shortfalls in revenues due to falls in commodity prices. With limited access to international capital markets, these countries might have to make deep cuts in social or infrastructural programmes.[5] Box 3 illustrates how Mexico, for example, is hedging oil price risk.

Box 3. Mexico's oil-hedging strategy

In 1990, Mexico used risk management techniques to protect its crude oil export earnings against a price fall. Mexico used options that gave the right to sell oil at a fixed price and entered forward sales of oil. Its goal was to guarantee a minimum price of $17 a barrel, the price used as the basis for its 1991 budget. The following year, as oil prices fell following the end of the Gulf war, Mexico made a profit on the financial hedges that helped to offset the decline in export earnings. This was very important, since most import expenditures were denominated in United States dollars.

It should be noted that, in this example, the financial hedge created a profit; however, this was not the purpose of the hedge. Oil prices might just as well have increased, in which case the financial hedge would have created losses; these losses, however, would have been offset by higher export earnings. Thus, the purpose of financial hedging is not to create additional profits, but rather to create stable earnings.

Taxes

149. Hedging may lower the average tax burden in situations of increasing marginal income tax rates, or when losses create insufficient tax credits. Assume a situation where, without hedging, profits can be $300 million or -$100 million with equal probability. With hedging, the dispersion of profits is reduced, for instance to either $200 million or zero. Note that in both cases, the expected profit is the same, $100 million. If profits are taxed at 40 per cent, then the expected tax (E) without hedging is 0.5 X (40 per cent of $300 million) + 0.5 X $0 = $60 million. With hedging, the expected tax (E) = 0.5 X (40 per cent of $200 million) + 0.5 X $0 = $40 million. A policy of not hedging leads to large profits in some years, taxed at high rates, and losses in other years that may not be credited against future profits; in contrast, a policy of systematic hedging will lead to stable profits. The net effect of hedging is to pay less taxes, on average.

Bankruptcy costs

150. Hedging is also useful if bankruptcy is costly. This may be the case because of direct costs such as legal fees or because the firm cannot be managed efficiently when undergoing bankruptcy proceedings. If hedging averts the possibility of bankruptcy, then hedging is useful.

Financing costs

151. When faced with the need to raise funds, a firm can use internal financing, generated by the firm's own cash flows, or external financing, such as through issuing bonds or stocks, or taking a bank loan. Hedging is useful when external financing is more costly than internally generated funds. If a firm does not hedge, there will be more variability in cash flow due to financial risk. When there is a shortfall in earnings, firms can either cut back on investments or raise funds externally. Cutting back on investments, however, may cause serious harm. If, instead, the shortfall is met by external financing, this will involve additional costs, such as underwriting fees or additional costs imposed by outside lenders. As can be seen, these costs are avoided by hedging.

2. Price discovery

152. The second major function of derivatives markets is price discovery. Price discovery is the process of providing equilibrium prices that reflect current and prospective demands on current and prospective supplies, and making these prices visible to all. As a result, derivatives markets are important not only because of the actual trading that takes place, but also because of their guidance of the rest of the economy to optimal production and consumption decisions. Futures on pollution rights, for instance, allow firms to make better investment decisions, because firms can now explicitly factor the cost of pollution into the decision to build a new plant or to close an old one.

153. Futures markets also create intertemporal price discovery, by setting prices for delivery at a series of dates in the future. Futures prices reflect current market expectations about what cash prices will be at specific points in the future. This is socially useful because it allows producers to make better production, consumption and storage decisions. For storable commodities, higher future prices signal the need for greater storage or production, thus smoothing the supply of a commodity over time and helping to avoid over- and undersupply conditions. Peck (1985) showed that stocks of corn are quite responsive to changes in storage costs implicit in futures prices; over the period 1971-1981, the United States, the only exporter with an active grain futures market, was the least destabilizing major exporter in the world market. Thus, futures markets help to stabilize prices by facilitating optimal production and storage decisions by firms.

154. Additionally, the price discovery process in beneficial for the following reasons.

Search costs

155. Exchange markets, in particular, provide highly visible prices that can serve as a benchmark of value. In theory, hedgers and speculators could trade with financial institutions. However, a search process is necessary to make sure that the proposed price is fair. Instead, by going to an exchange, one has direct access to centralized competitive trading, which ensures that the price will be fair. Thus, costly searches are avoided.

Quality differences

156. The price discovery function is also useful for commodities, for which differences in quality can lead to a multitude of cash prices. For instance, the fact that there is a wide variety of grades of oil makes it difficult to compare oil prices in different locations. Instead, crude oil futures create one reference price. In turn, this can be used to derive the fair price of other grades. Another example is that of government bond markets, where many bonds are outstanding, with different maturities and coupons. Individually, these are not in sufficient supply to support a large amount of trading. Instead, bond futures contracts create one reference price, which can be used to derive the fair value of individual bonds.

Volatility discovery

157. Another important function of options markets is the discovery of volatility, or risk of financial assets. Options are assets whose price is influenced by a number of factors, all of which are observable save for the volatility of the underlying price. Traditional option pricing models can then

be used to recover an "implied" volatility from the option price. This volatility is the market's assessment of the possible range of values for the asset price over the life of the option. This information is particularly useful for hedging decisions. For instance, knowing the volatility of exchange rates allows firms to infer a distribution of future exchange rates and assess worst-case scenarios, which is helpful in deciding whether the risk should be hedged or not.

3. Transactional efficiency

158. Derivatives markets allow institutions to transact more efficiently than would be possible otherwise. They reduce the direct cost of transacting in financial markets and also provide, through clearing-houses, an efficient mechanism to deal with counterparty risk.

Cost savings

159. Generally, derivative contracts offer greater liquidity and lower transaction costs than underlying cash markets. In addition, opening up derivatives markets allows market-makers in underlying cash markets to hedge efficiently, and appears to have enhanced liquidity in some of the cash markets. Finally, derivatives markets allow institutions to take advantage of less than perfectly competitive financial markets. Interest rate and currency swaps, for instance, are widely used by corporations to lower their cost of capital.

160. Liquidity measures the ease and speed with which transactions can be executed; it is also related to market impact, which is the adverse price movement due to the execution of a trade. A liquid market also means that customers who have positions can feel confident that they can exit the market. Assume for instance that a pension fund must purchase $100 million worth of stocks. A transaction of this size may be effected the same day in the futures market, at prevailing prices. In contrast, such a transaction in the stock market may take more time and, in addition, put upward pressure on prices, which leads to higher total costs.

161. Direct transaction costs can be broken down into commissions, fees, taxes and bid-ask spreads. In the United States, the total costs of buying and selling stocks are estimated to be about 0.90 per cent; these costs are only 0.09 per cent in futures markets. Thus, futures provide a ten-to-one transaction cost advantage over cash markets. This advantage is even greater in foreign equity markets. Costs for cash and futures are estimated at 3.10 per cent and 0.25 per cent in Japan, and 1.75 per cent and 0.50 per cent in the United Kingdom. Therefore, dealing with futures is considerably less costly than dealing in the underlying markets.

Standardization of counterparty

162. Organized exchanges with clearing-houses offer a major additional benefit relative to other markets. They essentially eliminate the credit risk of the counterparty, which leads to more efficient transactions because traders need not worry about the integrity of the counterparty.

163. After a trade on an exchange is confirmed, the clearing corporation interposes itself between all buyers and sellers and becomes the legal counterparty to all contracts. This solves the danger of trading with strangers. In turn, the clearing-house guarantees that the terms of the

contract will be fulfilled by, first, requiring the posting of a margin as collateral and, second, by marking-to-market the contract on a daily basis. Marking-to-market entails the daily settlement of gains and losses. This is particularly important in the context of growing regulatory concerns about credit or default risk.

C. The view of regulators

164. A major concern from the viewpoint of legislators and regulators are the risks posed by derivatives to the overall economy. In the last year, derivatives were blamed for a raft of colossal losses, ranging from the $1.4 billion loss of Metallgesellschaft and a $1.7 billion loss in Orange County to a $1.4 billion loss of Barings. These losses, generally due to a lack of supervision and to a very volatile financial environment, have created concerns among public officials. These losses have emphasized the need to assess critically the market exposure of all financial contracts and led to a generalized trend towards marking-to-market. For instance, the Bank for International Settlements is moving towards marking-to-market principles for banking institutions. Also, risk management systems such as the RiskMetrics system recently put forth by J. P. Morgan represent the market's response to the need for better control of financial risks.

165. A number of landmark public policy studies, however, have concluded that derivatives are socially beneficial to the economy.[6] More generally, many countries in Europe and Asia, with banking traditions very different from the United States, have created regulations that actively promote the success of derivatives markets.

166. An industry-funded report by the Group of Thirty (G30), issued in 1993, also states that derivatives activity "makes a contribution to the overall economy that may be difficult to quantify, but is nevertheless both favourable and substantial". The general view of the G30 is that derivatives do not introduce risks of a greater scale than those already present in financial markets. The G30 report also makes "best practices" recommendations for managing derivatives. Box 4 details recommendation 23, which covers the tax treatment of derivatives.

Box 4. "Tax treatment" recommendations from the Group of Thirty (G30)

In 1993, the Group of Thirty provided an authoritative review of the OTC derivatives markets. The study examined the risks associated with derivative products and gave an overview of industry practices and performance. It also provided a set of sound management practices.

The G30 noted that the tax treatment being applied to derivatives transactions dated back to before they had come into general use, which led to considerable uncertainty in determining how gains and losses should be taxed according to their uses. The following recommendation was made to legislators and regulators:

> Legislators and tax authorities are encouraged to review and, where appropriate, amend tax laws and regulations that disadvantage the use of derivatives in risk management strategies. Tax impediments include the inconsistent or uncertain tax treatment of gains and losses on the derivatives, in comparison with the gains and losses that arise from the risks being hedged.

IV. TAXATION OF DERIVATIVES

167. In developed markets, derivatives are already well established as essential risk management tools, but their taxation leads to considerable uncertainty. As noted by the G30 report, the tax treatment being applied to derivatives transactions dates back to before they came into general use. Derivatives will inevitably also appear in many emerging markets, where regulators can benefit from the experience of developed countries.

168. The economic theory developed in the previous section has shown that derivatives are particularly effective tools for risk management. They can be used in two functions: hedging and synthetic investments. Hedging involves a simultaneous position in a cash market and in a derivative instrument. Synthetic investment involves a position using derivatives that replicates a cash position.

169. The ultimate goal of a tax system is tax equity and neutrality. Equity, or fairness, implies that different individuals or corporations should be taxed equally; so should transactions with similar economic purposes. Neutrality implies that the tax system should not bias investment decisions towards less productive purposes that have a tax advantage. Taxation should not penalize the use of derivatives relative to underlying cash markets. Therefore, derivatives must be taxed as they would be if transactions were undertaken in the actual cash market. As we show, this principle has implications for withholding taxes.

170. Across countries, there is a wide variety of methods used to tax financial futures. Some countries tax profits and losses on futures as ordinary income, some as capital gains and losses. In addition to differences in taxation rates, countries also differ with respect to the time at which profits and losses on financial futures are recognized. Three principles seem to be used:

(a) Realization principle, under which profits and losses are recognized at the closing or expiration of the contract;

(b) Mark-to-market principle, under which profits and losses are recognized during the year that the position is held open;

(c) Matching principle, under which profits and losses are recognized at the same time as a hedge item.

The matching principle best meets the goals of neutrality towards hedging transactions. The realization principle meets the goal of neutrality between positions in synthetic instruments and those in actual cash markets.

171. Another issue is whether derivatives can be viewed as potential sources of taxation revenues. This appears tempting since the taxes will be mainly borne by foreign investors. The issue of the impact of taxes, however, must be very carefully addressed because derivatives markets thrive on low transaction costs. This issue is addressed in a later section.

A. Hedging transactions

172. Hedging transactions involves a simultaneous position in the cash market (either actual or anticipated), and in a derivatives contract. The purpose of hedging is to create a pattern of cash flows that offsets the pattern of cash flow on the underlying market. To be an effective hedge, the derivatives transaction must be treated in a manner consistent with the taxation of the underlying transaction. Many users of derivatives markets (40 per cent of end-users surveyed in the G30 report) indicate that the inconsistency of tax treatment of hedges is a major concern.

1. Tax treatment of hedges

173. Corporations and investors should be able to identify a particular derivatives transaction as a "hedging transaction". In this case, the derivatives transaction should be taxed:

(a) At the same rate as the underlying position;

(b) At the expiration of the hedge.

Differences in tax rates could cause a perfect pre-tax hedge to be imperfect after tax, and differences in the timing of tax payment will involve additional costs. These two principles will ensure that the transaction minimizes the variability of after-tax cash flows, which is the primary objective of hedging.

174. Even if the derivatives instrument is a futures contract, which is marked-to-market daily, the realization of gains and losses should be deferred until the hedging transaction is complete. This transforms a realized profit on the futures contract into an unrealized profit until the end of the hedge.

2. Straddles

175. This distinction between realized and unrealized profits is particularly important for "straddles". Straddles involve offsetting positions in two contracts that are highly correlated, but are not designated as hedges. They can be used as tax shelter devices to realize losses in one year and defer gains

in another year. Straddles, for instance, can involve positions in stocks and options tied to similar securities.

176. A typical example is a long position in a stock covered by the sale of a call option that is "deep-in-the-money". Going back to figure V, this corresponds to the case where the current price is well above the exercise price of $100. In this situation, the option price moves in a one-to-one ratio with the stock price (its hedge ratio is close to one). Because the correlation between the option return and stock return is close to perfect, the net position is close to riskless, yet one leg can be used to realize losses in one year. Box 5 illustrates a case where two forward contracts can be used to create straddles.

Box 5. Using a straddle to defer tax payments

This hypothetical situation illustrates how forward contracts on a foreign currency, the deutsche mark (DM), can be used to construct a straddle. In November 1995, an investor buys a DM forward contract expiring in March 1996 and sells a DM June 1996 contract. He is said to be "long" the March contract and "short" the June contract. These positions can be achieved for instance in the futures market, with only a small margin as down payment.

The value of the two contracts is derived from movements in the spot exchange rate. As a result, the two contract values are highly correlated. If the DM appreciates relative to the dollar before the end of the year, one contract will show a gain, the other a loss.

By December 1995, the trader could realize the loss on the losing side by closing the short DM March contract. The remaining exposure can then be hedged by opening a new short position in a DM September 1996 contract. These operations effectively create a realized loss in the current year, while postponing the gain to the next year.

177. Taking losses on such straddles is disallowed under United States tax rules. The basic principle is that realized losses cannot be taken if there exists an unrealized gain on the open end of the straddle, as is the case for a hedge.

B. "Synthetic" investments

178. Derivatives can also be used to create patterns of pay-offs similar to those in the underlying cash markets, before taxes. Again, economic efficiency dictates that the taxation level be similar for transactions in cash or derivatives markets. Taxation, however, may pose difficulties if capital gains taxes differ too much from ordinary income tax rates, or if capital gains are taxed at different rates depending on whether they are short-term or long-term. This is because derivatives contracts may blur the distinction between capital gain and income. This is illustrated using two common instruments.

1. Forward contracts

179. The economic function of a forward contract is to fix a price in the future. Consider for instance a United States investor who can invest for one year either in United States dollars at an 8 per cent rate or, synthetically, through a covered investment in Japanese yen. The spot rate is 100 yen per dollar and yen deposits return a low rate of 2 per cent. By interest parity, the forward rate must be set at

$$100\,x\,\frac{1+2\,per\ cent}{1+8\,per\ cent}=94.4$$

This forward rate ensures that, before taxes, an investment in one-year dollar deposits or in one-year covered yen deposits has the same return. Defining r_{US} as the dollar interest rate, r_Y as the yen interest rate and S and F as the spot and forward rates, we have $1 + r_{US} = (S/F)(1 + r_Y)$.

A synthetic investment

	i = 8 per cent	
DOLLARS NOW	→	DOLLARS IN ONE YEAR
S ⇓ 100 yen		F ⇑ 94.4 yen
YEN NOW	⇒	YEN IN ONE YEAR
	i* = 2 per cent	

180. Discrepancies can arise, however, if part of the transaction is taxed at a capital gains rate that differs from the ordinary income tax rate. For such investors, a lower rate of taxation can be obtained by investing in covered yen. Define τ_I as the income tax rate and τ_G as the capital gains tax rate. After taxes, the dollar investment will return

$$r_{US}(1 - \tau_I)$$

and the yen investment

$$r_Y(1-\tau_I) + \frac{S-F}{F}(1+r_Y)(1-\tau_G)$$

where the last term represents the after-tax capital gain on the forward contract.

181. Most countries tax capital gains at a lower rate than ordinary income. Suppose that the return on the forward contract is taxed at the capital gains rate $\tau_G = 28$ per cent; the tax rate on ordinary income is $\tau_I = 40$ per cent. With the same numbers as before, the after-tax returns on a million dollar investment will be, respectively,

$1,000,000 x [8 per cent (1 - 0.40)] = $48,000

and

$$\$1{,}000{,}000 \, x \, [2 \, per \, cent \, (1-0.40) + \frac{100-94.4}{94.4} \, (1+2 \, per \, cent) \, (1-0.28)] = \$58{,}000.$$

The covered yen investment therefore presents a tax arbitrage opportunity since the return is $10,000 higher after taxes than from investing in dollars. More generally, if forward contracts are priced on a before-tax basis, investors with favourable capital gain tax treatment will prefer investments denominated in currencies with low nominal interest rates. Conversely, borrowers will prefer to borrow in currencies with high nominal interest rates.

182. This arbitrage can be avoided by taxing the forward contract as ordinary income. Also, for financial institutions for which foreign exchange gains and losses are part of the "normal conduct of business", there is no tax arbitrage opportunity.

2. Stock index futures contracts

183. Stock index futures are used extensively by portfolio managers as substitutes for investing in the underlying cash markets. These contracts can be used:

(a) To protect a portfolio of selected stocks against general market downturns;

(b) To synthetically hold stocks in a national market;

(c) To implement tactical asset allocation models, where positions are rapidly changed either across national stock markets, or between stocks and bonds within a country.

Given that futures are much cheaper to use than underlying cash instruments, typically by a factor of at least 10 to 1, and much more liquid, portfolio managers now routinely use futures as part of their regular panoply of financial instruments.

184. Using futures instead of the underlying stock market is also quite convenient because the initial cash investment is minimal, as it is typically limited to the margin. Take for instance a United States investor who wants to invest $100 million in Brazilian stocks. The exposure can be achieved by buying IBOVESPA stock index futures contracts worth a notional $100 million. Perhaps $5 million will be required as margin.

185. In the mean time, the investor has full use of the remaining $95 million, which can be invested short-term (a) in the Brazilian currency, or (b) in United States dollars. In the first case, the investor has full exposure to the foreign currency. In the second case, the investor has effectively hedged against movements in the exchange rate.

186. The taxation of stock index futures, however, also raises difficult issues. Assume that, over a year, the stock market returns 15 per cent, of which 3 per cent is due to dividends. An investor in the stock market would then pay ordinary income tax on the dividend payment, and capital gains tax on the 12 per cent capital appreciation if realized. An equivalent position can be achieved by buying stock index futures, and investing the cash equivalent in a short-term deposit. If the short-term rate is 5 per cent, the futures contract will increase in value by 15 per cent-5 per cent = 10 per cent over the year.

Thus, the capital gain tax will apply to the 10 per cent appreciation only. The 5 per cent cash return will be taxed at the ordinary income tax rate.

187. To maintain the economic equivalence between positions in cash and futures markets, tax rates must be applied equally to both markets. For instance, if foreigners are exempt from capital gains taxes on the cash market, futures profits should not be taxed either. Any attempt to tax futures will simply choke off the stock index futures market.

C. Withholding taxes

188. Cross-border portfolio incomes originate from interest on deposits or bonds and from corporate dividends. For countries that apply the residence principle to taxation, the world-wide income of investors is taxed at their place of residence. Therefore, there is no need for withholding taxes because all income is ultimately subject to taxation.

189. This principle breaks down, however, if some foreign source income is not reported. In this situation, tax evasion can be addressed by exchange of information and cooperation between tax agencies. These mechanisms, however, are imperfect. Also, some countries try to gain a comparative advantage by creating "tax havens" in an attempt to lure foreign investors with very low or zero tax rates.

190. Because of these difficulties, withholding taxes may be applied to income going to non-residents as a second-best attempt at taxation. Statutory rates may be lowered through bilateral taxation agreements with countries that either enforce taxation of foreign income or are not considered tax havens.

191. In theory, this does not constitute double taxation as long as:

(a) The withholding tax rate is lower than the final rate of taxation;

(b) The withholding tax can be taken as a credit against final taxes;

(c) The definition and attribution of income are consistent across tax jurisdictions.

Therefore withholding taxes can be viewed as a second-best attempt to provide a level playing-field for global investors. It should be noted, however, that some investors such as United States pension funds, which are a driving force behind international investments, are not liable to domestic income taxes. Therefore, pension funds have a preference towards investments that allow them to avoid paying withholding taxes.

192. Derivatives instruments, for instance, can be used to avoid paying withholding taxes. In the previous example of stock index futures, the entire dividend is subsumed in the appreciation of the futures contract, and is therefore not subject to a withholding tax. No country currently imposes withholding taxes on payments to non-residents arising from domestic trades in financial futures contracts.

D. Tax revenues

193. An important issue, especially for developing countries, is whether tax revenues can be extracted from derivatives markets. When evaluating the potential for revenue generation from taxes, however, one must keep in mind the response of market participants.

194. A transaction tax, for instance, looks appealing because of the potential large volume of transactions. Transaction tax revenues can be written as

$$R = \tau\ (P + \Delta P)(Q + \Delta Q) + \Delta OR$$

which says that revenues are obtained from the tax rate τ times the transaction price (including the price change ΔP due to the tax) times the volume of trading (including the volume change ΔQ due to the tax) plus the change in other tax revenue (ΔOR) due to the imposition of the tax.

195. Transaction taxes have been proposed as recently as in 1990 in the United States, when there was a proposal to tax all transactions in the secondary market for equities at a 0.5 per cent rate. Initially, the "static" evaluation of tax revenues was estimated from

$$R = \tau\ (P)(Q)$$

which assumes no change in the behaviour of market participants. Using this approach, it was estimated that, based on an annual volume of trading of $2,200 billion, the tax would bring in $11 billion annually.

196. This number was severely flawed, however, for a number of reasons. First, the tax would have reduced the level of stock prices (ΔP). This is because the price of an asset represents the present value of future benefits to the holder; transaction costs reduce the flow of benefits and increase the discount rate owing to the loss of liquidity. It has been estimated that a 0.5 per cent tax would reduce stock prices by 35 per cent.[7]

197. Second, the volume of trading would have been reduced (ΔQ). Experience shows that investors react to a transaction tax either by shifting trading to markets with similar instruments that are less heavily taxed, or by reducing the volume of trading. Typically, a 0.5 per cent tax reduces volume by 30 per cent. Box 6 illustrates the Swedish experience in transaction taxes.

198. Third, the tax lowers capital gains receipts because of less frequent realization of lower profits (ΔOR). Overall, the net revenues from the tax were likely to be $5 billion, which was much lower than the static $11 billion estimate.[8] The lessons from this experience are that the use of static tax models can lead to substantial overestimates of potential tax revenues.

199. The United States derivatives industry voiced strong opposition to a transaction tax, because its very existence was at stake. The transaction tax would have severely reduced the cost-effectiveness of derivatives. Assume for instance that trading in stock index futures costs 0.1 per cent, versus 1 per cent in the cash markets. Imposing a transaction tax of 0.5 per cent would have increased the cost of trading futures by a fivefold factor. This would have had a devastating effect on futures trading in the United States. Many investors would simply have shifted trading to London, where futures trading is not subject to such taxation. The transaction tax was never passed.

Box 6. The Swedish experience with transaction taxes

Sweden started to impose transaction taxes on equities in 1984, partly to raise revenues and partly to penalize a financial service sector that was viewed as "unproductive and antisocial". The taxes reached 2 per cent of the principal for round-trip trades. As a result, the volume of trading in Swedish shares fell in Sweden, and moved to London and New York.

Then, in 1987, a transaction tax was also imposed on money market instruments, with the goal of reducing "socially worthless activities". The tax was applied to fixed-income securities including derivatives, and reached a maximum of 0.15 per cent of the face amount. As a result, trading in futures on bonds and bills fell by 98 per cent. In the cash market, trading was shifted to similar debt instruments that were not taxed.

Beginning in 1989, the political climate started to change. The taxes had raised disappointing revenues, and had increased the cost of government borrowing. On 1 December 1991, all remaining transaction taxes were eliminated.

200. The effect of taxation must also be viewed in the context of global competition for new products. When creating a successful product, the first mover achieves liquidity and economies of scales that are hard to replicate, because they lead to a dominant position. Excessive government regulation or taxation can also drive a market to another country. Once established abroad, these markets may be difficult to dislodge because investors are attracted to liquidity.[9]

V. CONCLUSIONS

201. In the last decade, derivatives markets have revolutionized the management of financial risks. As part of the expanding range of financial services made possible by technological innovations, derivatives provide unparalleled leveraging and hedging opportunities. They also create important additional social benefits, such as the dissemination of uniform prices based upon which investment decisions can be made, and the lowering of transaction costs in capital markets. All of these have positive effects on the allocation and accumulation of capital and contribute to higher economic growth. Derivatives markets will also support international capital flows, which are essential to developing countries. The general consensus is that derivatives should be encouraged, provided their use is accompanied by appropriate risk management policies.

202. Derivatives, which used to be the exclusive practice of developing economies, are now becoming a global phenomenon. Many developing countries are now considering establishing futures and options markets. To support an orderly growth of the derivatives market, it is essential to ensure that taxation policies do not hinder or differentially affect global capital flows. From the preceding discussion, two broad conclusions emerge.

203. First, tax neutrality implies that transactions with similar economic purposes should be taxed equally. Taxation should not penalize the use of derivatives relative to underlying cash markets. Also, derivatives transactions entered for the purpose of hedging a particular commercial transaction should be

taxed in a manner that is consistent with the taxation of the commercial transaction. Thus, the most important recommendation is that countries contemplating opening futures markets should implement tax legislation that provides for the recognition of gains and losses at the same time that a loss or profit on a hedged item is recognized and at the same rate.

204. Second, the revenue-generating potential of taxes on derivatives must be very carefully reviewed since derivatives thrive on low transaction costs, and could be driven to foreign markets if taxation is excessive. The creation of offshore markets would deny the local economy many of the benefits of a locally established and regulated derivatives market.

Notes

[1] For a survey of the recent evolution in global derivatives markets, see E. Remolona, "The recent growth in financial derivative markets", Federal Reserve of New York Quarterly Review, vol. 17 (1993), pp. 28-43.

[2] For a further analysis of the economic function of derivatives, and their implications for the Brazilian economy, see P. Jorion, The Importance of Derivative Securities Markets to Modern Finance (Chicago, Illinois, Catalyst Institute, 1995).

[3] See, for instance, the review in M. Pagano, "Financial markets and growth: an overview", European Economic Review, vol. 37 (1993), pp. 613-622.

[4] For a survey of how firms in developing countries manage risk, see J. Glen, How Firms in Developing Countries Manage Risks, International Finance Corporation Discussion Paper, No. 17 (Washington, D.C., World Bank, 1993).

[5] M. Debatisse and others, Risk Management in Liberalizing Economies: Issues of Access to Food and Agricultural Futures and Options Markets, World Bank Technical Report, 12220 ECA (Washington, D.C., World Bank, 1993), provide a comprehensive survey of risk management techniques by developing countries. They report very little recorded use of commodity futures by developing countries.

[6] See Board of Governors of the Federal Reserve, Commodity Futures Trading Commission and Securities and Exchange Commission, A Study of the Effects on the Economy of Trading in Futures and Options (Washington, D.C., 1984) and reports from the United States Congress (Safety and Soundness Issues Related to Bank Derivatives (Washington, D.C., 1994), and the United States General Accounting Office (Financial Derivatives: Actions Needed to Protect the Financial System (Washington, D.C., 1994)).

[7] In another example of the impact of taxes on prices, the Israeli Government approved a 20 per cent capital-gains tax on stock transactions in August 1994. The Stock Market fell by 10 per cent upon the making of the announcement.

[8] See Hubbard in Securities Transaction Taxes: False Hopes and Unintended Consequences (Chicago, Illinois, Irwin, 1995).

[9] A case in point is the Japanese financial markets, where trading activity in derivatives is actively discouraged by the Ministry of Finance. As a result, a substantial proportion of trading on the Nikkei 225 stock index futures has shifted to Singapore. The Japanese derivatives markets are the only ones in the world to have experienced a sharp decline in transaction volume over the last few years.

References

Black, F. and M. Scholes (1973). The pricing of options and corporate liabilities. Journal of Political Economy, vol. 81, pp. 637-659.

Board of Governors of the Federal Reserve, Commodity Futures Trading Commission and Securities and Exchange Commission (1984). A Study of the Effects on the Economy of Trading in Futures and Options. Washington, D.C.

Caprio, G. and others (1992). Financial Reform: Theory and Experience. Washington, D.C.: World Bank.

Debatisse, M. and others (1993). Risk Management in Liberalizing Economies: Issues of Access to Food and Agricultural Futures and Options Markets. World Bank Technical Report (12220 ECA). Washington, D.C.: World Bank.

Finnerty, J. (1988). Financial engineering in corporate finance: an overview. Financial Management, vol. 17, pp. 14-33.

Glen, J. (1993). How Firms in Developing Countries Manage Risks. International Finance Corporation Discussion Paper, No. 17. Washington, D.C.: World Bank.

Group of Thirty (1993). Derivatives: Practices and Principles. New York, New York: Group of Thirty.

Hammond, S. (1995). Securities Transaction Taxes: False Hopes and Unintended Consequences. Chicago, Illinois: Irwin.

Jorion, P. (1995). The Importance of Derivative Securities Markets to Modern Finance. Chicago, Illinois: Catalyst Institute.

________ and S. Khoury (1995). Financial Risk Management: Domestic and International Dimensions. Cambridge, Massachusetts: Blackwell.

King, R. and R. Levine (1993a). Finance and growth - Schumpeter might be right. Quarterly Journal of Economics, vol. 108, pp. 717-737.

______________________ (1993b). Finance, entrepreneurship and growth: theory and evidence. Journal of Monetary Economics, vol. 32, pp. 513-542.

Miller, M. (1991). Financial Innovations and Market Volatility. Cambridge, Massachusetts: Blackwell.

Organisation for Economic Cooperation and Development (1993). Taxation of New Financial Instruments. Paris: OECD.

Pagano, M. (1993). Financial markets and growth: an overview. European Economic Review, vol. 37, pp. 613-622.

Peck, A. (1985). Futures Markets: Their Economic Role. Washington, D.C.: American Enterprise Institute for Public Policy Research.

Remolona, E. (1993). The recent growth in financial derivative markets. Federal Reserve of New York Quarterly Review, vol. 17, pp. 28-43.

Schoenfeld, S. and others (1994). Emerging Futures and Options Markets: An Overview of Issues and Prospects in Developing Countries. Washington, D.C.: International Finance Corporation.

Tanzi, V. (1995). Taxation in an Integrating World. Washington, D.C.: The Brookings Institution.

United States Congress (1994). Safety and Soundness Issues Related to Bank Derivatives. Washington, D.C.

United States General Accounting Office (1994). Financial Derivatives: Actions Needed to Protect the Financial System. Washington, D.C.

World Bank (1990). Financial Systems and Development. Policy and Research Series, No. 15. Washington, D.C.: World Bank.

TAXATION OF DERIVATIVES AND NEW FINANCIAL INSTRUMENTS*

INTRODUCTION

205. This paper examines alternatives for taxing derivatives and other newer financial products. Section I discusses the treatment of holders and issuers of bonds issued at discount. Sections II, III and IV discuss the taxation of parties to the three basic types of financial derivatives - options, futures and forward contracts, and notional principal contracts, including swaps. Section V examines the issue of straddles whether special rules should be provided to curb tax avoidance strategies using offsetting positions. Section VI discusses tax problems arising from the use of derivatives and other financial instruments to produce synthetic instruments - combinations of instruments that yield financial results substantially identical to those of a type of instrument different from the constituent elements of the synthetic instrument. Section VII discusses the taxation of financial instruments used to hedge business and investment risks. Whereas sections I through VII focus primarily on issues a Government faces in developing its domestic tax laws on financial products, section VIII examines issues of international taxation affecting derivatives - the issues peculiarly arising when the parties to a financial instrument are residents of different countries.

206. Frequent reference is made to the laws of the United States, which has the most highly developed system of tax rules on financial instruments, including derivatives. The extensive United States response to financial innovation has at least two causes. First, highly developed markets for financial instruments of all sorts have a longer history in the United States than in most other countries. Taxpayer demand for guidance on the taxation of new financial instruments thus arose earlier and with greater intensity in the United States than in many other countries. Secondly, in the United States, political attitudes about taxation generally favour the taxation of all economic income from capital and vigorous responses to tax-avoidance strategies. In many respects, United States law represents the outer limits of what a country might do to attack the tax problems presented by financial innovation.

I. DISCOUNT BONDS

207. When an instrument is issued at a discount from its face value, the return to the instrument's holder, and the issuer's borrowing cost, include the amount of the discount as well as any periodic payments designated as interest in the instrument. Annual investment returns and borrowing costs are realistically reflected only if the discount accrues for tax purposes more or less as it accrues economically. Interest is compensation for the use of money and accrues solely by the passage of time. All compensation for the use of money - that is, all amounts that predictably accrue to the holder of a debt obligation solely by the passage of time - should be accrued for tax purposes in an economically realistic manner, whether those amounts are stated as interest in the instrument or take some other form, such as discount on the obligation's issuance.

---

* The original text of this paper, prepared by Professor Lawrence Lokken, Consultant to the Department for Development Support and Management Services, was issued as document ST/SG/AC.8/1995/L.6. Views expressed are those of the author and do not necessarily reflect those of the United Nations.

208. In the United States, original issue discount is accrued for tax purposes by a constant interest method, which is described below. Two alternatives to this method - ratable accrual and delaying the recognition of discount income and expenses until maturity or until the holder sells the instrument - are discussed thereafter.

A. Constant interest method

209. Under the constant interest method, the issuer and holder of a discount obligation annually accrue a portion of the discount as interest expense and income. This portion is computed by applying a constant interest rate against the sum of the issue price and all prior accruals of discount. If periodic interest payments are made on the obligation, each accrual of discount is reduced by the amount of interest payable for that period.

210. To illustrate the application of the constant interest method to a zero-coupon bond, assume a corporation organized, managed, and operating in country x issues a bond providing for a single payment of 10,000u (10,000 units of country x's currency) five years after the issue date; the bond is purchased by a country x investor at the issue price of 6,139u. The yield to maturity is 10 per cent compounded semi-annually.[10] If the discount of 3,861u is accrued on a constant interest basis, the accrual for the first six months in the bond's term is 307u (one half of 10 per cent of 6,139u), for the second six months it is 322u (one half of 10 per cent of the sum of 6,139u and the first interest accrual of 307u), and so forth throughout the bond's term. If a six-month accrual period begins in one taxable year and ends in the next, the discount accrued for the period if prorated on a daily basis.

211. To illustrate the application of the constant interest method to an interest-bearing bond, assume interest of 300u is payable each six months under a five-year, 10,000u bond. If the market rate of interest is 10 per cent when the bond is issued, the issue price is 8,456u (the present value at 10 per cent of semi-annual payments of 300u each for five years and 10,000u at the end of those five years). The discount accrual for the first six months is 123u (one half of 10 per cent of the issue price of 8,456u, less the interest of 300u); for the second six months, the accrual is 129u (one half of 10 per cent of the sum of 8,456u and 123u, less 300u).

212. An advantage of the constant interest method is that it conforms reasonably well to market forces. In the examples, if the prevailing interest rate remains at 10 per cent, the sum of the issue price and all interest accruals will always equal the bond's fair market value. In the first example, the fair market value of the bond at the end of the first year will be 6,768u (the present value at 10 per cent compounded semi-annually of 10,000u payable in four years), and the sum of the issue price and the interest accruals for the first year will also be 6,768u (the sum of 6,139u, 307u, and 322u). Thus, any gain or loss realized by a holder on a sale of the bond before maturity is largely true capital gain or loss-gain or loss resulting from a shift in market values, not from the mere passage of time.

213. A disadvantage of the constant interest method is that its administration is complex. Issuers and holders of discount obligations must annually recognize interest expense and income computed by a methodology that is unfamiliar to many investors. However, for most corporate debt, the complexity is not especially burdensome if issuers are required to report interests income to their bond holders and to the tax administration. Corporations typically have accounting

staff who can do constant interest calculations with little effort. Bondholders need only report on their tax returns the amounts reported by the issuer.

214. A criticism sometimes made of the constant interest method is that notwithstanding its relative complexity, it is not exact.[11] In the absence of any change in market rates of interest, a discount bond's market value usually is not identical to the sum of the issue price and prior discount accruals because the assumption of a constant yield to maturity does not fully conform to market behaviours. Typically, the market rate of interest is lower for a shorter-term obligation than for an otherwise identical longer-term instrument (although the opposite is occasionally true, usually for only brief periods of time). For example, the market rate of interest might be 10 per cent for five-year instruments and 9.8 per cent for four-year instruments. The bond in the first example is a five-year instrument when issued, but is a four-year instrument one year later. Thus, if market rates remain unchanged, the instrument's fair market value after one year is 6,820u (the present value at 9.8 per cent compounded semi-annually of 10,000u payable in four years). If the holder sells the bond after one year, gain is recognized of 52u (selling price of 6,820u, less the 6,768u sum of the holder's cost and income accruals).

215. This gain results solely from the passage of time and, in theory, should be accrued as interest, rather than being deferred until the instrument is sold. However, whereas the constant interest method can be applied solely from basic facts of the instrument (the issue price and the amount of time of each payment), a more precise calculation of the accrual could be made only with market data about the term structure of interest, which often is not available. Thus, the constant interest assumption, although inexact, is probably the only practical means of approximating economic reality.

216. Another disadvantage of the constant interest method is that it often taxes bondholders on interest income long before they receive any cash under the bond. However, since interest-bearing bonds are widely available, investors who lack the means to pay tax on accrued but unpaid discount can simply not invest in discount bonds, and the tax on accrued discount probably has little distortive effect on the market.

B. Alternatives to constant interest method

217. There are two obvious alternatives to the constant interest method - accruing discount on a straight line basis, and recognizing discount only as it is paid. Recall the first example used above, where a 10,000u, five-year zero-coupon bond is issued for 6,139u, producing a yield to maturity of 10 per cent compounded semi-annually. The discount of 3,861u might either be allocated ratably to each of 10 six-month accrual periods, 368u to each period. For most instruments, ratable accrual recognizes discount more rapidly than the constant interest method. In the example, the discount accrual for the first six months is 368u by ratable accrual and 307u by the constant interest method. Alternatively, the entire discount might be recognized when the bond is paid at maturity or, for holders who sell their bonds before maturity, when the bond is sold.

218. The advantages of ratable accrual are few. Computationally, it is simpler than current interest method, but the computations under the constant interest method are not especially difficult, particularly if issuers are required to inform bondholders annually of the amounts of accrued discount. The more substantial objections to the constant interest - deriving principally from the

fact that holders are taxed on amounts not received in cash - apply equally to ratable accrual.

219. Tax administration and compliance are simplified by recognizing discount only at maturity or on a sale of a discount bond. However, if capital gains are taxed differently from other income, this solution may not be as simple as first appears. Since discount income is a substitute for interest income, it should be taxed as ordinary income, not as capital gain. Thus, if gains on redemptions and sales of bonds are generally treated as capital gain, the portion of a gain on sale that represents accrued discount must be separated from the remainder of the gain, and this can be done only by the discount accrual mechanisms described earlier.

220. If bondholders and issuers treat discount consistently and are taxed at the same rates, tax revenues are not affected by a Government's choice between the various alternative treatments of bond discount. However, tax revenues can be severely depleted by rules on discount bonds that treat holders and issuers differently. For example, a tempting solution to the discount problem is to allow issuers to accrue discount as interest expense, while permitting holders to defer recognition of discount income until maturity, on the theory that large businesses are well equipped to do the computations but investors often are not. In the first example, this solution allows the issuer of the zero-coupon bond a deduction for discount expense of 307u for the first six months of the bond's term and taxes this amount to the holder only at maturity. If issuer and holder are both taxed at 30 per cent, the Government is out 92u (30 per cent of 307u) for four and one half years. If the Government borrows at 10 per cent, the cost of the holder's deferral of the discount income for this six-month period alone is 51u (measured as of the instrument's maturity).[12] Lesser, but significant, losses accrue to the Government for each of the remaining accrual periods in the bond's life.

C. Complications in international investments

221. Taxing discount income is particularly difficult when the holder of the bond is not a resident of the issuer's home country. Investment income is usually taxed in the country of source (typically, in the case of debt instruments, the issuer's country of residence) by withholding taxes. Among OECD countries, a minority (five of 22) attempt to impose withholding taxes on discount income of non-resident holders of discount bonds, and all but one of these countries considers discount income to be subject to the interest article of their income tax treaties.[13]

222. Withholding taxes on discount income are probably not practical. Tax can be withheld only from payments, not from accruals. Moreover, withholding taxes are typically not imposed on gains on sales of investments, largely because it is usually not feasible for the buyer or a broker to measure the seller's gain and because a withholding tax on gross sales proceeds would impede investment flows. A requirement that resident purchasers of discount bonds from non-residents withhold tax on discount income is especially problematical, because purchasers usually do not have knowledge of several facts crucial to the computation of the non-resident's discount income.[14]

223. If an interest-bearing bond is issued at a discount, tax on discount income can be withheld from the interest, so long as the withholding tax on the interest and discount income does not exceed the interest.[15] However, there is

no feasible means of withholding tax from discount accruals on zero-coupon bonds.

224. The issuer can be required to withhold tax on the discount income at maturity.[16] However, if resident investors are taxed on discount income on an accrual basis, rather than at maturity, requiring withholding from non-resident holders at maturity is futile unless a mechanism is developed for withholding tax on discount income when a non-resident sells a discount bond. If a non-resident holding a discount bond to maturity is taxed on discount income, but a non-resident selling a discount bond before maturity is not taxed, non-residents have a strong incentive to sell their discount bonds, rather than holding them to maturity. Economically, there is little difference to an investor between a sale shortly before maturity and a payment from the issuer at maturity. The result is that foreign investors are subject to tax only if poorly advised.

II. OPTIONS

225. Options come in two common varieties - options to buy (calls), and options to sell (puts). Since an option gives the holder a benefit without any obligation, the holder usually pays a premium to the issuer (writer) of the option when the option is issued. The amount of the premium is a function of the option price, the period for which the option will remain open, and the volatility of market prices for the underlying property. Since the issuer holds the premium during the option's term, the time value of money is also a factor affecting the market pricing of an option. An option may have a cash settlement feature, under which the option obligation is settled by a cash payment on the option's expiration date, rather than by an actual purchase or sale of the underlying property.

226. In many countries, standardized options are issued and traded on established options markets. Other options are individually designed in negotiations between the holder and issuer.

227. Three courses of action are open to holders of options: exercise the option by buying or selling the optioned property, let the option expire unexercised, or dispose of the option before it expires, either by selling it or by entering into a closing transaction with the issuer that effectively cancels the option. Tax rules on options must provide for all of these possibilities.

228. Countries vary in their tax treatments of options. Under one approach, which is generally followed in the United States, an option has no tax consequence to the holder or issuer until it is exercised, closed out, or lapses, when the results are as follows:

(a) Exercise. If a call option is exercised, the option premium is included in the holder's cost for the property acquired and the issuer's amount realized in the sale. For example, if a premium of 100*u* is paid for an option to purchase 1,000 shares of X Corp. stock for 5*u* per share and the option is subsequently exercised, the holder's cost for the stock is 5,100*u* (sum of the option premium of 100*u* and the exercise price of 5,000*u*), and the issuer of the option is treated as selling the stock for the same amount. If a put option is exercised, the premium is included in the selling price realized by the holder on the sale and in the issuer's cost of the property acquired in the transaction;

(b) Lapse or sale. If an option expires unexercised, the premium is then included in the issuer's taxable income and allowed as a deduction to the holder. If the holder sells the option before its expiration, gain or loss is recognized equal to the difference between the sales proceeds and the premium paid. If the holder and issuer close out the option, each party recognizes gain or loss equal to the net amount paid or received, including both the option premium and any payment made in the closing transaction. In the United States, gain or loss on the expiration or disposition of an option is usually capital gain unless the option is held or issued in the ordinary course of the taxpayer's trade or business.[17]

229. In other countries, the issuer is taxed on the option premium when it is received, and the exercise of the option, if it occurs, is treated as an independent transaction in which the issuer's sales or purchase price is the amount received or paid on exercise, exclusive of the option premium.[18] If the issuer enters into a closing transaction with the holder, any amount paid or received by the issuer in that transaction is gain or loss, recognized at the time of the closing.

230. Under the latter system, the holder is not typically allowed a deduction for the premium when it is paid, but recognizes gain or loss when the option is exercised.[19] Under a call option (option to buy), the holder has gain or loss on exercise equal to the difference between the value of the property at that time and the total of the holder's cost, including both the option premium and the amount paid on exercise of the option. Under a put option (option to sell), the holder's gain or loss on exercise is the difference between value of the property and the net amount received for it (the amount received on exercise, less the option premium). If the option expires unexercised, the holder is then allowed a deduction for the premium. If the holder disposes of the option, gain or loss is recognized equal to the difference between the amount received in the sale or closing transaction and the premium paid.

231. Neither of these approaches is without problems. The first approach, which links the option with the transaction occurring if and when the option is exercised, ignores the time-value-of-money advantage that the issuer enjoys by holding the premium during the option's term. As a result, options can be used to avoid rules requiring the accrual of interest income (including bond discount).

232. The first approach is also vulnerable to the use of straddles for avoiding tax. Assume A buys a call option on shares of the stock of X Corp. and simultaneously sells a call option on the same number of shares at the same option (strike) price, but with a slightly different maturity date. Apart from transaction costs, the premium paid on the first option approximately equals the premium received on the second, and any gain or loss on either option will be offset by a virtually identical loss or gain on the other. However, if the values of the options change at all, A might sell or close out the losing option near the end of the tax year, and replace it with a third option differing only slightly in maturity date from the option retained from the original two. This year-end manoeuvre has little effect on A's economic position, but it produces a deductible loss that will not be offset by taxable income until the options mature or are closed out during the following year. The result is a one-year deferral of tax. The straddle problem is discussed further in section V below.

233. Under the second approach, where the option is considered independent of the underlying property, the issuer is usually taxed on the option premium when it is received, while the holder is not permitted any allowance for the premium

before the option is exercised or disposed of or lapses. The result is favourable for the Government, and this approach effectively discourages at least some uses of options straddle transactions. However, it discourages option transactions generally, and contradicts economic reality. An option premium resembles an insurance premium, and a tax on option premium when received is like a tax on gross insurance premiums, making no allowance for the possibility of losses.

234. The United States uses a third approach for holders of "non-equity options" - exchange-traded options on property other than individual stocks.[20] Unless the option is identified as part of a hedging transaction, the holder of such an option is subject to a mark-to-market regime under which gain or loss is recognized annually equal to the difference between the premium paid and the option's value at the end of the year (adjusted for gain or loss recognized under this rule in preceding years). This approach avoids the deferral opportunities of the first approach and also avoids taxing issuers of options on receipts that have not fully accrued as income. However, the approach works well only for options traded on an active market providing realistic daily price quotes.

235. A fourth approach applies in the United States to options that have been identified as hedges. The treatment of hedging transactions is discussed more fully in section VII below.

236. Payments under option contracts are usually not subject to withholding taxes when made to residents of other countries.[21]

III. FUTURES AND FORWARDS

237. A futures or forward contract is a contract to buy and sell something for a stipulated price at a designated future date. The subject of the contract may be a physical commodity (e.g., wheat or pork bellies), a currency, or a financial instrument. The subject can also be a market index or floating interest rate. The term "futures" is generally reserved for contracts traded in organized markets, subject to extensive regulation. A "forward" is a contract made outside an organized market. Under futures contracts (also called exchange-traded contracts), the exchange clearing-house is effectively the counterparty to all contracts. Under forward contracts (also called over-the-counter contracts), the counterparty is usually a bank or other financial institution.

238. Because the rights and obligations under a futures or forward contract are mutual, it is not common for either party to pay a premium to the other when the contract is made.[22] However, exchange-traded contracts typically require each party to a contract to make a margin deposit with the exchange. The margin is initially 1 per cent to 5 per cent of the amount of the contract, but it is adjusted daily under a mark-to-market procedure by which each party's margin account is increased or decreased by the amount by which the contract's value changed from the preceding day.

239. Although futures and forward contracts usually provide for physical delivery of the underlying item, they are often closed out before the delivery date or settled for cash on the delivery date.[23] Some contracts provide exclusively for cash settlement, rather than physical delivery. A closing transaction or cash settlement consists of a cash payment by the losing party to the gaining party equal (in the case of a cash settlement) to the difference

between the spot market price for the underlying item on the delivery or settlement date and the contract price.

240. The relationship between the spot and forward price of an item is a function of the time value of money (including both interest and storage costs for physical commodities). For example, if the futures price of wheat exceeds the sum of the spot price and the cost of carrying the wheat to the settlement date, arbitragers can profit by making futures contracts to sell and covering their obligations under the contracts by buying wheat at the spot price and holding it for delivery under the futures. Arbitrage transactions thus keep the spot and forward prices near time-value equilibrium. The forward rate under a currency contract is a function of spot exchange rate and the prevailing interest rates on obligations issued in the two currencies.

241. Futures and forwards can be used as highly leveraged vehicles for speculation. For example, if the initial margin is 1 per cent of the contract amount, a futures contract is a means for reaping the entire benefit of a rise in the market price of an item with an investment of 1 per cent of the item's value. The risk of loss is equally great.

242. More often, futures and forwards are used for hedging. For example, if a person owns property and intends to sell it at a particular time in the future, the person can protect against declines in the property's market value by making a futures or forward contract to sell. Conversely, if a person anticipates a need to purchase property at a particular future time, a futures or forward contract to buy protects the person against the risk of rises in the market price.

243. Countries vary widely in their treatment of futures and forwards, but three basic approaches - a realization approach, a mark-to-market approach, and a matching approach for hedging transactions - predominate.

244. Under a realization approach, neither party to a contract recognizes gain or loss until the contract is concluded or disposed of by a sale, closing transaction, cash settlement, or delivery at maturity. On a sale, closing transaction, or cash settlement, each party recognizes gain or loss equal to the amount received or paid. On a physical delivery, the selling party has gain or loss equal to the difference between the amount received and the seller's cost or other tax basis for the property sold, and the buying party's cost for the property is the contract price.

245. Under the mark-to-market approach, gain or loss on a contract outstanding at the end of a taxable year is recognized in an amount equal to the contract's fair market value on the last day of the year, appropriately adjusted for any gain or loss recognized on the contract for earlier years. For contracts sold or closed out during the year, the gain or loss is the amount paid or received, adjusted for gain or loss recognized for earlier years. For exchange-traded contracts, the mark-to-market approach is facilitated by the fact that the contracts are marked-to-market daily by the exchange.

246. Under the matching approach, which is described more fully below in section VII, the tax treatment of a contract held as a hedge is coordinated with the taxation of the position being hedged.

247. The United States uses all of these approaches. The realization approach is the general rule. However, the mark-to-market approach usually applies to foreign currency contracts traded in the interbank market and to regulated

futures contracts (contracts that are traded on a national securities exchange or a board of trade regulated by the Commodity Futures Trading Commission and that are marked-to-market daily under exchange or board rules).[24] The matching approach applies to a contract held as a hedge, whether it would otherwise be subject to the realization or mark-to-market rules, if the hedge is identified in the taxpayer's records when the contract is made.

248. Payments and other transfers under futures and forward contracts are usually not subject to withholding taxes when made to residents of other countries.[25]

IV. NOTIONAL PRINCIPAL CONTRACTS

249. A notional principal contract is an instrument requiring one party to the contract to make payments to the other, and perhaps vice versa, in amounts calculated by applying a specified rate or index to a "notional" principal amount. An example is an interest rate swap under which for a particular period (say, five years), A agrees to make quarterly payments on 1,000u to B at the 90-day London Interbank Offered Rate (LIBOR) as of the date of payment, and B agrees to make simultaneous payments to A of 25u each (one fourth of 10 per cent of 1,000u). Because the payments in this case are simultaneous, they are offset, and only one payment of the net amount is made each quarter. However, the payments need not be simultaneous. For example, A might be required to make quarterly payments, while B's obligation might be annual, in which case netting is possible only for one set of payments each year.

250. Notional principal contracts can be made as speculations on market changes, but they are more often used to hedge market risks. B might make the contract in the example because it has borrowed 1,000u at a variable interest rate tied to the LIBOR and wants to eliminate the risk of interest rate fluctuation. B's variable interest payments under the loan will be offset by the variable payments it receives from A under the swap, and B's ultimate obligation consists of the payments at 10 per cent fixed interest to A under the contract. A might be an investment bank that will lay off the risk in another transaction. Alternatively, B might be an investment bank, and A might be an investor that holds a 1,000u bond paying interest at the LIBOR, but wants instead to receive interest at a fixed rate. Typically, a notional principal contract is made by a company or investor with a financial institution. The financial institution usually attempts to hold a balanced portfolio of contracts in which offsetting positions effectively eliminate all market risk. Occasionally, a financial institution acts as broker in making a notional principal contract between two customers.

251. Other notional principal contracts include the following:

(a) Other types of swaps, including

(i) Equity swaps: A pays amounts equal to the dividends on 100 shares of X stock, B pays amounts equal to the dividends on 100 Y shares, and the parties exchange payments at maturity equal to the values at that time of the notional amounts of stock;

(ii) Commodity swaps: for five years, A annually pays 100u to B, and B pays to A 40 times the price of a bushel of corn on the payment date;

(iii) Currency swaps: for five years, A annually pays $100 to B and B simultaneously pays 1,000u to A;

(iv) Basis swaps: one party's payments are based on one index and the other's on another index;

(b) Cap - one party makes periodic payments equal to a notional principal amount times the excess (if any) of a particular varying rate or index over a stipulated fixed rate, and the counterparty makes a single payment when the contract is made or a series of fixed payments. For example, suppose A, who has borrowed 1,000u at the 90-day LIBOR, is willing to absorb the risk of limited increases of the LIBOR but wants to be protected in the event the LIBOR rises above 10 per cent. To do so, A buys a cap from B under which B agrees to make a payment to A each quarter equal to one fourth of the product of 1,000u and any excess of the LIBOR for the quarter over 10 per cent;

(c) Floor - same as a cap, except that the periodic payment is the notional principal amount times the excess of the fixed rate over the variable rate (e.g., 1,000u times the number of percentage points by which the LIBOR on the payment date is less than 5 per cent). A floor might be purchased by an investor who, for example, holds a 1,000u bond paying interest at the 90-day LIBOR and who is generally willing to bear the risk of interest rate fluctuation but wants to be protected against the possibility of the LIBOR falling below 5 per cent;

(d) Collar - one party is simultaneously the recipient of the periodic payments under a cap and the payor of the periodic payments under a floor, or vice versa.

252. The basic payments under a notional principal contract are periodic, but one of the parties may make a lump-sum payment when the contract is made, at the end of the contract period, or at some other time. For example, under a cap or a floor, one party usually makes a single fixed payment, and the other party assumes an obligation to make periodic payments. Also, a swap, where both parties make periodic payments, may be off-market, in which case the party benefiting from the market deviation makes a compensating payment to the other in addition to that party's periodic payments under the agreement. Assume the market equates variable rate interest at the 90-day LIBOR with a five-year fixed rate of 11 per cent, but A and B make a five-year agreement to swap the 90-day LIBOR for fixed interest at 10 per cent. A and B will agree that the party making the fixed payments must also make a lump-sum payment, probably when the contract is made, to compensate for the below-market rate of the fixed payments. If the fixed interest payments are at, say, 12 per cent, the compensating lump-sum payment would be made by the payor of the variable payments.

253. In most countries, periodic payments under a notional principal contract are recognized as made (as income by the recipient and deductions by the payor). Countries vary in their treatment of non-periodic payments. In some countries, non-periodic payments, like periodic payments, are treated as income to the recipient and deductions for the payors when made. In other countries, non-periodic payments are amortized over the instrument's term.

254. The treatment of periodic payments has not been considered problematical, but non-periodic payments have proven to be more difficult to classify. If non-periodic payments are treated as income and expense as they are received, the parties to the contract are treated symmetrically, but taxpayers might nevertheless utilize this treatment as a means of reducing tax. For example, if

a company has a loss carryover deduction that is about to expire, it might make an off-market interest rate swap under which it receives a lump-sum payment when the contract is made. The inclusion of the payment in income when received does not increase the company's tax because the income is absorbed by the loss. The company will make larger periodic payments than it would have under a market-rate swap, but the deductions for these payments can be deducted against income for the years in which they are made. As a result, the life of the loss carryover is effectively extended.

255. Also, the recognition of lump-sum payments as made and received might disrupt the markets for notional principal contracts. If an investment bank holds a balanced portfolio and amortizes lump-sum receipts on a realistic basis, it essentially has no net income or loss from the contracts (apart from the margin it extracts as its profit) because deductions for payments will roughly equal income from receipts. On the other hand, if lump-sum receipts are income as received, the bank may have artificial net income when its portfolio is expanding and artificial net losses when the portfolio is contracting in size. This artificial income and loss may make dealing in notional principal contracts less profitable than it would be under tax rules treating receipts more realistically, or it might cause investment banks to charge customers more than they otherwise would.

256. These problems can be addressed by requiring taxpayers to amortize lump-sum payments under notional principal contracts, but reasonably realistic amortization schemes are complex. For example, in the United States, lump-sum payments are usually amortized by reference to market prices for forward contracts and options equivalent to the taxpayer's rights under the notional principal contract.[26] For this purpose, a swap is considered analogous to a series of cash-settled forward contracts, and a lump-sum payment under a swap is allocated over the contract's life according to the market prices for the analogous forward contracts. This method is illustrated by the following example:

> A swap contract requires A to make three annual payments to B of $2,350 each (the notional principal amount 1,000 bushels of corn times $2.35, the current price for corn) and B to make simultaneous payments to A equal to 1,000 times the spot price for corn on the payment dates.[27] When the contract is made, the forward prices for corn are $2.40 for a one-year forward, $2.55 for a two-year forward, and $2.75 for a three-year forward. Because A's fixed payments are below market, A pays B $535 when the contract is made. This non-periodic payment is amortized by treating it as a loan from A to B that B will repay, with interest, in three payments of $50 in one year (1,000 times the excess of the one-year forward price of $2.40 over the $2.35 price at which A's fixed payment is pegged), $200 in two years (1,000 times excess of $2.55 over $2.35), and $400 in three years (1,000 times excess of $2.75 over $2.35). The non-periodic payment of $535 equals the present value of these three payments at a discount rate of 8 per cent compounded annually. Each assumed payment is divided between a time-value component (determined at 8 per cent) and a principal component, as follows:

Year	Assumed payment	Time-value component	Principal component
1	50	43	7
2	200	42	158
3	400	30	370
	650	115	535

> The principal component is treated as a periodic payment under the swap, and the time-value component is disregarded. A's periodic payment to B for the first year is thus deemed to be $242 (sum of $235 actually paid at the end of the first year and $7 amortization of the upfront payment); the deemed periodic payments for the second and third years are $393 (sum of $235 and $158) and $605 (sum of $235 and $370). The periodic payments, enhanced by amortization of the non-periodic payment, are treated as income of the recipient (B) and deductible expense of the payor (A).

257. This procedure is complex because it requires both extensive information about market transactions and considerable computational sophistication. Since most notional principal contracts are large transactions constructed by major financial institutions, this complexity is not often troublesome for taxpayers. Moreover, the forward rates used by the parties in determining the amount of the lump-sum payment can be the basis of the allocation if they are "reasonable".

258. However, in some situations, the parties' pricing of the contract is not based on forward rates, and comparable forward rates may not be available. The United States Treasury therefore provided an alternative "level payment method", under which the lump-sum payment is amortized as though it were the present value of a series of equal payments falling due simultaneously with the periodic payments under the contract. This method is illustrated by the following example.

> An interest rate swap requires A to make five annual payments to B of $11,000 each (11 per cent of the notional principal amount of $100,000) and B to make simultaneous payments to A equal to the product of $100,000 and the one-year LIBOR on the date of payment.[28] When the contract is made, the LIBOR swaps even on the market for fixed interest of 10 per cent. B, who gets 11 per cent in this off-market swap, therefore pays a "yield adjustment fee" to A when the contract is made of $3,791, which the parties computed as the present value at 10 per cent of five annual payments of $1,000 each (11 per cent of $100,000, less 10 per cent of $100,000). Under the level payment method, the allocation to the first year is $621 - the assumed payment of $1,000, reduced by the time-value component (10 per cent of the yield adjustment fee of $3,791). This amount is recognized as a receipt by A and a payment by B in addition to the periodic payments for the year. Similarly, the allocation to the second year is $683 ($1,000, less the time-value component computed as 10 per cent of the excess of $3,791 over the principal component of $621 for the first year), to the third year is $751, and so forth.

259. If the lump-sum payment is made other than when the contract is made (e.g., at the end of the contract term), the level payment method is applied as though the contract provided for a lump-sum payment at the outset equal to the present value of the payment actually required.

260. Payments under notional principal contracts are generally not subject to withholding taxes when made to residents of other countries, but some countries apply withholding taxes to such payments in at least some circumstances.[29]

V. STRADDLES

261. The United States has found it necessary to provide special loss deferral and capitalization rules for "straddles". Assume A buys a call option on shares of the stock of X Corp. and simultaneously sells a call option on the same number of shares at the same option (strike) price, but with a slightly different maturity date. Apart from transaction costs, the premium paid on the first option very nearly equals the premium received on the second, and any gain or loss on either option will be offset by a virtually identical loss or gain on the other. However, if the values of the options change at all, A might sell or close out the losing option near the end of the tax year and replace it with a third option differing only slightly in maturity date from that of the original two. This year-end manoeuvre also has little effect on A's economic position, but it produces a loss that, if allowed as a tax deduction, will not be offset by taxable income from the options transactions until the remaining options mature or are closed out during the following year. The loss can therefore be deducted against other income, effectively producing a one-year deferral of tax. The United States Congress found this result unacceptable.

262. Since 1981, United States law has generally disallowed any deduction for loss on the sale, exchange, or closing of a "position" in actively traded property to the extent that the loss is offset at year-end by an unrealized gain in an "offsetting position".[30] The disallowed loss is carried forward and is allowed in the succeeding year, except to the extent it is offset by unrealized gain in an offsetting position held at the end of that year. In the example, the loss realized by selling or closing out one of the options in the first year is deferred until the offsetting option is exercised, sold, or closed out.

263. The actively traded property comprising a straddle may, for example, be a commodity, a debt instrument, a futures or forward contract, or a notional principal contract.[31] Stock may also be part of a straddle, but only if the offsetting position is an option.

264. Offsetting positions exist "if there is a substantial diminution of the taxpayer's risk of loss from holding any position with respect to personal property by reason of his holding one or more other positions with respect to personal property (whether or not of the same kind)".[32] For example, if A holds 100 shares of the stock of X Corp. and also has a put option on 100 shares of X stock, the positions are offsetting because the put option, which can be exercised to sell the stock for the strike price if the stock's value falls below that amount, substantially diminishes A's risk of loss on the stock. Thus, if the stock's value increases above the strike price of the put and A allows the put to expire unexercised, while retaining the stock, the loss sustained on lapse (the amount of the option premium) is not deductible to the extent of the unrealized gain in the stock. The put does not eliminate all risk of loss; for example, if the value of X stock remains constant, A will lose the option premium without reaping any offsetting benefit. However, the straddle rule applies if an offsetting position produces a "substantial diminution" of the risk of loss; an elimination of risk is not necessary. Moreover, the positions may be considered offsetting even if the strike price under the put is less than the stock's value when the put is acquired and the put therefore does not protect A from all risk of loss on the stock.

265. The straddle rules are complex and difficult to enforce. The taxpayer's purpose in acquiring the offsetting positions is not relevant. Assume B, a United States resident, purchases a bond denominated in Japanese yen and, to protect against currency risk, simultaneously enters into a forward contract to sell yen; the term of the forward contract is shorter than the bond's term, and B realizes loss on the forward when it matures. Because the loss on the forward is offset by currency gain in the yen position represented by the bond, it is non-deductible, at least in part, even if B promptly enters into another forward contract to continue the protection against currency risk. The ultimate result - deferral of the loss deduction until the offsetting gain is realized - is not unreasonable, but the accompanying record-keeping burden may be more than B bargained for in acquiring the investment.[33]

266. Conversely, if a taxpayer's purpose in acquiring offsetting positions is to defer tax by a straddle strategy, the taxpayer is likely to keep records that do not call attention to the connection between the two positions, thus leaving for the tax auditor a difficult job in making the connection required for the application of the straddle rules. The auditor's task is even more difficult if the property underlying the two positions is not identical (e.g., stock in a mutual fund invested in all stocks in a particular index and a cash-settled put option on the index).

267. The straddle rules also defer deductions for interest and other costs incurred in financing or carrying any position (leg) of a straddle.[34] Assume A purchases silver and simultaneously enters into a futures contract to sell an identical amount of silver in 18 months; the purchase is financed with borrowed money, and A's costs in carrying the silver include interest on the borrowing and storage and insurance costs.[35] The futures price for the silver approximates the sum of A's purchase price and the interest, storage, and insurance costs for 18 months. The futures contract thus guarantees A reimbursement of the carrying costs as well as offsetting the risk of loss from a drop in silver prices. The United States Congress concluded that the carrying costs, as well as any loss on a closing out of either the silver position or the futures contract, should be deferred until income from the straddle transaction is recognized. However, a consequence of the capitalization of carrying costs is greater complexity for taxpayers and tax auditors, who must identify both the positions comprising a straddle and the interest and other costs "properly allocable" to property included in the straddle.

268. The United States straddle rules apply only to United States citizens and residents and to non-residents engaged in business in the United States. They do not affect United States withholding taxes and thus have no application to non-resident investors in the United States who are not engaged in business in that country.

269. Much of the complexity of the straddle rules derives from Congress' efforts to frustrate avoidance strategies. For individual investors, these efforts seem to have largely succeeded. However, United States-based multinational corporations may have less difficulty in avoiding the straddle rules. For example, if a domestic affiliate holds one leg of the straddle and a foreign affiliate holds the other leg, the straddle rules apparently do not apply, because domestic and foreign affiliates cannot join in a consolidated return.

270. Few, if any, countries other than the United States have adopted tax rules to curb straddle strategies. The United States experience probably proves that compliance and enforcement complexity is an unavoidable consequence of any effective effort to deal with straddles. This experience may also establish

that straddle strategies, if not limited by anti-avoidance rules, can impair a country's ability to tax income from capital.

271. In the United States, gains and losses on most instruments used in straddles are capital gains and losses,[36] and capital losses are generally deductible only against capital gains. Thus, straddles, if not curbed by the straddle rules, would usually be effective only to defer tax on capital gains. A country that does not tax capital gains may encounter fewer difficulties with straddle transactions if it categorizes straddle losses as capital.

272. However, countries that want to have effective taxes on capital gains are likely to find these taxes increasingly compromised by straddles. Straddle strategies are abetted by the relatively low margin requirements and transaction costs for many derivatives. In the absence of straddle rules, a taxpayer wanting to shelter a large gain from tax can often defer the capital gains tax indefinitely by engaging in a series of straddle transactions involving huge nominal amounts but having a cost to the taxpayer that is not large in relation to the deferred tax.

VI. SYNTHETIC INSTRUMENTS

273. In many contexts, derivatives can be used to convert an investment in one type of property into an investment with characteristics indistinguishable from property of another type. If the tax rules for the two types of property are different, this use of derivatives allows a taxpayer to combine the economic consequences of one type with the tax consequences of the other type. This problem has at least two aspects - mischaracterization of income, and avoidance of realization rules.

A. Mischaracterization

274. Assume T purchases silver and simultaneously enters into a futures contract to sell an identical amount of silver. The forward price of silver equals or closely approximates the sum of the spot price for silver and the costs (interest, storage, and other expenses) of holding silver until the delivery date; whenever the prices in the spot and forward markets depart from this relationship, arbitragers enter the market to restore the relationship. Since T holds both silver and a contract to sell silver, T will not be affected by changes in the price for silver, but the spread between the price paid in the spot market and the price to be received under the futures contract guarantees a profit compensating T for the time value of the investment in silver. T's ownership of the silver and the contract put T "in the economic position of a lender because he has an expectation of a return from the transaction which in substance is in the nature of interest and he undertakes no significant risks other than those typical of a lender".[37] A lender's return (interest income) is usually taxed as ordinary income. However, T's profit will be in the form of gain on the sale of the silver, and gains on sales of investments are usually capital gain. If T's profit qualifies for a preferential capital gains tax rate, this back-handed way of investing in a debt instrument allows ordinary interest income to be converted into capital gains.

275. The simplest solution to this problem is to tax capital gains at the same rates as ordinary income. This solution might be seen as allowing the tail to wag the dog since the taxation of capital gains has traditionally been seen as a much larger issue than the taxation of derivatives. However, as taxpayers

become more sophisticated in investment strategies, the use of derivatives to avoid unwanted tax characterizations will become more common, and the capital-gains/ordinary-income distinction might become a dividing line between well advised and poorly advised taxpayers, rather than a line separating different types of income.

276. The United States has pursued more limited responses to the problem. In 1993, the United States Congress adopted a provision taxing as ordinary income all or part of the gain on a "conversion transaction".[38] The hallmark of a conversion transaction is that "substantially all of the taxpayer's expected return from [the transaction] is attributable to the time value of the taxpayer's net investment in such transaction".[39] An example is an acquisition of property and the making of a contemporaneous contract to sell the property. A straddle (two or more offsetting positions in exchange-traded property) is also a conversion transaction if the expected return is attributable to the time value of money. The silver transaction described in the paragraphs above was cited by Congress as an example of a conversion transaction.

277. Gain on a disposition or termination of any position included in a conversion transaction (the silver or the futures contract in the example) is ordinary income, except to the extent it exceeds the "applicable imputed income amount". The latter amount is interest on the taxpayer's investment in the transaction (the purchase price of the silver), computed at 120 per cent of the prevailing yield on United States Treasury securities of like term.[40] In the example, if the futures contract is made through a clearing-house of a major board of trade, the interest rate implicit in the contract is likely to be no higher than the rate imputed by the statute, and the investor's gain, whether it occurs on a sale of the silver, a sale or closing of the futures contract, or both, will probably be ordinary income in whole.

278. A more mechanical system applies in the United States to synthetic instruments constructed with currency contracts. Assume B, a United States person, has $1,000 to invest in a one-year debt instrument; the prevailing interest rates are 8 per cent in the United States and 2 per cent in Japan, and the spot exchange rate is $1 equals 100 yen. If B invested in a United States instrument, the investment would accumulate to $1,080 after one year. However, B (a) converts the $1,000 to 100,000 yen, (b) purchases a one-year 100,000 yen debt instrument at 2 per cent interest, and (c) makes a forward contract to sell 100,200 yen in one year. The forward rate is $1 equals 94.44 yen,[41] and B will thus have $1,080 after one year (102,000 yen at 94.44 yen per dollar). The $80 profit consists of interest of $21.18 (2,000 yen at 94.44 yen per dollar), and currency gain of $58.82. Under United States law, currency gain is ordinary income unless it arises from a forward or futures contract or option that is held for investment <u>and is not part of a straddle</u>.[42] Since the forward contract in the example protects B against the risk of currency loss on the yen note, the note and the forward contract are offsetting positions - a straddle. B's income from the transaction is thus ordinary income, just as it would have been if B had invested in a United States instrument.

279. The United States solutions to these problems are complex and incomplete. The practical alternatives to these solutions are, on the one hand, eliminating from the income tax laws any distinction between ordinary income and capital gains and, on the other hand, allowing taxpayers a free hand to alter tax characterizations at will through the use of derivatives. As derivatives become more widely available and understood, the latter alternative will probably become increasingly unpalatable to countries that either exempt capital gains from tax or tax capital gains at rates much lower than ordinary income.

B. Avoidance of realization rules

280. Under most income tax laws, gains and losses on investments in property are recognized only when realized by a sale, exchange, or other disposition of the property. Thus, a holder of appreciated property is not taxed on the appreciation so long as the property is held, but a capital gains tax may be incurred if the holder sells the property and reinvests the sales proceeds in other property. By the use of derivatives, it is often possible to obtain the economic equivalent of a rollover of investments but without making a sale or exchange that triggers a capital gains tax.

281. Assume individual E, an employee of X Corp., owns substantial amounts of X stock, which was acquired by the exercise of employee stock options and which comprises the majority of E's wealth. E wants to have a more diversified investment portfolio but would incur substantial capital gains taxes on selling X stock and reinvesting in securities of other firms. E enters into a swap agreement with an investment bank under which, for a period of five years, E will pay the bank amounts equal to the dividends on 1,000 X shares and the bank will pay to E amounts equal to the dividends on a specified basket of stocks of other companies (when the agreement is made, the basket of stocks has the same value as 1,000 X shares); at the end of these five years, E will pay the bank an amount equal to the value of 1,000 X shares at that time, and the bank will pay E an amount equal to the value of the basket of shares. The economic result is the same as though E had sold 1,000 X shares and reinvested the proceeds in the basket of shares. However, E has made no sale or exchange of X shares, and thus incurs no capital gains tax.

282. Few countries, if any, have addressed the realization-avoidance potential of derivatives. Any effort to address the problem would quickly encounter a frustrating reality: Given the great variety and flexibility of derivatives, rules prescribing particular results for particular investment techniques could easily be avoided. For example, suppose a rule were adopted declaring that the making of an equity swap of the sort illustrated in the above paragraph shall be treated as a sale or exchange of the stock that is the basis for the taxpayer's payments under the swap (1,000 X shares in the example) to the extent that the taxpayer owns such stock when the swap agreement is made. The effect of this rule would be to eliminate equity swaps without solving the problem, because numerous other techniques can be used to obtain the same results. For example, a short sale of X stock, combined with an investment in the basket of stocks, has the same effect as the equity swap, and at least in the United States, the making of a short sale against the box is not a realization event. A sale of a call option on X stock, combined with a purchase of a put on X stock and a futures contract on the basket of stocks, also has the same effect.

283. The realization-avoidance problem could be attacked effectively only by a rule that treats a taxpayer as having sold property whenever the taxpayer enters into one or more transactions that have the effect of offsetting the benefits and burdens of the taxpayer's ownership of the property. But such an approach is also beset by numerous problems. E's five-year equity swap looks a lot like a sale of X stock combined with an investment in the basket of stocks, but would such a characterization be fair if the term of the equity swap was six months? If a six-month swap is not a realization event, what should be done about a taxpayer who enters into a series of six-month swaps extending over, say, five years and thereby accomplishes the same results as E? Would the proposed rule apply only when the offsetting positions eliminated all risks and benefits of ownership or when these risks and benefits are substantially eliminated? If the latter, how is the line to be drawn between substantial and insubstantial?

Whatever rules were settled on, would tax auditors have the sophistication and time to sort through taxpayers' records to determine whether and how the rules applied?

284. A more comprehensive, and perhaps simpler, approach to the problem would be to require all substantial investors to use a mark-to-market system for exchange-traded securities, requiring unrealized gains and losses to be recognized annually and thereby eliminating the realization rule. This is a radical solution because it would change the entire system of dealing with gains and losses on property in order to frustrate a particular avoidance technique. However, as the availability and understanding of derivatives expands, the application of the realization rule may become increasingly arbitrary, and Governments may be pushed to consider radical alternatives to the rule.

VII. HEDGING

285. Derivatives are remarkably effective as instruments for gambling. Using derivatives, investors can take large positions with cash investments as small as 1 per cent of those positions; their investments can double, triple, or more, or be wiped out, by relatively small changes in the value of the positions.

286. However, a much more common use of derivatives is for hedging against risks arising from business activities or investments. A manufacturer of products from corn might make futures contracts to buy corn to ensure that its manufacturing profits will not be impaired by rises in the price of its basic input.[43] An export seller of goods might make a forward contract to sell foreign currency to be received in a sale in order to protect its profit on the sale from erosion by currency fluctuation. A company that has borrowed in the currency of country x but reports its profits in the currency of country y might make a series of forward contracts to purchase X currency with Y currency to cover its payments under the loan, thereby eliminating the possibility that borrowing costs might be increased by an unfavourable change in the exchange rate. A bank that makes long-term loans from funds received as short-term deposits might acquire a variety of derivatives positions to mitigate the resulting interest-rate risk.

287. One of the more important steps a Government can take to facilitate productive uses of derivatives is to formulate tax rules allowing gains and losses from derivatives held as hedges to be coordinated, both in character and in time, with the income and loss from the transactions being hedged. The United States Treasury adopted hedging rules in 1994. They are briefly described below as a means of highlighting the crucial issues and outlining one set of responses to those issues.[44]

288. The United States rules apply only to transactions made in the normal course of the taxpayer's business, primarily to reduce either or both of two types of risk:

(a) The risk of price changes or currency fluctuations with respect to property held or to be held by the taxpayer, provided that gain or loss on a disposition of the property cannot produce capital gain or loss;

(b) Risks of interest rate or price changes or currency fluctuations with respect to obligations of the taxpayer, both current and anticipated, whether arising from borrowings or business operations.[45]

The rules do not apply to a hedge of a dividend stream, the overall profitability of a business unit, or other business risks that do not relate directly to interest rate or price changes or currency fluctuations.[46]

289. The risks of a taxpayer's business are judged by looking at the business as a whole. For example, if the prices of products the taxpayer manufactures from corn vary directly with the price of corn, the business probably is not subject to a price risk, and if so, purchases of corn futures cannot be justified as a hedge. However, the taxpayer's judgement on these matters is usually respected. A hedge of a particular asset or liability or pool of assets or liabilities is generally considered to reduce overall risk if it reduces risk with respect to those assets or liabilities and is reasonably expected to reduce the overall risk of the taxpayer's operations.[47] Similarly, if the taxpayer has a programme that, as a whole, is reasonably expected to reduce overall risk, the risk-reducing effect of each instrument acquired as part of the programme need not be demonstrated.

290. The character rules for hedges apply to an eligible transaction only if it is identified as a hedge in the taxpayer's records before the end of the day on which the transaction is entered into.[48] Also, substantially contemporaneously with entering into the hedging transaction, the taxpayer must identify the item, items, or aggregate risk being hedged, usually by identifying the transaction creating the risk and the type of risk that the transaction creates.[49]

291. The policy underlying the identification requirement is twofold. First, it is probably not feasible to apply the hedging rules mandatorily to all transactions serving hedging functions because, given the quantity of derivatives transactions made by many taxpayers, it is not possible for tax auditors to police a mandatory requirement. Secondly, although the identification requirement effectively makes the character rules elective, the requirement that the identification be made on the day the transaction is entered into precludes taxpayers from using the rules selectively - applying them when they turn out to be advantageous and otherwise disregarding them.

292. Gains from transactions identified as hedges are generally ordinary income, even if the transactions do not qualify as hedges or the identification is defective.[50] Loss from a hedging transaction is ordinary loss if the transaction fully qualifies and the identification is made in accordance with the rules, but loss is characterized without regard to the transaction's hedging function if the rules are not fully complied with. Since the hedging rules apply only to hedges of risks arising in the ordinary course of business, the ordinary characterization of gains and losses from hedging transactions usually matches with the characterization of income from the property and activities being hedged.

293. The United States hedging rules also deal with the timing of the recognition of income or loss from hedging transactions, but without prescribing detailed timing rules. Generally, taxpayers' accounting methods for hedging transactions must clearly reflect income, and this standard requires that taxpayers "reasonably match the timing of income, deduction, gain, or loss from the hedging transaction with the timing of income, deduction, gain, or loss from the item or items being hedged".[51] The matching requirement, which applies whether or not a hedging transaction is identified as such, often is not satisfied by accounting methods that recognize hedging gains and losses as realized.

294. For example, if a taxpayer hedges an aggregate risk, rather than matching particular hedges with the risks from particular transactions, the taxpayer might use a mark-and-spread method, under which hedges are marked-to-market at least quarterly and gain or loss from hedges is allocated over the period for which the hedging transactions are intended to reduce risk.[52] Gains and losses on hedges of inventory must generally be taken into account at the times they would affect income if treated as parts of the costs of the goods being hedged.[53] Although the rules require coordination of the treatment of gains and losses from hedging transactions with the treatment of income or loss from hedged activities and property, it is not permissible to merge hedges into the accounts for hedged items. For example, gain or loss on an inventory hedge cannot be included in the inventory accounts.

295. The hedging rules supersede several inconsistent rules that might otherwise apply to transactions used as hedges. For example, futures contracts and currency forward contracts are generally subject to a mark-to-market requirement and gains and losses from these contracts are arbitrarily classified as 40 per cent short-term capital gain or loss and 60 per cent long-term capital gain or loss,[54] but neither the mark-to-market rule nor the characterization rule applies to contracts properly identified as hedges.[55]

VIII. INTERNATIONAL ISSUES

A. Withholding taxes

296. Under the present practices of most countries, payments to non-residents under derivatives and other unconventional financial instruments are generally not subjected to withholding taxes. As noted above:

(a) Discount income of foreign holders of discount bonds is nominally subject to withholding taxes under the laws of several countries, and this tax is permitted under the interest articles of many income tax treaties, but compliance with these withholding taxes is likely spotty at best;

(b) Payments under options and futures and forward contracts are rarely subject to withholding taxes when made to residents of other countries;

(c) Payments under notional principal contracts are generally not subject to withholding taxes when made to residents of other countries, but a few countries apply withholding taxes to such payments in at least some circumstances.

297. The issue of withholding taxes on payments under derivatives is a conundrum for which there is no satisfactory solution. On the one hand, derivative transactions, if not subject to withholding taxes, may be used to avoid withholding taxes on dividends and interest. For example, if a country x resident owns stock of a country y corporation, dividends on the stock are likely subject to a country y withholding tax. However, the country x resident can achieve the same economic result without the withholding tax by purchasing stock of a country x corporation and making an equity swap agreement with a country y bank to swap cash flows from the X corporation stock for the cash flows under the Y corporation stock.

298. As another example, assume the prevailing interest rates are 2 per cent in country x and 8 per cent in country y, and the currency exchange rates are 100ux (the country x currency) for 1uy (the country y currency) on the spot market and

94.44ux for 1uy on the one-year forward market; A, a resident of country x, wants to invest 1,000uy at the 8 per cent rate. If A acquires a one-year, 8 per cent, 1,000uy bond issued by a country y person, the interest of 80uy will likely be subject to withholding in country y. However, A might achieve the same result by purchasing a one-year, 2 per cent, 100,000ux bond issued by a country x person, and simultaneously entering into a one-year forward contract to exchange 102,000ux for 10,080uy (102,000/1,080 is 94.44). In the latter transaction, A has no interest income from country y sources and thus is not subject to any country y withholding tax on interest.

299. However, it is not likely that country y could recoup the withholding tax in either of the foregoing examples by imposing a withholding tax. In the first example, if country y imposes a withholding tax on swap payments on the theory that they substitute for dividends from a country y corporation, the withholding tax can probably be avoided by making the contract with a country z bank. Even if numerous countries follow country y's lead in taxing swap payments, there will always be a country z wanting to be a tax haven in such transactions.

300. Moreover, it is not clear that country y should be concerned that foreign investors obtain the economic equivalent of dividends or interest from country y sources through the use of derivatives. Country y retains the ability to tax all dividends paid by country y corporations and all interest paid by country y issuers, and the object of its withholding taxes is presumably to reach income produced by economic activities in country y. This objective does not require that country y tax a shadow, created by financial wizardry, even though that shadow has all the appearances of dividends or interest from country y persons.

301. The emerging practice of a few countries to impose withholding taxes on swap payments, but not on payments under options and futures and forward contracts, is likely to be especially destructive and self-defeating. Notional principal contracts are not a unique breed. Virtually anything that can be done by a notional principal contract can also be done by one or more options, futures, or forwards.[56] The likely effect of withholding taxes on swap payments is a skewing of international transactions in derivatives, without any material amounts of tax being collected.

302. On the other hand, the clothing of derivatives can be used to cloak transactions that should be subject to withholding taxes. Assume A, a country x resident, enters into a swap agreement with B, a country y resident, under which A transfers to B 1,000u when the contract is made and B promises to transfer 80u to A on each of the first, second, third, and fourth annual anniversaries of the date of the agreement and 1,080u on the fifth anniversary. This transaction is simply a five-year, 8 per cent loan of 1,000u by A to B, and the 80u payments by B should be taxed as interest. If country y's tax laws include a substance-over-form doctrine, its withholding tax on interest should apply to these payments. If country y does not have a substance-over-form doctrine and does not impose withholding taxes on swap payments, it is vulnerable to this charade. However, the extension of the withholding taxes to all swap payments, including the vast majority that are not artificially constructed to avoid tax, seems to be a poor solution to the problem.

303. Concern has also been expressed about the potential for avoiding tax through the derivatives transactions, directly or indirectly, between related persons. For example, if a country x corporation engages in a derivatives transaction with an affiliate in country y, the parties might, as a tax avoidance ploy, agree to terms that deviate from those prevailing in the market. The solution to this problem lies in an arm's length requirement, either in the

internal laws of countries X and Y or in an income tax treaty between them. But, suppose the X corporation and the Y corporation each enter into derivatives transactions with an unrelated bank in country z, a tax haven. Both of these transactions might be off-market on terms that make the Z bank whole (what it loses on one contract, it gains on the other) but have the net result of reducing the aggregate tax burden of the X and Y corporations. The solution to this problem is probably a more sophisticated use of an arm's length rule, although enforcement of the rule would be complicated by the difficulty tax auditors would inevitably encounter in identifying abusive transactions.

B. Distortions resulting from country-to-country variations in internal laws

304. Distortions might arise when the residence countries of the parties to a derivatives transaction follow different rules in taxing the transaction. Assume A, a resident of country x, purchases a cap from Bank B, a resident of country y; under the agreement, A pays 600u to B when the contract is made, and B agrees to make 12 quarterly payments to A equal to the product of 25,000u and any excess of the 90-day LIBOR on the date of payment over 9 per cent.[57] Under the laws of country x, all payments under a notional principal contract, including lump-sum payments, are taxable income to the recipient and deductible expense to the payer when made. Under the laws of country y, periodic payments are recognized as made and received, as under the laws of country x, but a lump-sum payment is amortized over the contract's term. Specifically, B recognizes the 600u as taxable income in three instalments - 55u for the first year, 225u for the second year, and 320u for the third year. Neither country imposes a withholding tax on any payment under the contract.

305. The lack of symmetry in the treatments of the lump-sum payment in countries X and Y may not be a problem. Each party to the contract is taxed in the same way as it would have been taxed if that party had made the contract with a resident of its home country. The lack of symmetry thus may neither encourage nor discourage either party from dealing internationally, rather than locally.

306. However, it is possible that the tax rules may be reflected in the pricing of the contract. That is, in domestic transactions where the lump-sum payment is made at the outset of the contract, the cap price may be higher in country x than in country y so as to reflect the larger present value of the tax on the recipient of the lump-sum payment; the opposite may be true when the lump sum is payable at the conclusion of the contract term. If so, the discrepancy between the tax rules in countries X and Y provides an incentive for a country x resident to purchase the cap from a country y resident when the lump sum is up front and from a country x resident when it is payable in arrears.

307. It seems unlikely that tax rules (other than those imposing withholding taxes) are reflected in the pricing of derivatives. In the absence of withholding taxes, each party to the contract is taxed in its home country on a net basis, and the amount of tax thus depends on the amounts of associated expenses. When investment banks maintain balanced portfolios and bank customers use derivatives as hedges, net income or expense from derivative payments is probably a small percentage of the payments. In any event, this percentage varies from bank to bank and customer to customer. In the United States, many users of derivatives (e.g., pension funds) are tax-exempt. The lack of a uniform relationship between the gross amounts of derivatives payments and the taxes on those payments makes it unlikely that tax consequences are passed from party to party in the pricing of derivatives.

IX. CONCLUSION

308. Derivatives pose a basic dilemma for tax policy makers. Because derivatives are sophisticated financial instruments, unsophisticated tax rules can simultaneously facilitate the use of derivatives in tax avoidance strategies and hinder useful market activities in derivatives. On the other hand, greater sophistication in tax rules carries the price of greater complexity for both taxpayers and the tax administration. Tax rules that perfectly mirror the market probably are not practically possible. Governments must try to achieve a balance where the tax rules do not impose a crushing burden in the form of either unrealistic tax results or unrealistic compliance burdens.

309. In the international sphere, derivatives, discount bonds, and other financial innovations put withholding taxes at risk. A country probably cannot impose withholding taxes on payments under any of the common types of derivatives without excluding that country's investment bankers from the international derivatives market. Discount income on domestic bonds held by non-residents can, in theory, be subject to withholding taxes as interest, but there probably is no practical means for collecting any material amounts of withholding tax on this income. Through the use of discount bonds and derivatives, non-resident investors can obtain virtually any desired financial result without incurring withholding taxes. Revenues from withholding taxes can therefore be expected to decline as investors become more knowledgeable about these financial instruments.

Notes

[10] That is, if 6,139u were deposited in an account bearing interest at the rate of 10 per cent compounded semi-annually, the account would grow to 10,000u in five years.

[11] Bankman and Klein, Accurate Taxation of Long-Term Debt: Taking Into Account the Term Structure of Interest, 44 Tax L. Rev. 335 (1989).

[12] The sum of 92u and interest thereon at 10 per cent compounded semi-annually for four and one half years is 143u.

Another way of expressing this comparison is that the deferral diminishes the present value of the tax on the holder from 92u to 59u (the present value at 10 per cent of 92u payable in four and one half years), thereby reducing the effective tax rate on this accrual from 30 per cent (92u/307u) to 19 per cent (59u/307u).

[13] OECD Committee on Fiscal Affairs, Taxation of New Financial Instruments 58 (1994).

[14] Among OECD countries, only two require resident buyers of discount bonds to withhold tax from the purchase price when the seller is a non-resident.

[15] Among OECD countries, the United States is apparently the only one that does this. United States Internal Revenue Code (IRC) sects. 871(a)(1)(C)(ii), 881(a)(3)(B). However, discount income, like express interest, is exempt from United States withholding taxes if the bond is held as a portfolio investment. IRC sect. 871(h).

[16] Among the five OECD countries that impose withholding taxes on discount income, all require withholding when a discount bond is redeemed from a non-resident holder.

[17] More completely, the option holder's gain or loss on the sale, closing transaction, or lapse of the option is capital gain if the underlying property is or would have been a capital asset, and for non-corporate taxpayers, the preferential rate for long-term capital gains (at present, 28 per cent) applies to a gain, if capital, only if the option was held for more than one year. IRC sects. 1234(a), 1234A. For the issuer of an option on stocks, bonds, commodities, or commodities futures, gain or loss on a closing transaction or on the option's lapse is treated as short-term capital gain or loss unless the option was issued in the ordinary course of the issuer's business. IRC sect. 1234(b).

[18] See OECD Committee on Fiscal Affairs, Taxation of New Financial Instruments 20-21 (1994).

[19] Under one variation of this approach, the holder amortizes the option premium as a series of deductions over the instrument's life.

[20] IRC sects. 1256(a), (b)(3), (g)(3).

[21] None of the 22 countries responding to a survey of OECD countries reported imposing withholding taxes on payments under options, although some reserved the right to reclassify such payments as interest in appropriate cases and to subject the reclassified payments to withholding taxes. OECD Committee on Fiscal Affairs, Taxation of New Financial Instruments 53 (1994).

[22] Occasionally, over-the-counter contracts are made "off market" - at prices different from the prevailing forward price for the subject-matter of the contract. When this is done, the party advantaged by the market deviation makes one or more compensating payments to the other party to the contract. In most countries, the tax rules for futures and forwards make no provision for these payments, and taxpayers often treat them in whatever way they find advantageous.

[23] An exchange-traded contract can be closed out by the contract holder purchasing an opposite contract (e.g., a contract to purchase if the original contract was a contract to sell) covering the same quantity at the same price and with the same delivery date. An over-the-counter contract can be closed out by negotiation with the counterparty.

[24] IRC sect. 1256.

[25] None of the respondents to a survey of OECD countries reported imposing withholding taxes on payments under futures and forward contracts. OECD Committee on Fiscal Affairs, Taxation of New Financial Instruments 48 (1994).

[26] United States Treasury Reg. sect. 1.446-3(f).

[27] The example is taken from sect. 1.446-3(f)(4) Ex. 7 of the income tax regulations of the United States Treasury Department.

[28] The example is taken from sect. 1.446-3(f)(4) Ex. 5 of the United States income tax regulations.

REPORT OF THE STEERING COMMITTEE OF THE AD HOC GROUP OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS*

(New York, 5-7 June 1995)

A. Origin and purpose of the Steering Committee

310. The work of the Steering Committee of the Ad Hoc Group of Experts on International Cooperation in Tax Matters forms part of the continuing international effort aimed at eliminating double taxation, preventing international tax evasion and avoidance and improving national tax collection performance, so as to generate increased financial resources for fostering sustainable economic and social development and reducing public sector borrowing requirements and debt-servicing obligations. In 1968, pursuant to Economic and Social Council resolution 1273 (XLIII) of 4 August 1967, the Secretary-General set up the Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries, consisting of 20 experts and tax administrators nominated by Governments but acting in their personal capacity, from both developed and developing countries and adequately representing different regions and tax systems. The purpose of the Group was to explore "ways and means for facilitating the conclusion of treaties between developed and developing countries". The Ad Hoc Group, having completed that mandate with the publication in 1979 of the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries[58] and in 1980 the United Nations Model Double Taxation Convention between Developed and Developing Countries,[59] the Economic and Social Council decided in resolution 1980/13 of 28 April 1980 that the Group should continue and extend the scope of its work. To that end, the Group was expanded from 20 to 25 members and renamed the Ad Hoc Group of Experts on International Cooperation in Tax Matters. At its second meeting held in December 1983, the Group finalized the "Guidelines for international cooperation against the evasion and avoidance of taxes (with special reference to taxes on income, profits, capital and capital gains)" (document ST/ESA/142).

311. At its sixth meeting, held in December 1991, the Ad Hoc Group requested its preparatory Subgroup to prepare on the basis of materials to be submitted by members of the Group, working papers on the topics to be discussed at the seventh meeting of the Group, namely: transfer pricing, in particular as it related to pricing of primary products between related entities, cost-sharing arrangements and the provision of services; tax treatment of new financial instruments (hybrid instruments); tax treatment of students and teachers; draft revision of the United Nations Model Double Taxation Convention; and draft revision of the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries.

312. Draft documents on the five aforementioned topics were prepared for preliminary consideration by the Steering Committee, whose purpose is to facilitate the work of the Ad Hoc Group, inter alia, by reviewing in advance the drafts of the working and conference papers to be submitted to the Group with a view to strengthening and streamlining them as necessary during its Meeting at United Nations Headquarters from 5 to 7 June 1995.

---

* The original text of this paper was issued as document ST/SG/AC.8/1995/L.7.

B. Attendance

313. The Steering Committee consists of nine experts from industrialized and developing countries who are members of the Ad Hoc Group of Experts. The members of the Steering Committee are the following: William W. Alder (Jamaica), Ernst Bunders (Netherlands), Mordecai Feinberg (United States of America), Antonio Hugo Figueroa (Argentina), Nemi Chand Jain (India), Daniel Luthi (Switzerland), Reksoprajitno Mansury (Indonesia), John Evans Atta Mills (Ghana) and Alain Ruellan (France).

314. The meeting was attended by the following observers: Mark V. Follmi (Union Bank of Switzerland), Francisco Garcia Arjona (Harvard International Tax Program) and Alfredo Garcia Prats (University of Valencia, Spain). The meeting was also attended by the following consultants: Peter D. Byrne (Harvard International Tax Program), Harold Ullman, Esq. (Curtis, Mallet-Prevost, Colt & Mosle) and J. Pierre Benoit (former Chief of the Fiscal and Financial Branch in the United Nations Secretariat).

C. Documentation

315. The Steering Committee had before it the following documents:

Working papers

Provisional agenda (ST/SG/AC.8/1995/WP.1) (English only)

Annotated agenda of the Seventh Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters, Geneva, 11-15 December 1995 (ST/SG/AC.8/1995/WP.2) (English only)

Provisional list of participants (ST/SG/AC.8/1995/WP.3) (English only)

Tax treatment of students and teachers: working paper prepared by the Subgroup of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (ST/SG/AC.8/1995/WP.4) (English only)

Transfer pricing: working paper elaborated by the Subgroup of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (ST/SG/AC.8/1995/WP.5) (English only)

La mondialisation des marchés de capitaux (ST/SG/AC.8/1995/WP.6) (French only)

Derivative markets: economic implication for taxation (ST/SG/AC.8/1995/WP.7) (English only)

Taxation of derivatives and new financial instruments (ST/SG/AC.8./1995/WP.8) (English only)

United Nations Model Double Taxation Convention Between Developed and Developing Countries (ST/SG/AC.8/1995/WP.9) (English only)

List of documents (ST/SG/AC.8/1995/WP.10) (English only)

Conference papers

Taxation of students, teachers and other categories (ST/SG/AC.8/1995/CP.1) (English only)

Taxation of students and teachers (ST/SG/AC.8/1995/CP.2) (English only)

Article 20 of the UN Model Double Taxation Convention: Payments Received by Students (ST/SG/AC.8/1995/CP.3) (English and French only)

Transfer pricing guidelines for multinational enterprises and tax administrations (ST/SG/AC.8/1995/CP.4) (English only)

The arm's length principle in Swiss fiscal law (an extract) (ST/SG/AC.8/1995/CP.5) (English only)

Tax treatment of new financial instruments (hybrid instruments) in Indonesia (ST/SG/AC.8/1995/CP.6) (English only)

Taxation of new financial instruments (ST/SG/AC.8/1995/CP.7) (English and French only)

The New OECD Model Tax Convention: working document prepared by a member of the Subgroup of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (ST/SG/AC.8/1995/CP.8) (English only)

Revision de la Convencion Modelo sobre la Doble Tributacion entre Paises Desarrollados y Paises en Desarrollo (ST/SG/AC.8/1995/CP.9) (English and Spanish only)

The New OECD Model Tax Convention (ST/SG/AC.8/1995/CP.10) (English and French only)

Tax treatment of financial instruments and derivatives (ST/SG/AC.8/1995/CP.11) (English only)

Taxation of the new financial instruments, relevance of tax conventions (ST/SG/AC.8/1995/CP.12) (English and French only)

Taxation of teachers and researchers' remuneration (ST/SG/AC.8/1995/CP.13) (English and French only)

D. Opening of the meeting

316. The meeting was opened by Ji Chaozhu, Under-Secretary-General, Department for Development Support and Management Services. After welcoming the participants, the Under-Secretary-General emphasized the importance of the issues to be discussed and in particular that of the revision of the United Nations Model Double Taxation Convention. He also stressed the importance of taxation in view of the globalization of the world economy brought about by the end of the cold war and observed that even though the world was no longer polarized into different economic systems, any discussion of international tax issues must take account of the varying levels of economic development of countries around the world. After summarizing the history of the Group of Experts, Mr. Ji said that there was an urgent need for international cooperation aimed at reducing incompatibilities between tax systems in order to promote

international trade and investment and the transfer of technology. Such cooperation was likewise necessary with regard to the exchange of information, so as to facilitate the implementation of double taxation treaties and enhance tax payment compliance. In his concluding remarks, he noted that, as suggested by the Ad Hoc Group of Experts at its sixth meeting, the United Nations Secretariat could play an increasingly useful role as a clearing-house for information concerning taxation issues and the availability of technical assistance.

E. Chairman and meeting servicing officials

317. Nemi Chand Jain (India) was elected Chairman by acclamation. The United Nations Secretariat was represented by Guido Bertucci, Director of the Division of Public Administration and Development Management, and Abdel Hamid Bouab, Officer-in-Charge of the Public Finance and Enterprise Management Branch, who served as Secretary of the Ad Hoc Group of Experts. Peter E. Heijkoop and Cynthia J. Conti provided the necessary support to the Committee.

F. Agenda

318. The Steering Committee adopted the following substantive agenda:

1. Taxation of special categories: teachers and students: Articles 14-15 and 20 of the United Nations Model Double Taxation Convention Between Developed and Developing Countries.

2. Taxation of financial instruments and derivatives (hybrid instruments).

3. Transfer pricing, in particular as it relates to pricing of primary products between related entities, cost sharing arrangements and the provision of services.

4. Discussion of the draft revision of the United Nations Model Double Taxation Convention Between Developed and Developing Countries.

5. Discussion of the draft revision of the Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries.

6. Other matters.

I. TAX TREATMENT OF STUDENTS AND TEACHERS

319. The Steering Committee's discussion was based on document ST/SG/AC.8/1995/WP.4, prepared by the Subgroup (that is, the Steering Committee's predecessor), at its 1993 meeting. It was observed that the goal of the United Nations Model Convention was the elimination of double taxation, not the elimination of all taxation in both the source country and the country of residence. With regard to the tax treatment of students, covered by article 20 of the United Nations Model Convention, the Steering Committee considered the proposal in paragraph 2 of the aforementioned document that in article 20, paragraph 1, the word "solely" should be replaced by "principally," and decided that the text should remain unchanged.

320. One participant questioned the need for article 20, paragraph 2: he noted that there was no corresponding provision in the OECD Model Convention and although he found the paragraph acceptable he wondered whether it was necessary. It was decided to refer the proposal to the Ad Hoc Group of Experts. In the ensuing general discussion, it was pointed out that developed countries often accorded students from developing countries favourable treatment under their domestic law. The question was raised as to whether the issue deserved more comprehensive treatment, because such students often remained in the host countries after completing their studies, causing a "brain drain" which was detrimental to developing countries. It was also suggested that other factors to be considered in connection with the tax treatment of students might include the age of the student and the duration of the studies abroad.

321. With regard to the tax treatment of teachers, who are subject to the normal personal services provisions of articles 14 and 15 of the United Nations Model, one participant proposed that article 14, paragraph 1 (c), concerning taxation of independent personal services where remuneration exceeded a certain fixed amount, should be deleted, among other reasons because inflation could cause that provision to have unintended results.

322. The Steering Committee then discussed the distinction between the tax treatment of students and the tax treatment of teachers. One participant suggested that the United Nations Model Convention should include a separate provision covering teachers, along the lines of those included in some recent bilateral tax treaties. After some discussion, it was decided that such a separate provision was not necessary. One participant observed that if teachers were in the service of a Government, they could potentially be covered by article 19 of the United Nations Model. He suggested that the treatment of such persons might be clarified and noted that as long as there was no possibility of double taxation or double exemption, there would be no need to amend the United Nations Model.

323. The Steering Committee agreed by consensus to recommend that the Ad Hoc Group of Experts should, at its seventh meeting, consider the possible deletion of article 14, paragraph 1 (c), and article 20, paragraph 2, of the United Nations Model.

II. TRANSFER PRICING

324. The Chairman drew attention to the working paper on the item prepared by the Subgroup in 1993 (ST/SG/AC.8/1995/WP.5) and opened the discussion by observing that developing countries could benefit greatly from the experience acquired by economically advanced countries with regard to transfer pricing, which was an important facet of international taxation. He noted that while some developing countries had adopted rules concerning the tax treatment of transfer pricing, they did not have sufficient administrative capacity to enforce them to the full.

325. One participant cautioned that in considering the aforementioned working paper as well as the other working papers on the topic, it should be remembered that the Organisation for Economic Cooperation and Development (OECD) had conducted a comprehensive analysis of the transfer pricing issue and was expected to issue its final report on the subject in the course of the next 12 months. Another participant suggested that waiting for that report might imply that the United Nations was displaying undue deference to the anticipated OECD conclusions on the issue. Several participants questioned whether those

conclusions would address transfer pricing concerns which were unique to developing countries. In response, it was suggested that the Ad Hoc Group of Experts should analyse the OECD findings in the light of the developing countries' transfer pricing concerns, so that the United Nations efforts would supplement those of OECD, thus contributing to attainment of the overall goal of international consensus on the treatment of transfer pricing.

326. It was emphasized that the complex issue of transfer pricing would probably continue to develop over the next decade and that therefore no definitive United Nations approach could realistically be expected to emerge at the seventh meeting of the Ad Hoc Group of Experts. An extended discussion ensued on various technical aspects of transfer pricing, particularly those relating to transfer of technology and the developing countries' lack of adequate administrative capability to deal with transfer pricing. It was agreed that economically advanced countries should assist developing countries in their efforts to improve their enforcement capabilities. It was noted that the work to be done on transfer pricing might lead to changes in the United Nations Manual and in the commentary to the United Nations Model Convention but not in the text of the United Nations Model itself.

327. One participant noted that the OECD transfer pricing rules might focus on issues relating to the pricing of finished goods, whereas developing countries would be more concerned about primary goods. In response, it was pointed out that the arm's length principle was a general principle that should cover all transactions and all countries. Another participant observed that many economically advanced countries were very concerned about transfer prices for primary goods such as oil and natural gas. Other participants mentioned advanced pricing agreements as a potential future solution to the transfer pricing problem. One participant emphasized the need for an adequate exchange of information and an effective mechanism to ensure correlative adjustments.

328. Two participants pointed out that many of the transfer pricing issues which were of concern to developing countries were also of concern to economically advanced countries. The view was expressed that the OECD Model should not be viewed as "an anti-United Nations Model". The concerns of all countries, developing and economically advanced countries alike were similar. In that connection, it was noted that OECD, placed great emphasis on relations between its current membership - which included countries at various stages of economic development - and developing countries; furthermore, Mexico was already a member of OECD, and other developing countries could be expected to become members in the near future.

329. At the conclusion of the discussion on transfer pricing, the Secretary suggested that the Ad Hoc Group of Experts should become involved in the proceedings being conducted by OECD and other international fiscal organizations. It was agreed by consensus that such an approach would constitute an appropriate and effective way of ensuring that the views of developing countries, as well as those of economically advanced countries, would be considered in any emerging consensus on transfer pricing issues. The participants agreed that the matter should be actively pursued and that the United Nations Secretariat should take steps to ensure United Nations participation in meetings convened by OECD and other international fiscal organizations so as to foster a consensus-building approach.

III. TAX TREATMENT OF FINANCIAL INSTRUMENTS AND DERIVATIVES

330. The Chairman opened the discussion of the topic by noting that the taxation of financial instruments and derivatives was a new area, especially for developing countries. A major problem in that connection was whether the income from such instruments should be treated as interest, capital gains, business profits or income from other sources. There were several possible ways of solving that problem: for example, the definition of "debt claims" in article 11 of the United Nations Model Convention could be expanded to encompass new financial instruments, or the income could be treated as business profits under article 7 or as "other income" under article 21.

331. He emphasized that cross-border financial cooperation was necessary, given the need for funds for capital projects, but that the lack of uniform views on the treatment of financial instruments could seriously impede the free flow of funds and might also lead to tax evasion or double taxation.

332. One participant proposed that article 21, paragraph 3, should be amended to provide that income from financial instruments should be taxed solely in the country of residence. Another participant noted that the United Nations Model Convention differed from the OECD Model Convention in that the former permitted such other income to be taxed by the source country as well. Concern was expressed that the proposal could lead to the erosion of the source country's tax base. Another participant noted that income from financial instruments raised questions not only about the characterization of such income but also about its source.

333. With regard to the domestic treatment of such income in developing countries, it was noted that some of those countries did not have a separate capital gains tax and would treat such income as "ordinary income" for domestic tax purposes. Developing countries would have to weigh the economic benefits derived from such instruments against the tax losses associated with the acceptance of proposals to tax such income solely in the country of residence.

334. Another participant, noting that OECD had held lengthy discussions on new financial instruments, summarized its preliminary conclusions. OECD had considered, but rejected, the idea of including in the OECD Model a separate article on the taxation of new financial instruments. Concern had been expressed in OECD that abuses might exist in the case of financial instruments involving entities with special relationships and it had been recommended that the OECD Model Convention commentary should be broadened to provide that article 21, paragraph 3, could be amended in bilateral negotiations to deal with the issue of tax abuse in the context of special relationships. Thus far, however, few countries had experienced difficulties in that area. He further noted that OECD had organized a special study group to analyse issues relating to financial instruments.

335. One participant drew attention to the difficulty of taxing income from financial instruments, particularly those that were publicly traded and held by multinational companies; it was often difficult to attribute income from such instruments to the various permanent establishments of those entities. Another participant noted that under the United Nations Model Convention the source of income would be determined under the domestic law of the source country, and if such income arose in a country which was a party to a bilateral tax treaty it could be subject to taxation in that country, under article 21, paragraph 3.

336. The importance of such financial instruments to the world economy was emphasized further by the Secretary who noted that the proper treatment of such instruments was not clear. It was estimated that the capital invested in such instruments currently exceeded US$ 5 trillion, and that both capital-importing and capital-exporting countries had competed for that capital. If considerations relating to the generation of revenue too heavily outweighed considerations relating to the free flow of investment, access to such capital could be limited.

337. The Secretary recommended that the Ad Hoc Group should cooperate with other institutions, such as OECD, in developing a common approach to the taxation of such instruments. A participant suggested that a member of the Ad Hoc Group should be requested to report on the progress of OECD with regard to issues relating to financial instruments, and it was recommended that OECD reports on those issues should be made available to the members of the Group. One participant with connections to OECD noted that the latter had declared its readiness to present its conclusions at the seventh meeting of the Ad Hoc Group and to increase its cooperation with the Ad Hoc Group. He noted, however, that even within OECD, much work remained to be done on the issues relating to financial instruments.

338. A general discussion followed on various economic aspects of such instruments. It was noted that while there were many types of financial instruments, such instruments could be divided into three basic categories: swaps, futures and options. One participant noted that those instruments had increased market efficiency and in some instances had become relatively standardized. He recommended that any guidelines adopted by the Ad Hoc Group of Experts should permit the free flow of capital.

339. The Steering Committee reached the following consensus:

(a) The Ad Hoc Group of Experts should be kept informed of the progress made by OECD on the topic and, in particular, a report on that progress should be presented to the Ad Hoc Group at its seventh meeting;

(b) There should be increased cooperation between the Ad Hoc Group of Experts and OECD with a view to harmonizing the tax treatment of such instruments and specific proposals concerning such cooperation should be presented to the Group for consideration at its seventh meeting.

IV. DRAFT REVISION OF THE UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION

340. The Chairman opened the discussion by asking the secretariat of the Steering Committee to provide some background concerning the revision of the Convention contained in document ST/SG/AC.8/1995/WP.9. The Secretary noted that at its sixth meeting the Ad Hoc Group had recommended that the Model Convention should be revised. He mentioned a number of justifications for the revision, including developments in the world economy and the emergence of international trade as the primary factor in global development. The draft revision which reflected many of the changes made in the OECD Model Convention, had not yet been circulated outside the Steering Committee, but if the Steering Committee approved it could be circulated to other international organizations for their comments prior to the seventh meeting of the Ad Hoc Group.

341. It was noted that the changes proposed in the draft revision included a definition of the term "national" in article 3, a new provision concerning the purchase of goods in article 5, a new provision concerning limited force of attraction in article 7, a new transfer pricing provision in article 9, a new branch profits provision in article 10 and a drafting change in article 17.

342. Concern was expressed by several participants that the revision of the United Nations Model Convention could erode its unique quality as an instrument designed to protect developing countries. Concern was also expressed that other organizations needed to be consulted regarding the revision process. One participant expressed the opinion that the current United Nations Model contained several loopholes that needed to be addressed.

343. The Chairman noted that since the adoption of the United Nations Model in 1980 many developments had occurred that warranted its revision; the Model simply provided guidelines and parties in bilateral negotiations were free to work out their own solutions. A number of participants observed that several of the changes suggested in the draft revision were unique to the United Nations Model Convention, and did not necessarily relate to or follow the OECD Model Convention.

344. One participant involved in the drafting of the proposed revision mentioned that it was intended merely as a draft. In preparing the revised text, account had been taken of an analysis of trends in treaties between developing and economically advanced countries, the work of other groups and scholarship in the field. Where doubts had existed, it had been decided to follow the current text of the United Nations Model Convention. It was reiterated that with the consent of the Steering Committee, the revised text would be submitted to other organizations for their comments.

345. Another participant noted that in his experience, the United Nations Model Convention had facilitated the negotiation process and had provided a starting-point for the development of ideas. Developing countries often requested that specific provisions in the United Nations Model Convention be incorporated during bilateral negotiations. With regard to the concern expressed that the revised United Nations Model might follow the OECD Model too closely, he noted that many of the new provisions had been discussed at prior meetings of the Ad Hoc Group of Experts and had often been discussed also in bilateral treaty negotiations.

346. The Chairman expressed the view that the revised text of the United Nations Model should be seen as a working paper. He noted that commentators had identified shortcomings in the United Nations Model Convention and that the discussion on the revision should be pursued. The Ad Hoc Group could amend the proposed draft revision in whole or in part and would not approve any final revision unless it was found to adequately protect the interests of developing countries. Another participant noted that it would be more useful to discuss a draft document than to start with no document at all.

347. It was recommended that the revision of the United Nations Model Convention should be discussed further. One participant observed that it would be useful to have available at the seventh meeting of the Ad Hoc Group the computer base on tax treaties of the International Bureau of Fiscal Documentation (IBFD) so that the language of specific treaties could be reviewed. Another participant said that it would also be useful to have the analyses of treaties between developing and economically advanced countries used in the preparation of the

draft revision. It was noted that IBFD would be represented at the seventh meeting.

348. The Steering Committee agreed by consensus that the draft revision of the United Nations Model Convention (document ST/SG/AC.8/1995/WP.9) should be circulated to the other members of the Ad Hoc Group of Experts and other international organizations for their comments in advance of the seventh meeting, where the draft revision would be discussed.

V. DRAFT REVISION OF THE MANUAL FOR THE NEGOTIATION OF BILATERAL TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES

349. One participant noted that the Manual predated the United Nations Model Convention and questioned the need for the Manual in the light of the revision of the Model Convention and the possibility that many items in the Manual could be included in the Model Convention commentary.

350. The Secretary noted that the United Nations Secretariat had not yet begun revising the Manual and that it wanted first to gauge the reaction of the Steering Committee to the revision of the United Nations Model Convention. He pointed out that the United Nations Secretariat had received more requests for the Manual than for the United Nations Model Convention and that in many parts of the world the Manual was better known. One participant noted that the Manual was the only handbook of its kind and recommended that its name should be changed to the "Manual for the Negotiation of Bilateral Tax Treaties" without any reference to developing and developed countries.

351. The Steering Committee agreed by consensus that the United Nations Secretariat should consider the possibility of preparing a revised and updated text of the Manual which could be retitled "Manual for the Negotiation of Bilateral Tax Treaties".

VI. OTHER MATTERS

A. Possible expansion of the role of the Ad Hoc Group of Experts on International Cooperation in Tax Matters

352. The Steering Committee considered whether the role of the Ad Hoc Group of Experts should be expanded to include the provision of technical assistance. The Secretary noted that thus far the Group had been primarily a policy-making body, but had often been requested to provide technical assistance in the areas of tax administration, international taxation, and negotiation of tax treaties. Such assistance could help developing countries generate revenue and facilitate the resolution of treaty disputes. In that connection, reference was made to the work of the United Nations Development Programme (UNDP) and other international organizations in offering technical assistance, and to seminars convened in Africa with United Nations assistance for the training of tax inspector instructors.

353. The Steering Committee agreed by consensus to recommend that a new item concerning the possible expansion of the role of the Ad Hoc Group to include the provision of technical assistance should be added to the agenda of the seventh meeting of the Group.

B. Additional meeting of the Ad Hoc Group of Experts

354. The Steering Committee agreed by consensus to recommend that at its seventh meeting the Ad Hoc Group should consider the possibility of holding another meeting in 1996 to complete the work begun at the seventh meeting.

Notes

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

[59] United Nations publication, Sales No. E.80.XVI.3.

TRANSFER PRICING AND TAXATION OF INTERNATIONAL INCOME IN DEVELOPING COUNTRIES*

INTRODUCTION

355. Intercompany transfer prices are prices charged among members of affiliated companies for goods, services and loans transferred on an intercompany basis from one country of operation to another. The prices charged for goods, services and loans by one group member to another affect how much tax will be received by each country in which the group operates. If the prices charged for transactions between group members operating in different countries are set too high or too low, then income is effectively shifted from one country to another. Not surprisingly, tax authorities around the world want to ensure that income is not understated, because, for example, a distributor overpays its foreign manufacturing affiliate or a manufacturer undercharges its foreign distributor.

356. For example, if a United States parent charges its foreign subsidiary $1,000 for goods to be resold in the foreign country, the foreign subsidiary's profit in the foreign country, absent a transfer pricing adjustment, will be the subsidiary's resale price over its $1,000 cost. If the Internal Revenue Service (IRS) determines that the appropriate transfer price is $1,200, the United States parent will have an additional $200 of income in the United States. Does that mean that the foreign subsidiary then adjusts its cost to $1,200 and reports $200 less income in the foreign country? Not necessarily. It depends on whether the foreign country has similar rules for determining appropriate transfer prices as the IRS. It then further depends on whether the foreign country's tax authorities agree with the IRS as a factual matter based on all the relevant data.

357. If the foreign country's tax authority agrees that the appropriate transfer price is $1,200, then tax revenues are moved from the foreign country to the United States. In many cases, however, the multinational in this example would be indifferent whether the transfer price is $1,200 or, for example, $800, for if it pays more taxes in the foreign country because the transfer price on goods sold to its foreign subsidiary is lower, the taxes in its home country will be correspondingly lower and, therefore, its overall tax liability may be substantially the same. The main reason is that tax rates in many major trading countries are fairly similar and have tended to converge in the past 10 years. From a tax point of view, the multinational is often merely a stakeholder between the tax authorities of the two countries. Obviously, as between the two countries, where the tax is paid matters very much.

358. The situation for the multinational is quite different if one country has a lower effective tax rate than the other country. In that case, the multinational might have an incentive to shift income from the high-tax jurisdiction to the low-tax jurisdiction, particularly if the high-tax jurisdiction is unlikely to examine the multinational's transfer prices.

359. The situation for the multinational is also quite different if the multinational is being challenged in both countries on its transfer prices and

---

* The original text of this paper, prepared by Sheldon S. Cohen, Consultant to the Department for Development Support and Management Services of the United Nations Secretariat, was issued as document ST/SG/AC.8/1995/L.8. Views expressed are those of the author and do not necessarily reflect those of the United Nations.

the multinational is unable to persuade the tax authorities to adopt the same price. If the IRS says the appropriate price is $1,200 but the foreign country tax authority says the appropriate price is only $800, the multinational group will pay tax twice on the same $400 of income. Whether the rates are the same is beside the point. Double taxation may be avoided if the IRS and the other country are able to resolve their dispute through the competent authority provisions of the applicable tax treaty.

I. HOW INDUSTRIAL COUNTRIES HAVE ADDRESSED TRANSFER PRICING ISSUES

360. There have always been significant administrative difficulties in making sure that taxpayers set appropriate transfer prices for tax purposes in international transactions with related parties. As international commerce grows, this becomes a more and more important question. With the encouragement of the United States, the world community has largely adopted a so-called "arm's length" standard. It sets transfer prices based on prices charged in transactions between unrelated parties. This is the theoretically correct pricing rule. The problem is that it is usually difficult to find such a transaction from which to derive an arm's length price. As a result, the United States has tried to find alternative rules, involving functional analysis, comparative rates of return, and profit splitting. These approaches, while theoretically flawed, may be practical supplements to the arm's length standard.

A. The arm's length standard

1. In favour of the arm's length standard

361. The arm's length standard has been adopted by nearly every country as the guiding principle for determining transfer prices between members of a group. Its use has been recommended by both the United Nations and the Organisation for Economic Cooperation and Development.

362. The arm's length standard was first implemented by the United States in its 1935 regulations interpreting Section 482 of the Internal Revenue Code. These regulations simply stated that: "The standard to be applied in every case is that of an uncontrolled taxpayer dealing at arm's length with another uncontrolled taxpayer." They did not, however, require the use of any particular method. The courts applied a number of different standards for determining when transactions were conducted at arm's length, such as whether the related party received a "fair and reasonable price" or a "fair price including a reasonable profit".

363. By the early 1960s, the international and business climate had changed considerably. Congress became increasingly concerned that United States companies were shifting income to their foreign subsidiaries. The United States House of Representatives proposed legislation that required the United States taxpayer to demonstrate that its transfer prices with its foreign affiliates were supported by comparable prices with unrelated third parties; if not, the group's income was to be apportioned between the related members under a formula based on their relative economic activities. The United States Senate rejected the proposal, concluding that it was better to address improper multinational allocations through guidelines and formulas in regulations.

364. IRS regulations were issued under Section 482 that governed transfer pricing practices for United States taxpayers from 1968 until last year, when a new set of Section 482 regulations was issued. The 1968 regulations reaffirmed the arm's length standard and provided the first detailed articulation of the arm's length approach by establishing rules for specific kinds of intercompany transactions, including the performance of services, the licensing or sale of intangible property, and the sale of tangible property. The United States approach influenced other countries to adopt the same arm's length approach. Under most of its bilateral tax treaties, the United States is obligated to apply the arm's length standard to transactions by persons subject to its tax jurisdiction.

365. The arm's length standard uses real transactions that occur in the marketplace as the standard for allocating income between countries. This market-based approach is believed by its supporters to be more acceptable to taxpayers and tax administrators than arbitrary formulas that depend on relative assets and employees, for example, without regard to how the marketplace really operates.

366. Because the arm's length standard is so widespread, its consistent use throughout the world minimizes the problem of double taxation. Any industrialized country that departs from its use without coordinating the departure with other countries would increase the double taxation risk. The use of different methods places more pressure on competent authorities under the international treaty system to work out the differences, and the competent authority process is known for taking a long time to resolve cases.

2. Problems with the arm's length standard

367. Determining an appropriate transfer price can be very complex, particularly because the taxpayer rarely has available information on comparable third-party prices. In many cases, comparable third-party prices simply do not exist. The work necessary to compile data and properly analyse the related and unrelated transactions can be extremely burdensome and costly.

368. The determination of an appropriate transfer price is often very subjective. Taxpayers complain that the tax authorities use the benefit of hindsight to adjust prices, providing much uncertainty in the business environment. Even small changes in transfer prices can result in huge increases in tax liability.

369. Uncertainty also provides room for abuse by taxpayers. Transfers within multinational corporations often involve intangible property and non-standardized products. There are usually no comparable transactions involving third parties to judge the reasonableness of the multinational's transfer price.

370. Many economists believe that the arm's length standard does not reflect economic reality, because related group members do not behave the same way as unrelated parties. When companies are integrated into a multinational corporation, there are usually greater cost savings and efficiencies than if the companies were unrelated, and the arm's length standard's focus on unrelated parties fails to take these economies of scale into account.

371. Moreover, contrary to what the IRS may believe, transfer prices are often set with little regard for tax consequences. In the real world, corporate executives frequently set prices based on such non-income tax considerations as

import duties, anti-dumping rules, and local regulatory requirements. In addition, there are often internal political considerations within the organization, such as the relative power of executives in charge of the manufacturing and distribution functions within the group and the need for management to justify the success of its strategic decisions regarding the location of a plant or the selection of a market. Imposing the arm's length standard may interfere with the way business would otherwise operate.

B. Experience of the United States in enforcing the arm's length standard

1. IRS attempts to move away from the standard

372. The 1968 regulations stood the test of time quite well, but, by the 1980s, they were showing signs of strain, caused by several factors. In the 1986 tax legislation, the United States Congress made one significant but narrow change to the basic transfer pricing law by requiring income of the transferor from sales, licenses and transfers of intangible assets to be commensurate with income generated by the related transferee. Congress also directed the IRS to study whether legislative or regulatory change to the scheme of the existing transfer pricing regulations was needed. It was recognized that change was needed because the 1968 regulations reflected the status of the United States as a major capital exporter.

373. In response, the IRS issued its 1988 White Paper on transfer pricing. The White Paper was received with extreme hostility because it appeared to constitute a wholesale rejection of the arm's length standard. Instead, the IRS proposed applying arm's length rates of return in circumstances where taxpayers had little hope of being able to gather adequate comparison data (which would often have to come from competitors or unreliable or unavailable industry statistics).

374. After much reflection, in January 1992, the IRS proposed new transfer pricing regulations to provide more detailed guidance on transfers of tangible property and to implement the 1986 legislation that requires royalties on intangible property to be commensurate with the income derived by the transferee from such property. These regulations also added a requirement that the taxpayer's transfer prices be justified by comparing the taxpayer's profits to the profits of its competitors. This requirement evoked significant protest from multinational business and foreign Governments. Businesses claimed that sufficient information about their competitors was not available. Foreign Governments claimed that the "comparable profits" requirement undermined the arm's length standard's focus on comparable transactions rather than comparable profits.

375. Finally, in July 1994, the IRS issued final transfer pricing regulations. These regulations reaffirm the use of the arm's length standard and require the taxpayer to determine arm's length using the "best method" available. The comparable profits test is no longer required but may be used as a method for determining transfer prices if there are no comparable transactions. These regulations represent an extraordinary good-faith effort by the United States to make the arm's length standard work in a complex world.

376. The question still at issue, however, is how much importance should be placed on comparable profits of competitors. Foreign tax authorities have asserted that any method keyed to comparable profits is impossible to reconcile

with the arm's length standard. But if comparables simply do not exist or are too difficult to find, then some form of comparable profits approach or perhaps even a formulary apportionment approach may be the only way to determine an appropriate allocation of international income.

2. Possible legislation

377. The United States Congress has introduced several bills in recent years which would require a minimum amount of taxable income to be reported by certain foreign-owned (that is, 25 per cent) United States corporations (or United States branches of foreign corporations) that engage in more than a threshold level of transactions with foreign related parties. Under H.R. 5270, the taxpayer's taxable income from any category of business would be no less than 75 per cent of the amount determined by applying the applicable profit percentage to the taxpayer's gross receipts from that business category.

378. This formulary apportionment is similar to the manner in which income among States is allocated and apportioned, as if the multinational were a unitary world-wide business. Most States use a three-factor apportionment formula of sales, property and payroll, with each factor equally weighted. A "unitary" formulary apportionment formula combines the income of the entire affiliated group and then applies the three-factor formula to that larger income base.

379. The IRS will continue to object to formulary apportionment, citing the need for international conformity, the uncertainties created by the differences in accounting methods and record-keeping, the administrative burdens imposed by formulary apportionment on United States and foreign multinationals alike, and the intense international resistance to moving away from the arm's length standard.

3. Enforcing the arm's length standard

380. The 1986 tax legislation permitted the IRS to shift its attention away from tax shelters, which have comprised as many as 50,000 of the 82,000 cases docketed in the Tax Court. In the mid-1980s the IRS began to step up its international audit focus by forming litigation teams of economists, engineers, accountants and attorneys; devoting more resources to Section 482 cases through the Coordinated Examination Program; and identifying key international tax issues for litigation. At the end of 1994, there were 105 Section 482 cases pending in the Tax Court and the United States Court of Federal Claims, with at least $3.7 billion of Section 482 deficiencies at issue (a total of $33 billion in deficiencies is pending in federal courts). Audits of foreign corporations increased over 350 per cent from 1990 to 1993. Despite the IRS emphasis on auditing and litigating Section 482 cases, its victories in the area have been few and far between. The history of its efforts are discussed below.

381. Initially, the IRS experienced difficulty gaining access to information used by related parties in making pricing decisions, particularly where foreign-based documents were in the custody of foreign parents of United States subsidiaries. Summons were often unenforceable because courts lacked jurisdiction over the foreign parent. In other cases, foreign-based documents did not exist due to lax record-keeping standards in foreign jurisdictions. Information-exchange provisions in treaties have been ineffective in providing the IRS the requested information because of exceptions for measures that would violate the other country's laws or require the disclosure of trade secrets, as well as delays in negotiating with the foreign Government over what information is accessible.

382. Although the IRS had authority to impose the general 20 per cent accuracy-related penalty in transfer-pricing cases even before the 1990 legislation discussed below and periodically did so, there were no known cases where the taxpayer actually paid the penalties. A 20 per cent penalty based on negligence or a substantial understatement was a possibility only in the flagrant case, because there are usually reasonable points of view on both sides. Application of the 20 per cent penalty based on grounds other than negligence, such as a substantial understatement of tax, was also difficult.

383. United States tax law requires every person liable for United States tax to keep records sufficient to establish their correct federal income tax liability, for inspection by the IRS. There is little guidance on the scope of this requirement. Courts have held that the IRS may not use this requirement to compel a taxpayer to create new records during the audit process if its existing records otherwise meet the minimum record-keeping requirements. Moreover, this requirement does not apply to foreign parents that are not themselves liable for United States tax.

384. Section 982 (1982) provides that IRS may issue a "formal document request" for foreign-based documentation after an "informal" document request has been issued and rejected. If the taxpayer does not "substantially comply" with the formal document request, the taxpayer will be precluded from later introducing any foreign-based documentation covered by that document in court. The exclusionary rule does not apply if the taxpayer shows "reasonable cause" (e.g., difficulty of producing documents). The potential violation of foreign law is not an excuse. Section 982 precludes only the introduction of documents, not testimony.

385. Based on concerns that foreign multinationals were not paying their fair share of United States tax by artificially reducing the United States tax liability of their United States subsidiaries, Congress completely reworked Section 6038A (enacted in 1982) in a manner that will virtually eliminate the difficulties the IRS has experienced in obtaining foreign-based documents in the custody of foreign multinationals. First, because of expanded reporting requirements, many new foreign parties and transactions are now brought under IRS scrutiny. Secondly, the United States taxpayer must maintain records that are sufficient to establish the correctness of his United States tax returns with respect to transactions with foreign related parties. Thirdly, every foreign related party is required to designate the reporting corporation in the United States as its agent for service of process in the United States. Fourthly, a $10,000 civil penalty may be imposed on reporting corporations for non-compliance with either the annual information reporting and record-keeping requirements, with an additional penalty of $10,000 for each 30-day period of continuing noncompliance after the taxpayer has been notified by the IRS.

386. Fifthly, and most important, the IRS has been granted sweeping new powers to impose the "non-compliance penalty" if a foreign related party fails to designate the reporting corporation in the United States as its agent for service of process or if a reporting corporation refuses to comply with a summons issued to such corporation directly or as agent for the foreign party, even if there is reasonable cause for such failure. When the non-compliance penalty applies, the IRS has sole discretion to determine transfer prices between the reporting corporation and the foreign related party with respect to the transaction for which documents or testimony are requested. The IRS may apply the non-compliance penalty to any year not closed by the statute of limitations.

387. During his presidential campaign, then Governor Clinton pledged to collect $45 billion in tax revenues by cracking down on foreign companies that prosper in the United States and manipulate tax laws to their advantage. Once in office, President Clinton pledged to increase transfer pricing enforcement and to require multinationals - both United States and foreign - to support their transfer pricing calculations with more thorough and contemporaneous documentation. The revenue estimate, however, was down to $3.8 billion (from $45 billion) over five years. The President's proposal was enacted in 1993. His 1994 budget also proposed additional funding to double the audit rates on the United States subsidiaries of foreign multinationals.

388. In 1993 Congress enacted new penalties equal to 20 per cent, or as high as 40 per cent, of the tax underpayment attributable to a transfer pricing adjustment. To avoid these penalties, a taxpayer must maintain sufficient documentation to establish that, given the available data and the applicable Section 482 pricing methods, the chosen method for determining transfer prices provides the most reliable measure of an arm's length result. The documentation must exist when the tax return is filed, and must be provided to the IRS within 30 days of request.

389. These penalty rules and the final transfer pricing regulations are inextricably linked. The extent to which taxpayers wish to adopt aggressive positions under the transfer pricing rules is controlled by the requirements in the penalty rules to act reasonably. The penalty rules are intended to change taxpayer behaviour by forcing taxpayers to prepare contemporaneous documentation of their transfer pricing methods and to provide such documentation to the IRS upon request. These penalty rules are the culmination of years of IRS' complaints that taxpayers wait until the audit stage to justify their related party transactions. Such delay resulted in delays in (or denial of) IRS access to taxpayer's transfer pricing information, and therefore caused more controversy between the IRS and the taxpayer. Contemporaneous documents are more probative since they do not allow a taxpayer to delay stating its reasoning.

C. Transfer pricing practices in other industrial countries

390. A task force of nine OECD member countries prepared part I of a draft of a report on transfer pricing on 8 July 1994, under a mandate from the OECD Committee of Fiscal Affairs, and released part II of the draft on 8 March 1995. The complete report, which is a revision of another OECD report from 1979, will reflect and update the views of OECD members on transfer pricing issues in light of the "increased globalization of national economies" and the change in legislation and practices of a number of countries since 1979.

391. OECD believes that each enterprise within a multinational's world-wide group should be treated as a separate entity. The arm's length standard for establishing transfer prices on cross border transactions is believed to be the best method of taxing these separate entities, avoiding double taxation, minimizing conflict between tax administrations, and promoting international trade. The arm's length principle is believed to place multinational enterprises and independent enterprises on a more equal footing for tax purposes and thereby avoid the creation of any tax advantages or disadvantages attributable to operating as either a multinational or an independent.

392. OECD recognizes the difficulty of applying the arm's length method and the administrative burdens it causes for both taxpayers and tax administrators, but

it none the less believes that the costs are worth the benefits. To depart from the arm's length principle would threaten the international consensus and increase the risk of double taxation. The degree of experience and common knowledge among taxpayers and tax administrators has established a sufficient body of common understanding. This understanding should continue to be streamlined so as to improve the administration of the arm's length principle.

393. OECD believes that the most direct and reliable way to determine arm's length prices is by use of the comparable uncontrolled price method, resale price method and cost plus method. Substantial concern is expressed over the use of a comparable profits method or a profit split method.

394. OECD rejects global formulary apportionment as an alternative to the arm's length principle for determining the proper level of profits across national taxing jurisdictions. A global formulary apportionment formula would presumably allocate global profits of a multinational group on the basis of some combination of relative cost, assets, payroll and sales. Effectively to avoid double taxation, one would need world consensus on the measurement of global income and the associated accounting system, the factors to be used for apportionment, and the relative weight of each factor. Each country would want to emphasize factors that maximized its revenue. There also is concern that any formula would be arbitrary and would disregard market conditions and relative functions and risks. Exchange rate movements would skew the formula's application. Compliance costs and data requirements for an application of a global formulary apportionment would generally be more burdensome than those under the separate entity approach of the arm's length standard.

II. CONSTRAINTS ON THE ABILITY OF DEVELOPING COUNTRIES TO TAX MULTINATIONALS EFFECTIVELY

A. Dependence on the corporate income tax

395. Developing countries have long relied on corporate income taxes as a principal means of revenue. These taxes account for up to a third of revenue in some developing countries.

396. It may seem at first unusual that a levy as complex as the corporate income tax would be so prominent in developing countries, where the number of tax experts is relatively low. One reason is that many of the tax systems of developing countries that are former colonies can be traced to the tax systems of their colonizing countries. And the corporate income tax is a principal means of taxation in industrial countries. Another reason is the foreign tax credit granted to taxpayers in industrial countries. The foreign tax credit gives credit only for income taxes paid abroad. No credit is given to the multinational in its home country for sales taxes or gross receipts taxes paid abroad. Obviously, to attract foreign investors, developing countries need to preserve as much as possible the investors' foreign tax credit.

397. Corporate income taxes are important for another reason: they are relatively easier to collect than other types of taxes. Personal income taxes, for example, are difficult to collect when the economy is mostly agricultural and the population is geographically dispersed. Moreover, much of the population may fall below even the low personal exemption levels. In practice the individual income tax typically becomes a tax on employees who work in large firms that withhold taxes from wages.

398. Property taxes are only a minor revenue source in most developing countries. Many properties are too small to be readily assessed. Self-valuation does not work well. Assessors are often subject to political influence.

399. The majority of tax revenues in developing countries comes from taxes on commodities, which include value added taxes, sales taxes and excise taxes on imports and exports. Sales taxes come in various forms, but the least desirable form is the turnover tax, which has been quite common in developing countries. The turnover tax is imposed at every stage of the production/distribution chain. These taxes distort decisions at the production level and cause a cascading of tax liabilities as each transaction accumulates more tax. The pure form of value added tax (VAT) (that is, one that allows the tax paid by a firm on its purchases or inputs to be credited against or subtracted from the tax the firm charges on its output or sales) generally has less distortive effects. Many developing countries have difficulty administering a pure form of VAT. However, in recent years, several developing countries have implemented a pure VAT with success. India is a good example. Uganda has adopted a new VAT to begin in 1996. The bottom line, though, is that each country needs to do what is administrable - there is no single type of VAT or sales tax that is most appropriate in all cases.

B. Administrative constraints

400. The transfer pricing arena, perhaps better than any other area of the tax law, illustrates how taxpayers can often gain the upper hand through their access to highly qualified tax professionals. Even the IRS, with all its resources, has a fairly dismal record of successfully challenging taxpayers in this area. This problem, however, is world wide.

401. The most important additional constraints one faces in the developing countries are the relative lack of sophisticated record-keeping in many of the business enterprises and the limited resources available for tax enforcement. Those are barriers to implementing broad-based taxes such as income taxes and the VAT. The key to overcoming those barriers is to modify those taxes and the rules applied in collecting them so that taxes are enforceable using the available business records and the limited resources available to the tax administration.

402. There are also differences among the developing countries. It may be that some of these differences arise more or less by accident or from the peculiarities of the taxes that those countries have imposed. Or, they may, in part, reflect cultural and historical differences in the willingness of some peoples to voluntarily submit to the income tax.

403. One could also point to numerous similar examples in which developing countries have responded to administrative realities in choosing their tax policies. In many respects those developments have paralleled the trends that have been noted in the United States and other developed countries.

404. In recent years countries in Latin America and elsewhere have abandoned their highly progressive income tax rate structures. This shift in tax policy has in large part resulted from the conclusion in those countries that they cannot effectively administer such highly progressive taxes. At the same time that developing countries have been reducing the progressivity of their income taxes, they have been adopting the VAT as a central part of their tax systems.

Once again, relatively simple, broad-based tax has proved the most effective. Difficulties have arisen when they have employed a variety of rates or a complicated scheme of exemptions from the tax.

405. Another common strand in most of these reforms of the income tax or the VAT is the enactment of relatively broad exclusions for low-income taxpayers (in the case of the income tax) or broad groups of small merchants (in the case of the VAT). In several countries the movement away from highly progressive income taxes and towards broad-based consumption taxes has been accompanied by the elimination of a variety of less productive taxes that they have previously imposed. In other developing countries reforms have been unsuccessful when they have been too complex or have otherwise failed to take sufficient account of the realistic limits of the country's tax administration.

406. This experience suggests that in developing a more productive tax system, one should realistically assess the country's ability to administer particular taxes and tax rules and its ability to improve those administrative capacities. One cannot make dramatic improvements in the tax administration in the short run. Numerous administrative constraints must be taken into account in developing tax policy.

III. RECENT ATTEMPTS BY DEVELOPING COUNTRIES TO COMBAT TRANSFER PRICING ABUSE

407. To understand how multinationals should be taxed by the various countries in which they operate is a daunting task for even the most experienced tax practitioner, much less the staff of a developing country's tax administration. They must see the 40,000 pages of regulations under Section 482 and shake their heads, possibly with awe but more likely with disgust and frustration. In the United States, the rules for taxing foreign operations have reached a level of complexity that threatens to result in a breakdown of the system for taxing and auditing multinational taxpayers. In many instances even the most sophisticated taxpayers find it difficult to determine their tax liability. IRS officials freely admit they are unable to enforce the rules effectively. It is no wonder that developing countries conclude that their tax administrations are incapable of administering such a complex system of taxation and resort to simpler, but none the less cruder, ways of taxing multinationals.

408. Many developing countries have no laws on their books regarding intercompany pricing. Examples are Indonesia, the Philippines and Thailand, to name a few. Some of these countries implement controls through their Customs divisions for import and export transactions. Declared prices are compared with standard prices compiled by Customs, and the duty base can be increased for any differences. However, there is rarely coordination between Customs and the tax administration with respect to income taxes.

409. Other developing countries have general statements in their law regarding transfer pricing, often providing broad authority to their tax administrators to determine transfer prices but without any specific rules as to how they will be determined. Chile, for example, empowers its Internal Revenue Service to question the prices or values in which intercompany transactions are carried out, when those prices differ from those ordinarily obtained in the domestic or foreign market. In Malaysia, when a Malaysia company derives less profit than would normally arise from a trading transaction with a commonly controlled non-resident, the Director General can tax the non-resident on a fair percentage of the profits from trading in Malaysia. A similar rule exists in Singapore.

In Papua New Guinea, the Commissioner General of Internal Revenue is authorized to ascertain the arm's length value of intercompany transactions by reference to contemporary market value and, where no such reference is available, to determine the arm's length value using its own discretion.

410. Some developing countries are slightly more specific in their provisions designed to counter tax avoidance through transfer pricing. In Argentina, for example, when exports are priced below the wholesale market price of the goods in the importing country, the Tax Board is authorized to assess the exporter's profits on the basis of the wholesale market price in the importing country. Conversely, when the price of imports into Argentina is above the wholesale market price in the exporting country, plus shipping and insurance expenses, the Tax Board may adjust the importer's costs of goods downwards and treat the difference as Argentine source income of the importer.

A. Mexico

411. Mexico has made great strides in recent years in its regulation of transfer pricing. Effective as of 1 January 1994, Mexico amended its transfer pricing provisions to increase the authority of the Ministry of Finance pertaining to transfer pricing and to recognize four transfer pricing methods of determining arm's length prices: comparable uncontrolled price; resale price; cost plus; and profit split. Mexico's signing of the North American Free Trade Agreement, tax treaties with the United States and Canada, and its admission to the OECD have no doubt accelerated Mexico's increased interest in transfer pricing. Mexico began international audits of firms on transfer pricing issues in the last several years and collected its first transfer pricing adjustment in 1994. Mexico has been assisted by the IRS in training international examiners. Mexican tax authorities have said they will apply international transfer pricing principles. They have no current plans to issue transfer pricing regulations.

412. Effective as of 1 January 1995, the Mexican tax authorities will require that maquiladora companies comply with the arm's length principle. (Maquiladoras are Mexican corporations that operate assembly plants, generally along the United States/Mexico border, to assemble or further manufacture component parts to take advantage of lower labour costs, and then to resell the finished goods outside of Mexico). These corporations typically are wholly owned by a United States parent corporation that repurchases the goods. While they were technically subject to arm's length principles under prior law, there was no enforcement. Thus, most maquiladoras did not incur significant income taxes and paid the minimum assets tax instead. With these new requirements to report profits on an arm's length basis, there is evidence that the maquiladoras are paying more attention to Mexican income taxes. According to the Government of Mexico, to date the Mexican tax authorities have received at least eight requests for advance pricing agreements from maquiladora companies and have released an APA ruling procedure modelled after the United States advance pricing agreement programme.

B. Republic of Korea

413. With OECD membership on the horizon in 1996, the Republic of Korea has recently repealed several controversial rules relating to taxation of multinationals and has adopted in their place rules more or less conforming with international norms. First, the Republic of Korea's definition of "dependent agent" has been revised to follow the OECD Model Treaty definition. The

National Tax Authority had been taking an aggressive position on this issue, treating some independent agents as dependent agents, which resulted in several controversial cases subjecting foreign companies to Korean tax.

414. Secondly, the Republic of Korea repealed a 1990 ruling that required formulary apportionment in determining the Korean income of a foreign corporation's permanent establishment. That ruling resulted in about 40 per cent of a foreign manufacturer's profits from Korean sales being attributed to the Republic of Korea and 100 per cent of a non-manufacturer's profits from Korean sales being attributed to the Republic of Korea. The country had the authority to apply these formulas when the world-wide profit rate of the foreign corporation was "substantially lower" than the profit rate of domestic corporations engaging in the same business. Recognizing that this rule violated OECD principles, the Republic of Korea will now apply four transfer pricing methods - uncontrolled price method, resale price method, cost-plus method, and other reasonable method - in computing Korean-source income attributable to a foreign corporation's permanent establishment.

415. Thirdly, the Republic of Korea repealed a 1988 guideline under which Korean-source income attributable to an industrial plant construction project was determined under an apportionment formula. The National Tax Authority announced that the guideline was not in accordance with the internationally accepted method of allocating income. The new guideline applies arm's length principles by comparing what a comparable, third-party enterprise would earn if it performed the same or similar functions as those performed by the permanent establishment in light of the functions performed and risks borne by the permanent establishment. The National Tax Authority intends to ask for accounting records and other relevant evidence located outside the Republic of Korea, either from the foreign contractor or from the tax authorities of the contractor's home country.

IV. OTHER APPROACHES TO DEVELOPING AN EFFECTIVE TAX ON THE INCOME OF MULTINATIONALS

416. One approach for overcoming administrative constraints is to adopt taxes or tax rules that are simpler to administer, even if they are only approximations of the taxes or rules that one would ideally like to impose. Several presumptive approaches have been used in countries where the tax administration is not equipped to enforce an income tax properly. Over time, certain countries, have replaced these approaches with taxes based on actual income, as tax collection and enforcement have developed. Another approach is the use of a minimum tax on imputed income from business assets as a means to overcome the difficulties that developing countries face in administering their income tax systems.

A. Taxes on "presumptive" net income

417. The idea of taxing imputed income is not new. Several of the countries of sub-Saharan Africa have long imposed such a presumptive tax as a percentage of a taxpayer's gross revenue. Even colonial America once had a presumptive tax based on the number of windows in a taxpayer's house.

418. Presumptive taxes have more recently been used by developing countries to overcome the difficulties of administering an income tax. Of course such presumptions are often very imperfect measures of net income. Nevertheless,

these taxes have the advantage of simplicity in sectors of a developing economy, where it may be unrealistic to try to enforce a tax on net income in a purer form.

419. The use of such presumptive taxes can lead to distortions and tax evasion, especially if different presumptive taxes are applied in different sectors of the economy. If one is more favourable, then taxpayers will attempt to shift income artificially to that sector.

420. In Argentina, there is a presumed net taxable income for certain types of activities of non-residents, including international transportation, international news agencies, insurance and reinsurance operations, and distributors of foreign films. For example, a non-Argentine company that ships goods in containers within Argentina or from Argentina abroad is deemed, as an irrebuttable presumption, to have net income from Argentine sources equal to 20 per cent of the gross amount collected from those activities.

421. In Colombia, on the other hand, there is a broad-based presumptive income tax applicable to all corporations. The taxpayer's net income is presumed to be at least equal to 4 per cent of its total net assets as of the last day of the preceding fiscal period. The 30 per cent corporate income tax is paid on the basis of the higher of presumptive income or ordinary taxable income. The taxpayer may rebut the presumptive income amount only in very limited circumstances. Since 1990, taxpayers who pay corporate taxes on the basis of presumptive income may deduct in the following two years the excess of taxes paid on presumptive income over taxes that would have been paid on an ordinary taxable income.

B. Rebuttable presumptions under the income tax

422. Many countries also employ rebuttable presumptions in enforcing their income taxes. These are basically collection devices which impose tax based on indicators of income rather than true income. They can be either withholding taxes based on gross wages or presumptions as to net income based on a taxpayer's professional experience or lifestyle. The French *forfait* system, which is widely employed in West Africa, uses a practice of determining income tax assessments through a process of negotiation with the individual taxpayer, starting with rebuttable presumptions developed for classes of taxpayers based on indicators other than conventional records of income and deductions. Such systems are subject to corruption because the tax collectors typically do not have the information needed to negotiate an objective assessment.

423. Other countries, such as the Republic of Korea, have attempted to apply a variant of the *tahshiv* system first developed in Israel. Under this system the tax administration attempts to estimate taxpayers' incomes based on more objective factors, including detailed studies of samples of businesses in various sectors.

424. Even in some relatively developed countries, the vast majority of taxpayers are taxed on the basis of such rebuttable presumptions. Such systems may result in improved enforcement for some countries. It seems likely, however, that a country that has sufficient resources and sophistication to develop the information needed to work well should also have sufficient resources to enforce some variant of a more conventional income tax.

425. Such collection devices must be distinguished from what have been referred to above as taxes on "presumptive" net income. First of all, the taxpayer can overcome a rebuttable presumption by showing his true net income, though as a practical matter rebuttable presumptions often result in a final determination of tax for many taxpayers. Secondly, use of such rebuttable presumptions generally should not prevent a foreign taxpayer doing business in the developing country from receiving a foreign tax credit for the developing country's income tax against the taxpayer's income tax liability in his home country. By contrast the United States and other countries generally do not allow such a foreign tax credit for foreign presumptive tax on a tax base other than net income.

C. Minimum taxes on assets

426. In recent years several countries have supplemented their conventional income tax on business activities with a minimum business assets tax of general application which is based on an assumption that taxpayers realize a minimum net return from assets that they employ in such activities. These new business assets taxes are more sophisticated than a tax on gross revenue or on the number of windows in a taxpayer's house. They are also more limited than some other presumptive taxes in that they only apply to assets employed in business activities.

427. A business tax is based on the value of the assets employed in a taxpayer's business, at a rate intended to be the equivalent of such an imputed income tax. The assets can be valued on either a gross or net basis. Mexico's assets tax, adopted in 1989, has contributed to Mexico's progress in achieving voluntary compliance. Other Latin American countries, including Venezuela, Peru and Ecuador, have since adopted various forms of a business tax.

428. The imposition of taxes on imputed business income results from the difficulties these countries have faced in enforcing their income taxes, in both the domestic and international sectors of the economy. Because an income tax is based on accounting for a taxpayer's costs and deductions, it is hard to enforce an income tax against domestic taxpayers whose accounting systems are not well developed. Furthermore, because developing countries have limited resources for enforcing their income taxes, they are vulnerable to taxpayer efforts to conceal their gross income. Obviously it is more difficult to conceal physical assets. Also, because each year's calculation is based on the prior year's calculation, the tax authorities are in a better position to detect fraud by comparing different years. In the international sector, multinational companies have the necessary accounting systems, but they are often able to avoid a developing country's income tax through manipulation of transfer prices in transactions with related foreign parties. An imputed income tax or assets tax cuts through both of these problems because it is not based on a direct measurement of a taxpayer's net income.

429. Of course such a tax is not a panacea, because it requires continuous revaluation of the taxpayer's business assets. If the tax is imposed on net assets, it is also open to abuse by taxpayers who fraudulently reduce their net assets with fraudulent debt. Mexico's assets tax eliminates the potential of abuse from artificial debt by imposing its assets tax on a taxpayer's gross assets. Thus, a country considering such a tax must weigh these difficulties against the extra revenue that they can obtain from the tax.

430. The minimum assets tax is based on the theory that capital should produce a minimum return. Presumably, the taxpayer would put the capital to a more productive use if a minimum return were not being met. The rate used is generally 1-2 per cent on gross assets and as high as 3 per cent on the basis of net assets.

1. <u>Preserving the United States foreign tax credit</u>

431. If a tax authority structures a tax such as a minimum tax within his income tax system, he should be careful not to do so in a way that discourages investment in his country by a foreign company. (The United States and other developed countries generally avoid double taxation on foreign income by allowing their taxpayers a credit for foreign income taxes paid on foreign source income.) An investment in his country will typically not be economically attractive for such a company if foreign tax credit is not available for income taxes paid to his country. Such a foreign tax credit is generally available only for foreign income tax liability.

432. Peculiarities of the rules governing the United States foreign tax credit cause the credit to be based on the amount of foreign income tax that is actually paid under the law of the foreign country. A business assets tax is not creditable in the United States. Further, a taxpayer's tentative liability for his country's income tax will not be eligible for a United States foreign tax credit to the extent that it is offset by a credit for an assets tax or other presumptive tax that he enacts to back-stop his income tax. This is because of the so-called multiple-levies rule under IRS regulations. It provides that if two taxes overlap, the tax imposed first is the tax that must qualify for the foreign tax credit. It is important that in structuring his assets tax as an alternative minimum tax, the authority allows a credit for a taxpayer's income tax liability against the assets tax that it would otherwise owe, rather than structuring the offset as a credit of assets tax against tentative income tax liability. Thus, if the income tax liability is 30 and the assets tax liability is 20, the 30 of income tax should be paid first, with 20 of it acting as a credit against the assets tax; if the 20 of assets tax is paid first, as a credit towards the 30 of income tax, only the excess 10 of income tax will be creditable.

2. <u>Assets tax in selected Latin American countries</u>

433. <u>Mexico</u> imposes a 2 per cent tax on the average value of gross assets owned by all companies and individuals engaged in business in Mexico, including the permanent establishments of non-residents. The assets tax operates as a minimum tax. It is payable only to the extent that it exceeds the taxpayer's income tax liability. A taxpayer may credit any income tax liability for a tax year against its tentative assets tax liability. This helps to mitigate the inflation problem which is the biggest systematic threat to the integrity of an assets tax. Mexico does employ a system of indexing values for inflation throughout its tax system. Such indexing is important because of inflation. But even if the valuation of a taxpayer's assets is imperfect, the assets tax still serves a useful function of back-stopping the income tax for taxpayers who would otherwise evade it.

434. The Mexico law has a number of features designed to cause the assets tax to be a reasonable estimate of the taxpayer's net income. Assets so employed are not included in the assets tax base until two years after they are first placed in use in the business. This takes into account the possibility that a taxpayer

will realize a below-market rate of return on its assets during such start-up phase.

435. The Mexico assets tax is also structured to take into account the fact that a taxpayer's actual return on business assets will fluctuate over time. As mentioned above, the assets tax is only imposed to the extent that a taxpayer's tentative liability for such tax exceeds its current income tax liability. If the taxpayer pays assets tax in one year because it exceeds the income tax, but pays income tax in a subsequent year, the taxpayer is entitled to a refund of the "excess" assets tax in the prior year up to the amount by which the income tax in the subsequent year exceeds the assets tax. The taxpayer may recover "excess" assets taxes for up to 10 previous years. It should be noted that income tax in the subsequent year must be paid even though a refund of the prior year's excess assets tax is due; that is, the tax and the refund are not netted. This ensures that the income tax paid in the subsequent year is fully creditable for foreign tax credit purposes.

436. In Venezuela, the assets tax is 1 per cent of gross assets. Unlike Mexico, however, excess assets tax is not separately refunded but rather is offset against the following three years of income tax liability, if any. Thus, it is uncertain whether the portion of income tax liability which is offset by prior payments of excess assets tax will be creditable in the United States; it is possible that only the net payment of income tax will be creditable.

437. In Peru, the assets tax is 2 per cent of gross assets. Unlike Mexico and Venezuela, there is no ability to reduce payments of income tax for payments of excess tax in prior years. There is also a question of whether the income tax is creditable in the United States, because the tax law provides that the income tax is not to be less than 2 per cent of gross assets. This contrasts with Mexico and Venezuela where the income tax liability is determined separately from the assets tax.

438. Bolivia has a 3 per cent tax on net assets which applies in lieu of income tax. No portion of this tax is creditable in the United States.

3. Use of an assets tax to combat transfer pricing abuse

439. The assets tax not only will ease the problems that developing countries experience in their attempts to assess tax on multinationals but also will reduce the incentives of multinationals to manipulate transfer prices when the multinationals know that they must pay at least some tax in the local jurisdiction. Indeed, the multinational will want to ensure that its income tax liability is higher than the assets tax so that the taxes paid are creditable in its home country. Tax administration would be simplified by substituting a simple tax calculation for the complexity involved in auditing transfer prices.

V. IMPROVING THE COLLECTION AND ENFORCEMENT OF TAXES ON THE INCOME OF MULTINATIONALS

A. Effective administration

440. Effective administration is the key to creating a productive tax system. The best designed tax system will not work if it is poorly administered. Even a poorly designed tax system, on the other hand, can work reasonably well if it is well administered.

441. Moreover, a country's efforts to establish a productive tax system will be more likely to succeed if its taxes and major tax rules are appropriate for its own needs and circumstances.

442. Every tax expert can appreciate just how difficult it is to get Governments to focus on the priorities of good tax administration and choice of appropriate tax rules. Questions of administration are seldom glamorous. It is always easier to assume that enacting a law or issuing a regulation solves the problem. It is a struggle to obtain the resources needed to administer the law and regulations properly. And in choosing taxes and major tax rules, it is often easy to resort to gimmicks, to argue about what is the ideal tax regime, or to borrow rules directly from another country. It is always harder to figure out what taxes and what rules will really work well under a country's own unique circumstances.

443. Whatever the other goals for a tax system, however, the system will not be productive unless it is well administered and is designed to take the country's economic and social circumstances into account. Because these are basically pragmatic considerations, they are equally important, whether the prevailing philosophy is market-oriented, statist, or anything in between.

B. Penalty structures

444. To the extent that a developing country cannot collect its taxes through withholding and other automatic collection mechanisms, it must rely on enforcement activities directed at individual taxpayers. The goal of such individual enforcement activities must be to promote what is generally known as "voluntary" compliance. This is compliance that does not require direct enforcement activity against the taxpayer in question. The key to such quasi-voluntary compliance is to increase the probability that a taxpayer who evades the law will pay significant penalties. This requires the imposition of appropriate penalties, the allocation of sufficient resources to enforcement activities, and the efficient use of those resources.

445. The penalty structure need not be elaborate. In fact, as with so many other issues, there is a great advantage in having a system of penalties that can be easily understood. The penalties must be severe enough to be effective but not so severe that they are unlikely to be imposed at all in practice. An effective penalty structure also requires an effective administrative structure for adjudicating tax disputes and imposing appropriate penalties fairly and predictably. No penalty structure will be useful if the probability of detection and likelihood of being penalized, if detected, are low.

C. Targeting enforcement activities

446. No matter how successful the tax authorities are in expanding their enforcement budget, however, they will undoubtedly be operating with limited resources. Therefore, it will also be essential for them to target their enforcement activities effectively. This means identifying groups of taxpayers whose compliance is low and then allocating resources effectively among the enforcement efforts directed at those groups.

447. There are obvious political limitations on such a targeting process. Often it will mean directing increased enforcement activity against politically important groups. This is particularly true in countries in which elite groups

have not paid their fair share of tax in the past. Thus, the targeting process requires a great deal of political sophistication and restraint. It is doubtful, however, that a developing country can develop a productive tax system unless it gives the tax authorities a great deal of latitude in targeting the domestic taxpayers with the greatest potential for increased collections.

448. Apart from such political considerations, the main tension in this targeting process will arise from balancing the conflicting needs to focus on both the largest taxpayers and on the groups with the largest collective tax avoidance. In most countries the most obvious targets for enforcement activity are the largest firms operating in the country. The IRS, for example, has in recent years made a point of shifting its ablest people and its primary resources towards the tax controversies with the most at stake.

449. It is equally important, however, that the tax authorities achieve at least a minimum level of enforcement in the broader sectors of the economy where the total amount of tax avoidance may be greatest. These are usually the agricultural and small business sectors. Assuming that the taxes imposed on such taxpayers are reasonably enforceable, it is probably wise to target these groups with enough enforcement to move them to a higher level of "voluntary" compliance.

D. Obtaining qualified personnel

450. The key to sound tax administration is good people - finding them, then training them, keeping them and protecting their integrity. Hard choices must be made on how best to utilize the best people. Some of them clearly must be assigned to the critical tasks of drafting regulations, devising forms and internal manuals and organizing enforcement activities. It is advisable, however, also to assign some of the best people to tax analysis units. Their job should be to identify problems in administration and enforcement, to analyse the causes of those problems and to identify solutions. Clearly it will also be helpful for those people to be in touch with their counterparts in other countries and to make use of the resources available from regional and international organizations.

E. Incentives for tax personnel

451. In many countries the question of targeting particular groups for enforcement activities will be related to the question of motivating the country's tax collectors. Many tax reforms have floundered and the enforcement of many existing taxes has lagged because countries have been unable to mobilize their tax collectors to enforce the law. Sometimes the problem has resulted from problems with the way tax officials are compensated.

452. Many developing countries employ financial incentives based on revenue "targets", or quotas, in financing their tax administration. Apparently those countries believe their resources are insufficient to pay their officials an adequate salary, and they must use incentive compensation as an alternative. Every developing country must consider whether it is more economical in the long run to pay salaries that will attract competent and well-motivated employees or to economize and substitute incentive compensation schemes that undermine the tax collection system. Agents will always respond to incentives, but sometimes in perverse ways. If a developing country must rely on incentive compensation, it is important that it adjust the incentives to ensure that they encourage

administrative effort and permit the central authorities to exercise the necessary oversight.

VI. CONSIDERATIONS WHEN MAKING CHANGES IN TAX LAWS

453. The recent tax reform efforts in developing countries reflect a new pragmatism in their approach to taxation. In a wide variety of countries, there has been movement towards tax systems that are more effective in raising revenue and away from tax systems designed primarily to promote certain economic or social objectives. This has parallelled similar pragmatic trends in the more developed countries. Many new techniques are being tried, and it remains to be seen which will work.

454. Among the most important considerations that any country must take into account in designing its tax system are the administrative requirements for enforcing particular taxes and the limitations on the ability of its tax administration to implement certain taxes or tax rules. Developing countries, like developed countries, must be realistic and creative in choosing taxes and tax rules that will take such administrative realities into account, with minimum sacrifice of tax equity or economic efficiency. If it will not be possible to administer a particular tax or tax rule effectively for the foreseeable future, one must consider whether there is a substitute or a backup tax or rule that will work better, even if this means a fundamental change in the tax system.

455. The tax authorities should also continually reexamine whether they have overcome administrative constraints that they have tried to accommodate in the past. For example, trade taxes have been widely accepted as a necessary evil for many low-income countries that have not developed the capacity to impose more broadly based consumption or income taxes. Most of us would agree, however, that a developing country should work to shift its reliance away from trade taxes as soon as possible.

456. There are more than merely practical reasons both to favour taxes that work and to adopt the best rules that will work well. If one cannot administer a tax effectively, it will not be applied equally to different taxpayers. That is the most fundamental kind of inequity in a tax system. Moreover, if a tax is widely evaded, that will tend to destroy taxpayers' sense of the equity of the tax system and ultimately their willingness to cooperate with the system. Conversely, rules designed solely to accommodate administrative constraints almost always do so at the cost of equity or economic efficiency in the tax system. Thus, developing countries should move towards more equitable or efficient rules as soon as it is administratively feasible.

457. Every country must also evaluate its tax system in light of its particular social environment. There are many social, political and economic factors that are cited as limitations on the ability of developing countries to employ certain taxes or to develop a productive tax system. One of the main tasks must be to evaluate the many potential barriers and to distinguish the real constraints from the problems that can be overcome.

458. It is important to be wary of fads and to avoid adopting particular taxes or rules because everyone else is doing so. In developing a tax system that is appropriate for a country, the tax authority must keep in mind that the idea of the "best" possible tax system is the enemy of actually developing a better tax system. Small improvements should not be put off because one cannot get the

"best" system. Modest reforms introduced early may give the best results in the long run.

VII. INTERNATIONAL COOPERATION

A. Bilateral cooperation in taxing international transactions and capital flows

459. The most direct kind of cooperation, of course, is in the area of tax enforcement itself. Informal cooperation in tax administration between developing and developed countries has become much more common over the past 30 years. It is important, however, to go beyond informal cooperation. Only formal public agreements can provide both the framework needed for systematic cooperation and a clear incentive to taxpayers to comply with the law.

460. In the past some developing countries have hesitated to formalize such cooperation. They may have thought that in this way they could attract investment from those foreigners seeking to avoid taxes in their home countries. It is increasingly clear, however, that attracting such "hot" money is far less important to most developing countries in the long run than creating the kind of environment that will enable them to attract stable investment from legitimate multinational enterprises. This requires bilateral cooperation with the countries in which those enterprises are based. An important part of such cooperation is the cooperation in tax enforcement.

B. Multilateral cooperation in analysing administrative problems and developing administrative capacity

461. Just as important as bilateral cooperation in tax enforcement is increased cooperation among the developing countries in addressing their common problems of tax administration. Thirty years ago one of the first regional organizations of this kind, the Inter-American Center of Tax Administrators (CIAT) was formed.

462. CIAT has developed into a useful forum for the exchange of ideas. Its annual conferences have produced a wealth of informal contacts and useful technical papers. Through its own publications and its central library, it has increased its members' access to useful materials on tax administration. Its professional staff has coordinated technical assistance projects in the hemisphere and has published a handbook on tax administration that has had a major impact on improving tax administration in its member countries.

463. CIAT also served as a model for similar organizations, such as the African Association of Tax Administrators, the Commonwealth Association of Tax Administrators, the Study Group on Asian Tax Administration and Research, and the Caribbean Organization of Tax Administrators. Since 1985 the Council of Executive Secretaries of Tax Organizations (CESTO) has held an annual meeting. The meetings have provided a useful forum for world-wide exchange of information and for expanding cooperation in addressing basic questions of tax administration.

464. There are many areas in which the developing countries could benefit by pooling of resources to study common problems and to develop practical programmes for increasing the productivity of their tax systems. One particularly promising possibility is in joint development of appropriate computer software. Others are the joint study of methods for estimating the

public and private compliance costs of existing taxes and tax reform proposals, including the transitional costs of changes in the law. Another area where joint efforts might be useful is in the study of methods for training and compensating tax administration employees.

465. Such cooperation would not eliminate the need to base reforms squarely on the country's individual situation. Nevertheless, there would be several clear benefits from closer cooperation on these and other issues. Perhaps the most obvious benefit would be the savings that could result from avoiding unnecessary duplication of effort in studying problems and developing solutions. Through such a pooling of resources, a country should be able to accelerate its progress towards improving its tax administrations and developing simpler and more stable tax systems.

466. A less obvious but equally important benefit from such cooperation would be the encouragement that it could provide to increased foreign investment. One of the big costs for a multinational company investing in the developing world is the need to cope with the ambiguities and peculiarities of the various tax systems. The proliferation of approaches to tax administration in the developing countries increases those costs and discourages such investment.

467. Cooperation in developing common approaches to common problems can provide a big boost to the efforts of developing countries to achieve full participation in the world economy if it helps reduce the uncertainties facing multinational companies doing business in the developing world.

VIII. RECOMMENDATION FOR A NEW INTERNATIONAL TAX INITIATIVE

468. Some countries do not have the capacity to ensure that sophisticated international corporations pay their fair share of taxes for their business activities within the countries' territory. The arm's length standard, which seems now to be the norm in the developed countries, is not easily administered. It requires a staff of well-trained lawyers, accountants, economists, business planners etc. to follow the profits from the ultimate sale back along the chain of commerce. Several legislators in the United States wish to go to some formulary system, but it only gives the appearance of simplicity.

469. I would like to propose a new initiative. It would require a good deal of international cooperation but would not require large staffs, nor would it increase complexity. What I want to do is to put tax and administrative staffs on a level playing field with the corporate world.

470. In the United States many of the states realized a number of years ago that they had a problem similar to the one being discussed with regard to developing countries. That is, the smaller states lacked the capacity to audit large national corporations, which operated across many state boundaries. They therefore organized what is called the Multi-State Tax Commission. This is a group to which each state pays dues in accordance to its size and use of the Commission's services: really, a fee for service. The Multi-State Commission then audits the activities of the large corporations in various states and makes a fair and uniform allocation of the corporation's income among the states in which it operates.

471. My suggestion is that either the United Nations or some regional body or CIAT-like organization take over a similar function. That body would develop a set of uniform principles or model statute - like Section 482 of the Internal

Revenue Code - which would be adopted by all of the countries participating. Thus, they would all agree to use the same principles in allocating income in multinational transactions. This may sound like a large step, but it is really rather minor; most of the rules are similar now. On top of that, many countries have strict and arbitrary rules which are not really enforced or, if they are, there are no transactions against which to apply them.

472. Thus, a group of international experts would draft a code. They would also draft implementing regulations or forms. Thus, a corporation doing business in four or five countries which are members of the new alliance would prepare one form for that allocation.

473. The next step is to have a group of experts at the call of this international group. Retired professionals in many countries could be used as a corps of experts in law, accounting, auditing, economics etc. to be on call to provide advice and to assist in the resolution of disputes. This would lead to an *in terrorem* effect: returns would be better and more forthrightly prepared if the corporate world knows that the authority has the capacity to meet them with equal intellectual force. A fairer system would yield better international commerce and fairer allocation of prices.

474. I know that what I suggest sounds revolutionary. But when an organization like CIAT was first proposed in the United States in 1966, many people were sceptical. Now, almost 30 years later, CIAT is a real force in the tax world and has produced a number of offspring in other parts of the world. I hope the United Nations can act as a catalyst in working on this and other ideas to help Governments do their job better; and, most importantly, to help countries receive their fair share of the income produced by international activities.

475. I am hopeful that a working group will be appointed by the United Nations or some similar organization to work out the details of this proposal. From my experience I have learned that the tax systems of the world have more similarities than differences. I believe that we can find a mutually acceptable method of fair taxation both for the countries involved and for international businesses.

TRENDS IN RECENTLY NEGOTIATED TAX TREATIES BETWEEN DEVELOPED AND DEVELOPING COUNTRIES*

INTRODUCTION

476. The present paper surveys income tax treaties established during the past 10 years between developing and developed countries. The survey compares the United Nations Model Double Taxation Convention between Developed and Developing Countries (1980)[60] with more than 50 recent treaties between developed and developing countries and with the model treaty promulgated by the Organisation for Economic Cooperation and Development (OECD) in 1992. The treaties examined represent approximately 20 per cent of all income tax treaties concluded between developed and developing countries during the past 10 years.

477. Section I summarizes the divergences between these treaties and the United Nations Model Convention that, in so far as they occur with sufficient frequency, can fairly be characterized as trends. Section II contains a detailed, article-by-article comparison of the treaties examined with the United Nations Model Convention. The treaties examined are listed in the annex to this paper.

I. SUMMARY

Article 2: Taxes covered

478. The second sentence of paragraph 4 requires that the competent authorities of the Contracting States notify each other of changes in their respective taxation laws "at the end of each year". Few treaties contain the quoted words.[61] Many of them have no time requirement, and others require that notice be given within a reasonable time or at an appropriate time.

Article 3: General definitions

479. Paragraph 1, which defines various terms for purposes of the treaty, does not define "Contracting State". Nearly all of the treaties contain definitions of "Contracting State" and "other Contracting State".[62] Typical language is as follows: "The terms 'Contracting State' and 'the other Contracting State' mean country X or country Y, as the context requires".

480. Paragraph 1 (d) defines "international traffic" as "any transport by a ship or aircraft operated by an enterprise which has its place of effective management in a Contracting State". The effective management concept is used in only a minority of the treaties. This issue is covered more fully below in the discussion of article 8.

481. Treaties like the OECD model generally include a definition of "nationals" in article 3, whereas the United Nations Model Convention includes this

---

* The original text of this paper, prepared by Professor Lawrence Lokken, consultant to the Department for Development Support and Management Services of the United Nations Secretariat, with the assistance of Monica Gianni and Robert Kopstein, was issued as document ST/SG/AC.8/1995/L.9. Views expressed are the author's and do not necessarily reflect those of the United Nations.

definition in article 24 (non-discrimination). Since the term "national" is used in articles other than article 24 (for example, in para. 2 (c) of art. 4), article 3 is probably the more appropriate home for this definition.

Article 4: Resident

482. Paragraph 1 defines the term "resident of a Contracting State". In many treaties, following the OECD model, the definition explicitly excludes persons liable to tax in the Contracting State only on income from sources therein.[63]

483. Under paragraph 3, if an entity is a resident of both Contracting States under the definition of paragraph 1, then it is classified as a resident of the State in which "its place of effective management is situated". Although many of the treaties do not use the effective-management rule, they do not establish any consensus on a substitute test.[64]

Article 5: Permanent establishment

484. Most of the treaties, like the OECD model, do not contain paragraph 3 (b) of the United Nations Model Convention, stating that the furnishing of services through employees is to be treated as constituting a permanent establishment if such activities continue (for the same or connected projects) for more than 6 months during any 12-month period.[65]

485. Paragraphs 4 (a) and (b) of the United Nations Model Convention provide that the use of facilities or the maintenance of a stock of goods for "storage or display" does not constitute a permanent establishment. Most of the treaties follow the OECD model in adding "delivery" to the quoted words.[66]

486. Most treaties also follow the OECD model in adding a subparagraph (f) to paragraph 4 stating that a combination of activities as described in subparagraphs (a) through (e) does not constitute a permanent establishment if "the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character".[67]

487. Paragraph 5 (b) of the United Nations Model Convention provides that a dependent agent acting in a Contracting State on behalf of an enterprise of the other Contracting State without authority to make contracts constitutes a permanent establishment if the agent "habitually maintains in the first-mentioned State a stock of goods or merchandise from which he regularly delivers goods or merchandise on behalf of the enterprise". This paragraph is not found in the OECD model and had been omitted from about one half of the treaties examined.[68]

488. Paragraph 6 of the United Nations Model Convention provides that if an insurance enterprise of a Contracting State collects insurance premiums or insures risks within the other Contracting State, then the enterprise shall be deemed to have a permanent establishment in the other Contracting State unless the activities are carried on through an independent agent or involve only reinsurance. Most of the treaties, following the OECD model, omit this provision.[69]

Article 7: Business profits

489. Paragraph 1 of the United Nations Model Convention provides that profits of an enterprise with a permanent establishment in a State are taxable by that State to the extent they are attributable to (a) that permanent establishment, (b) sales in that State of goods similar to those sold through that permanent establishment or (c) other business activities in the State that are similar to those of the permanent establishment. Most of the treaties follow the OECD model in containing only (a) and omitting (b) and (c).[70]

490. In paragraph 3, the United Nations Model Convention, like the OECD model, provides that expenses incurred "for the purposes of the business" of a permanent establishment, including administrative expenses, regardless of where incurred, are allowed as deductions in determining the permanent establishment's profits. The United Nations Model Convention goes on in two further sentences to state that no deduction is allowable for amounts paid by the permanent establishment to the head office of the enterprise for, among other things, royalties and commissions for specific services performed. Most of the treaties follow the OECD model in not including the latter sentence.[71]

491. A large majority of the treaties follow the OECD model in including a paragraph in this article stating the following: "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise".[72] The United Nations Model Convention contains no such provision, but states that this issue should be resolved by bilateral negotiations.

Article 8: Shipping, inland waterways transport and air transport

492. Under paragraph 1 of the United Nations Model Convention, profits from the operation of ships or aircraft in international traffic are taxable only in the State where the enterprise maintains its "place of effective management". Only a minority of the treaties follow the effective management rule, but the replacements for this rule vary among the treaties, with some treaties granting tax jurisdiction to the taxpayer's residence country, other treaties stating that an enterprise of a Contracting State is subject to tax on these profits only in that State, and still others using other formulations.[73]

493. The United Nations Model Convention contains an alternative paragraph 2 providing that international shipping profits are taxable exclusively in the State where the place of effective management is located unless shipping activities in the other State are "more than casual". None of the treaties in the survey utilize this alternative.

494. The United Nations Model Convention and the OECD model both contain a provision (para. 2 in alternative A and para. 3 in alternative B) dealing with profits from the operation of boats in inland waterways. Very few treaties contain this provision.[74]

Article 10: Dividends

495. Paragraph 3, defining "dividends," refers to "'jouissance' shares or 'jouissance' rights, mining shares, founders' shares". Most or all of these words are omitted from most of the treaties.[75]

Article 11: Interest

496. The second sentence of paragraph 2 requires that the competent authorities "settle the mode of application" of the rate ceiling established by this paragraph. A large number of the treaties do not contain this sentence.[76]

497. Many treaties contain provisions exempting the Government of a Contracting State, and often its central bank and other government instrumentalities, from tax on interest received from sources in the other State.[77] The scope and language of these provisions vary considerably.

Article 12: Royalties

498. The second sentence of paragraph 2 requires that the competent authorities "settle the mode of application of" the rate ceiling established by this paragraph. Many treaties omit this sentence.[78]

Article 13: Capital gains

499. Model paragraph 3 allows gains on alienation of ships or aircraft operated in international traffic, and of boats operating in inland waterways, to be taxed only by the State in which the enterprise has its place of effective management. Following their modifications of article 8, most treaties substitute another touchstone for the effective-management concept and drop the language on boats operating in inland waterways.[79]

500. Paragraph 5 of the United Nations Model Convention allows gains on alienation of shares in a company resident in a Contracting State to be taxed in that State, even if the selling shareholder is a resident of the other State, if the shares disposed of represent "a participation" exceeding a threshold. This provision, not contained in the OECD model, had been omitted from about one half of the treaties examined.[80]

501. Many of the treaties add a provision to this article allowing a Contracting State to tax capital gains of a former resident of that State for some period of time after the residence was abandoned.[81]

Article 14: Independent personal services

502. Paragraph 1 of the United Nations Model Convention provides that income of a resident of a Contracting State from independent personal services are taxable in the other State if (a) the recipient has a fixed base in the other State, or (b) the recipient is present in the other State for at least 183 days during the fiscal year, or (c) the remuneration for activities in the other State exceeds a threshold amount established by bilateral negotiations. The OECD model omits (b) and (c). A substantial minority of the treaties follow the OECD model on this point; other treaties contain (b) but not (c), and the treaties containing (b) often modify the wording.[82]

Article 15: Dependent personal services

503. Under United Nations Model Convention paragraph 3, wages of employees aboard a ship or aircraft in international traffic or a boat operating in inland waterways are taxable only by the State in which the operator of the ship, aircraft, or boat has its place of effective management. Most treaties do not use this rule, but the alternative to it varies from treaty to treaty.[83]

Article 16: Directors' fees and remuneration of top-level managerial officials

504. Model paragraph 2 provides that salaries and wages of a resident of a Contracting State received as "an official in a top-level managerial position" of a company resident in the other State may be taxed by the latter. This provision, not found in the OECD model, is omitted from nearly all of the treaties.[84]

Article 17: Income earned by entertainers and athletes

505. Although this article generally allows taxation at source of the income of entertainers and athletes, most of the treaties contain a paragraph, not found in the United Nations Model Convention, exempting such income from source taxation if the activities are supported by one or both of the Contracting States or are pursuant to a cultural exchange.[85] These provisions differ substantially in their details, although two or three patterns are clearly discernible.

Article 18: Pensions and social security payments

506. This article generally reserves the right to tax pensions in the Contracting State of the taxpayer's residence, but the United Nations Model Convention contains an alternative paragraph 2 allowing taxation at source. The alternative paragraph 2 had not been found in any of the treaties examined.[86]

507. The United Nations Model Convention contains another paragraph (para. 2 in alternative A and para. 3 in alternative B), which allows each State to tax the social security payments that it makes to residents of the other State. The latter paragraph is not in the OECD model, and is found in only a minority of the treaties.[87]

508. In a large number of treaties, this article is extended to apply to annuities.[88] However, the rules on annuities provided by these treaties differ greatly, some allowing taxation at source and some allowing taxation only by the country of the recipient's residence. Some treaties also address the taxation of alimony in this article.[89]

Article 20: Payments received by students and apprentices

509. Paragraph 2 provides that visiting students and business apprentices, to the extent that they are not exempt from taxation in the visited State under paragraph 1, are entitled in that State to the same "exemptions, reliefs or reductions" as are provided to residents. This provision, not found in the OECD model, is omitted from most of the treaties.[90]

510. Many treaties contain provisions, either as part of this article or as separate articles, exempting visiting teachers and researchers from tax in the State being visited.[91] These provisions generally limit the period of stay, but the length of this period and the description of the visitors qualifying for the exemption varies from treaty to treaty.

Article 22: Capital

511. Most of the treaties omit this article, probably because neither State has taxes on capital that would be affected by the article.

Article 23 A: Exemption method; Article 23 B: Credit method

512. The provisions on avoiding double taxation were not rigorously examined because variations from treaty to treaty, mostly reflecting peculiarities of the Contracting States' tax systems, precluded the identification of any trends.

Article 24: Non-discrimination

513. The definition of "nationals", constituting United Nations Model Convention paragraph 2 is found in article 3 of the OECD model and most of the treaties.[92]

514. Paragraph 3 of the United Nations Model Convention, extending the benefits of the non-discrimination article to some "stateless persons", is absent from most of the treaties, even though it is identical to the corresponding provision of the OECD model.[93]

Article 25: Mutual agreement procedure

515. A few recent treaties add to this article a provision authorizing or requiring an issue to be submitted to arbitration if the competent authorities are unable to resolve it.[94]

Article 26: Exchange of information

516. Paragraph 1 differs in several respects from the corresponding text of the OECD model. Several of the treaties examined follow the OECD model more closely than the United Nations Model Convention.[95]

Article 27: Diplomatic agents and consular officers

517. Some treaties add to the United Nations Model Convention language of this article the provision that a diplomat is to be considered a resident of the State the diplomat represents if various conditions are met.[96]

Other issues

518. Treaty shopping. Many treaties, but still a minority, contain one or more provisions denying treaty benefits for tax-minimizing schemes sometimes referred to as treaty shopping. Some examples:

(a) In some treaties, the articles on dividends, interest, royalties, and other income contain provisions stating that these articles do not apply if the right to the income was created or assigned principally to gain the benefits of the treaty;[97]

(b) Some treaties made by the United Kingdom of Great Britain and Northern Ireland deny the benefits of the interest article for interest on obligations held for less than three months unless the recipient is taxed on the interest in the country of residence;[98]

(c) Several treaties made by the United States of America have "Limitation on benefits" articles that deny the benefits of the treaty to an entity resident in one of the States unless it has substantial connections with that State in the form of, for example, public trading of its shares in that State, active business operations there, or majority stock ownership by individual residents of that State.[99]

519. Branch profits taxes. Many treaties have provisions allowing one or both of the Contracting States to impose branch profits taxes on the remitted profits of a permanent establishment. These provisions appear sometimes in the dividend articles[100] and sometimes in the non-discrimination articles.[101]

520. Pass-through entities. An increasing number of treaties, but still a minority, address the treatment of income of pass-through entities. For example, a few treaties contain a sentence within the definition of "resident" in paragraph 1 of article 4 stating that a partnership is to be treated as a resident of a Contracting State to the extent that partnership income is taxed in that State as income of a resident.[102] Other treaties have similar provisions located elsewhere in the treaties.[103]

II. DETAILED COMPARISON

Article 1: Personal scope

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

521. This provision is found in the OECD model and in all of the treaties examined.

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."

522. This article, which is identical to article 2 of the OECD model, is generally followed. The treaties specifically define the taxes to which the treaty applies in each country (paragraph 3). Some treaties do not include either paragraph 1 or 2 or both[104] but the scope of the treaty is made clear through paragraph 3.

523. Paragraph 4 is always included, although the introductory clause in the last sentence, "At the end of each year", is usually omitted or altered.[105] Some treaties include a variation authorizing the competent authorities to determine whether a subsequently introduced tax is a tax to which the treaty applies.[106]

524. One treaty adds a provision stating that penalties for tax fraud or evasion and interest for late payment are not "taxes".[107]

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): ...."

525. Differences noted in this paragraph are as follows:

(a) Most treaties contain definitions of the two countries that are parties to the treaty, and many of them define other terms not specifically defined in the United Nations Model Convention. For example, nearly all of the treaties contain definitions of "Contracting State" and "other Contracting State";[108]

(b) The definition of "person" in (a) is usually followed. A few treaties restate or expand the definition without much change in substance.[109] Some include trusts and estates[110] or partnerships;[111]

(c) In subparagraph (d), defining "international traffic", many of the treaties eliminated "place of effective management". The most common substitute involves transport by a ship or aircraft operated by an enterprise of one of the Contracting States.[112] The effective management concept appears throughout the shipping provisions of the models, but it is eliminated in many recent treaties wherever it appears. This is discussed further in conjunction with each section;

(d) Nearly all of the treaties examined follow the OECD model in including in this paragraph a definition of "national". This definition is in article 24(2) of the United Nations Model Convention. The definition is more appropriately included in article 3, rather than in article 24, because the term "national" is used in articles other than article 24 (for example, article 4). Some treaties used more specific definitions for each country.

> "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."

526. Few differences with this paragraph were noted.[113]

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."

527. Differences noted in this paragraph are as follows:

(a) A minority of the treaties expand the definition to include place of incorporation[114] or place of habitual abode;[115]

(b) Some treaties define more specifically by country what a resident is;

(c) Many treaties explicitly exclude persons liable to tax in the Contracting State only on income from sources therein.[116] These provisions generally follow the OECD model, which since 1977 has contained the following additional sentence in this paragraph: "But this term 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";

(d) A few treaties add language such as the following: "In the case of a partnership or estate this term ('resident') applies only to the extent that the income derived by such partnership or estate is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners."[117]

> "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."

528. This paragraph, which is identical to that of the OECD model, appears without alteration in most of the treaties. In one treaty, subparagraphs (b) through (d) are omitted.[118] Some treaties provide no tie-breaking rules, but state that the competent authorities shall resolve the issue of residence of an individual who is a resident of both States under paragraph 1.[119]

"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."

529. This paragraph is identical to the corresponding provision of the OECD model. In several of the treaties, the paragraph does not use the place of effective management as the tie-breaker for entities.[120] In some of these treaties, residence is determined by the competent authorities.[121] In other treaties, the term "practical day-to-day management",[122] "general management",[123] or "registered office"[124] is used instead of "effective management".

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."

530. Few differences with this paragraph were noted.[125] The provision also appears in the OECD model.

"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."

531. This language, which is identical to the OECD model, is found in all of the treaties. Some treaties include additional examples:

(a) Warehouse;[126]

(b) Permanent sales exhibition;[127]

(c) Sales outlets;[128]

(d) Agricultural, pastoral or forestry property;[129]

(e) Farm or plantation;[130]

(f) Installation used in exploring for natural resources;[131]

(g) Supervisory activities relating to building, construction, installation, or sale of equipment.[132]

"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."

532. Most treaties include a provision such as (a) for building or construction sites, although it is often included in paragraph 2. The time period varies. The six-month period of the United Nations Model Convention is sometimes used,[133] but the twelve-month period specified by the OECD model also appears in some treaties.[134] Other periods,[135] including 183 days,[136] three months,[137] and five months,[138] are also used. Some treaties reduce the time period for building activity that is incidental to the sale of equipment (for example, from 12 months to 6).

533. Part (b) on furnishing of services, which is not included in the OECD model, had been included in few of the treaties reviewed.[139]

"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."

534. This paragraph is generally followed, with minor differences:

(a) A large majority of the treaties follow the OECD model in including "delivery", as well as "storage or display" in (a) and (b).[140] Some treaties limits this to "occasional" delivery;[141]

(b) A large majority of the treaties also follow the OECD Model in including a subparagraph (f) providing that a place of business maintained "solely for any combination of activities mentioned in sub-paragraphs (a) through (e)" is not a permanent establishment if "the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character";[142]

(c) One treaty limits subparagraph (e) by adding "for the enterprise, such as advertising or scientific research."[143] Another restates (e) as "The maintenance of a fixed place of business solely for the purpose of advertising, or for the supply of information, or for similar activities which have a preparatory or auxiliary character, for the enterprise";[144]

(d) Additional factors in some treaties include:

(i) Sale of goods displayed in "an occasional and temporary fair or exhibition";[145]

(ii) Representative office of a bank where activities are preparatory or auxiliary;[146]

(e) Some treaties provide that "a fixed place of business used as a sales outlet" is a permanent establishment even if it is "otherwise maintained for any of the activities mentioned in paragraph 4".[147]

> "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."

535. With some variations in language, paragraph 5(a) is found in all of the treaties reviewed.[148]

536. A provision similar to paragraph 5(b) is found in a substantial minority of the treaties;[149] it is not included in the OECD model.

537. A few treaties provide that a dependent agent is a permanent establishment if the agent "habitually secures orders ... exclusively, or almost exclusively," for the enterprise or for other enterprises which are controlled by it or have a

controlling interest in it.[150] These provisions might be seen as tying into the second sentence of paragraph 7, stating that such an agent may not be considered an independent agent.

538. One treaty provides that a dependent agent manufacturing or processing goods on the principal's behalf is a permanent establishment.[151]

> "6. Notwithstanding the preceding provisions of this article, an insurance enterprise of a Contracting State shall, except in regard to reinsurance, 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."

539. This provision, which does not appear in the OECD model, is contained in a minority of the treaties reviewed.[152]

> "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."

540. The first sentence of this paragraph, which is similar to paragraph 6 of the OECD model, is generally followed.[153] One treaty adds the further proviso "that in their commercial or financial relations with the enterprise no conditions are made or imposed that differ from those generally agreed to by independent agents".[154]

541. Several of the treaties follow the OECD model in omitting the second sentence.[155] In some treaties, the second sentence applies only if it is shown that the transactions between the agent and the enterprise were not at arm's length.[156] Other treaties substitute for the second sentence a statement that the paragraph on dependent agents (paragraph 5) applies instead of paragraph 7 if transactions between the agent and the enterprise are not at arm's length.[157] In one treaty, the second sentence is included and extended to treat as dependent an agent whose activities are devoted wholly or almost wholly to the enterprise or to "that enterprise and other enterprises controlling, controlled by, or subject to the same common control, as that enterprise".[158]

> "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."

542. Few differences with this paragraph were noted.[159] It is paragraph 7 in the OECD model.

<u>Article 6: Income from immovable property</u>

> "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."

543. This article, which is identical to article 6 of the OECD model, is generally followed; only minor variations were noted. For example, in a few treaties, the term "real property" is substituted for "immovable property".[160] In one treaty, the second sentence of paragraph 2 is supplemented by the addition of the words "buildings, any option or similar right in respect of immovable property".[161] In another treaty, the definition of "immovable property" is included in article 3, rather than in this article.[162] In one treaty, the term "letting or share-cropping" is substituted for "letting" in paragraph 3.[163]

544. A few treaties add a provision allowing a resident of a Contracting State who is taxed in the other State on income from immovable property to elect to have that tax imposed on net, rather than gross, income from the property.[164]

545. Some treaties include an additional paragraph providing that if the ownership of shares or other corporate rights entitles the shareholder to "the enjoyment" of immovable property held by the company, the source country may tax the income from "the direct use, letting, or use in any other form" of this right.[165]

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."

546. This paragraph is found in all of the treaties. However, following the OECD model, most of the treaties allow business profits to be taxed in the country of source only if they are attributable to the permanent establishment, as in (a). Only a few treaties include the force-of-attraction rules of (b) and (c),[166] which are not found in the OECD model. One treaty contains (b) and (c), but qualifies them by providing that they "shall not apply if the enterprise

shows that such sales or activities could not reasonably have been undertaken by that permanent establishment".[167]

> "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."

547. This paragraph, which is identical to paragraph 2 of the OECD model, is found, usually without change, in all of the treaties.[168]

> "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."

548. The corresponding provision of the OECD model includes only the first sentence of this paragraph. Many of the treaties, following the OECD model, do not include the second and third sentences.[169]

549. One treaty restates the reference to administrative expenses to allow "a reasonable allocation of executive and general administrative expenses incurred for the purposes of the enterprise as a whole".[170] Another expands upon the types of allowable deductions to include research and development costs and interest, but qualifies the entire first sentence by making it clear that deductions are allowable only "in accordance with the provisions of and subject to the limitations of the taxation laws of [the taxing] State".[171] The latter expands the prohibitions of the second and third sentences to cover "know-how" as well as patents.

> "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."

550. This paragraph, which is substantially identical in the OECD model, is left out of some treaties.[172]

"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."

551. This paragraph, which is substantially identical in the OECD model, is left out of some treaties.[173]

"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."

552. No differences with respect to this paragraph were noted.

"(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.)"

553. The OECD model contains the following as paragraph 6: "No profits shall be attributed to a permanent establishment by reason of the mere purchase by that permanent establishment of goods or merchandise for the enterprise." A large majority of the treaties follow the OECD model in this.[174]

554. Treaties contained various additional provisions, including the following:

(a) Profits attributable to a permanent establishment engaged in "survey, supply, installation or construction activities" are limited to those resulting from the "actual performance of these activities";[175]

(b) This article does not limit taxation of profits of a non-resident's insurance activities under laws in effect when the treaty is signed;[176]

(c) Income of a permanent establishment is taxable in the State in which the establishment is located, even if the taxpayer does not receive the income until after the permanent establishment has ceased operations;[177]

(d) Where a permanent establishment takes an active and substantial role in the negotiation and conclusion of contracts, a proportionate part of the profits from the transactions is to be attributed to the permanent establishment;[178]

(e) Where the information available to the tax authority is inadequate to determine the profits to be attributed to a permanent establishment, the profits may be determined variously by the exercise of discretion,[179] apportionment,[180] or in accordance with the Contracting State's laws for dealing with such situations;[181]

(f) A partner's share of partnership profits from a permanent establishment is taxable in the country where the permanent establishment is located;[182]

(g) Provisions for trusts and estates entitled to business profits.[183]

Article 8: Shipping, inland waterways transport and air transport

Article 8A (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."

Article 8B (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.)"

555. This article is substantially modified in most of the treaties,[184] even though alternative A.1 is identical to that of the OECD model. For profits from international operations of ships or aircraft, some of the treaties reserve exclusive tax jurisdiction to the country of the taxpayer's residence,[185] while others provide that international shipping and air profits of an enterprise of a Contracting State are taxable only in that State.[186]

556. Several treaties extend the scope of this article to include profits from bareboat rentals[187] or from the use or rental of containers or trailers and equipment for the transport of containers,[188] but in each case usually only if the profits are incidental to the operation of ships and aircraft.[189]

Article 8 (Alternative A)/Article 8 (Alternative B)

"2./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."

557. Only a few of the treaties include this provision.[190] One treaty contains a provision for operation of boats in inland waterways that vests tax jurisdiction in the country where operations take place, not the place of effective management.[191]

"3./4. 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."

558. Treaties not using the "effective management" concept do include this provision,[192] and it is omitted in some treaties using that concept.[193]

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

559. Only minor differences with this paragraph were noted.

560. Several treaties contain an additional paragraph providing that when companies from different countries carry on a transportation business as a consortium, this article applies only to the portion of the consortium's profits that are allocable to a company that is a resident of a Contracting State.[194]

<u>Article 9: Associated enterprises</u>

"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 accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly."[195]

561. This paragraph, identical to the corresponding provision of the OECD model, is contained in all treaties reviewed, occasionally with minor changes in wording.[196]

562. Some treaties made by the Netherlands contain an additional sentence: "It is understood that the fact that associated enterprises have concluded arrangements, such as cost-sharing arrangements or general services agreements, for or based on the allocation of executive, general administrative, technical and commercial expenses, research and development expenses and other similar expenses, is not in itself a condition (departing from arm's length)."[197]

"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."

563. This paragraph, also found in the OECD model, is contained in most,[198] but not all,[199] of the treaties. A few treaties omit the second sentence of paragraph 2.[200] Some treaties require a State to make an adjustment under this paragraph only if it agrees with the adjustment or considers it justified or only if the adjustment is necessary to prevent double taxation.[201]

564. Additional provisions include:

(a) No adjustment may be made under paragraph 2 after the expiry of time limits of national laws;[202]

(b) Paragraph 2 does not apply to fraudulent or negligent conduct;[203]

(c) Paragraph 1 does not limit either State in applying its domestic law to adjust income, deductions, credits or other allowances "between persons" as necessary to prevent tax evasion or clearly reflect income.[204]

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."

565. This provision, identical to paragraph 1 of the OECD model, is contained in all treaties. In a few treaties, the provision applies only if the resident of the other State is "beneficially entitled" to the dividends.[205] In some treaties, it is combined with paragraph 2.

"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."

566. This paragraph is contained in all treaties reviewed except one.[206] The OECD model is the same except that maximum tax rates of 5 per cent and 15 per cent are prescribed, and the ownership threshold for the 5 per cent rate is 25 per cent. In the treaties examined, the tax rates vary, although the OECD

rates are quite common,[207] and the ownership threshold ranges from 10 to 100 per cent[208] and sometimes differs as to each Contracting State.[209] The ownership threshold is usually based on the percentage ownership of capital,[210] but in some treaties, it is based on ownership of voting stock,[211] voting rights,[212] or the monetary amount of invested capital.[213] Some treaties contain no analog to subparagraph (a), providing instead a single maximum rate for all dividends[214]

567. Several treaties omit the penultimate sentence, regarding competent authorities.[215]

> "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."

568. This definition, identical to that of the OECD model, is generally followed in the treaties, often with slight variations such as the omission of 'jouissance', mining, and founders' shares.[216]

> "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."

569. This provision, identical to the OECD provision, generally appears unchanged in the treaties.[217]

> "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."

570. This provision, identical to the OECD provision, often appears with some variations.[218]

571. Many treaties contain provisions allowing one or both of the countries to impose branch profits taxes on the after-tax profits of a permanent establishment maintained in that Contracting State by a corporation resident of the other State.[219]

572. Some treaties make this article inapplicable where the right to the dividends was created or assigned mainly to take advantage of the article.[220]

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."

573. This paragraph, identical to the corresponding provision of the OECD model, generally appears unchanged, occasionally with minor variations in wording.[221] In some treaties, particularly treaties that exempt interest from source country taxation, it is combined with paragraph 2.[222]

"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."

574. The OECD model is identical, except that a maximum tax rate of 10 per cent is prescribed. The first sentence of the paragraph generally appears in the treaties unchanged, although the maximum rate varies.[223] Many treaties do not include the second sentence.[224]

"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."

575. This paragraph, identical to the OECD provision, generally appears unchanged, in some treaties with variations in wording.[225] The last sentence beginning with "Penalty charges" is not included in many treaties.[226]

"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."

576. The OECD model is identical, except that the first sentence does not contain the words "or with (b) business activities referred to under (c) of paragraph 1 of article 7"; paragraph 1(c) of article 7 does not appear in the OECD model. Most of the treaties follow the OECD model in omitting both paragraph 1 (c) of article 7 and the quoted portions of paragraph 4 of article 11.[227]

"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."

577. This paragraph, identical to the OECD provision, generally appears in the treaties unchanged. This paragraph is omitted in some treaties, mostly treaties that exempt interest from tax at source.[228]

"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."

578. This paragraph, identical to the OECD provision, generally appears unchanged.[229]

579. Other provisions found in the interest articles:

(a) Most of the treaties add a provision exempting from tax interest received by the Government of the other State.[230] These provisions often also exempt interest on obligations insured or guaranteed by the other State.[231] Some treaties also exempt interest paid by the Government;[232]

(b) Some treaties exempt an enterprise of a Contracting State from tax in the other State on interest under credit sales of goods to enterprises of the other State, except where the enterprises are related persons;[233]

(c) Some treaties exempt interest on bank loans for a term exceeding a specified term;[234]

(d) A few treaties exempt interest paid to pension funds in the other State;[235]

(e) Some treaties deny the benefits of this article if the purpose of the creation or assignment of the debt claim is to take advantage of the article;[236]

(f) Treaties made by the United Kingdom often deny the rate reduction provided by this article if the interest is exempt from tax in the recipient's country of residence and the recipient holds the interest-bearing obligation for less than three months.[237]

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."

580. Paragraphs 1 and 2 generally appear as in the United Nations Model Convention,[238] except that the last sentence often is not included[239] and a few treaties make these paragraphs also applicable to fees for technical services.[240] The rate ceiling in paragraph 2 varies.[241] In some treaties, differing rates are used for various specified situations, such as 5 per cent for royalties for the use of industrial, commercial or scientific equipment and 10 per cent for all other royalties[242] or a lower rate for royalties on patents and similar items than on other property, such as copyrights.[243]

581. Under the OECD model, royalties are taxable only in the country of the taxpayer's residence, and some treaties follow the OECD model on this point.[244]

"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."

582. The OECD model is identical, except that it does not contain the words "or films or tapes used for radio or television broadcasting".[245] The model definition is generally followed, sometimes with variations in wording that are apparently intended to broaden the reach of the definition.[246] In a few treaties, "royalties" includes gains on alienations of intellectual property if they are contingent on the property's productivity, use or disposition.[247] Treaties extending this article to fees for technical services include provisions defining the fees covered.[248]

"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."

583. This paragraph generally appears as in the United Nations Model Convention. However, treaties following the OECD model in omitting paragraph 1 (c) of article 7 do not contain the words "or with (b) business activities referred to under (c) of paragraph 1 of article 7".[249]

"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."

584. Some treaties, mostly treaties made by the United States, substitute a source rule providing that royalties arise where the property is used.[250] In other treaties, only minor changes with this paragraph were noted.[251] The OECD model does not contain this provision.

"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."

585. No substantive changes with this paragraph were noted.[252] It is paragraph 4 in the OECD model.

586. Several treaties include a form of most-favoured-nation clause under which a lower rate or exemption for royalties, or a narrowing of the definition of "royalties", in any subsequent treaty made by the developing country will thereafter be substituted as the rate ceiling in this treaty.[253]

587. Under some treaties, the royalties article is inapplicable if one of the main purposes of the creation or assignment of royalty rights was to take advantage of the article.[254]

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."

588. This paragraph, identical in the OECD model, appears in all of the treaties, usually without material change.[255] One treaty restates this and much of the remainder of the article to provide that each State may tax gains from the alienation of immovable and movable property, including shares in companies, in accordance with its laws.[256] One treaty contains no article on capital gains.[257]

"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."

589. This paragraph, identical in the OECD model, generally appears as in the United Nations Model Convention.

"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."

590. Consistent with other articles on ships and aircraft, many treaties do not use the effective management concept, usually vesting tax jurisdiction instead in the country of residence.[258] Also, most treaties do not include the clause on "boats engaged in inland waterways transport".[259] One treaty supplements this paragraph with a paragraph on gains from dispositions of "containers (including trailers and related equipment for the transport of containers)".[260] Some treaties omit this paragraph.[261]

"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."

591. Many treaties contain this provision,[262] although some of them combine it with paragraph 1[263] and others restrict its application to companies whose shares are not publicly traded.[264] Some treaties provide that in determining whether a company's property consists principally of immovable property, shares it owns in other companies are "immovable property" if the latter companies' property consists principally of immovable property.[265] Some treaties extend the paragraph to include interests in partnerships, trusts, or "other legal persons".[266]

592. This paragraph is not included in the OECD model.[267]

"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."

593. This paragraph is not contained in the OECD model, and only some of the treaties contain it.[268] When it is included, a minimum ownership percentage is not always specified; instead, any alienation of shares may be taxed in the Contracting State of the company.[269]

"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."

594. This paragraph appears without change in most of the treaties, but it is omitted in a few.[270] One treaty adds an additional sentence providing that capital gains "derived" in the other State on sales of property held for one year or less may be taxed in the other State.[271] A few treaties reverse the rule of this paragraph, providing that the gains may be taxed where the property is "situated"[272] or where the gain "aris(es)".[273]

595. Other provisions have been added to this article in some treaties, including:

(a) A Contracting State may tax capital gains of an individual resident of the other State who was a resident of the first State at any time during a specified time period (for example, 5 or 10 years) before the alienation of the property;[274]

(b) Gains from property generating royalties subject to article 12 are taxable only under article 12.[275]

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)."

596. The substance of this paragraph, up through (a), is contained in the OECD model and nearly all the treaties.[276] Many treaties do not include (b) or (c).[277] When present, subparagraph (b) is often modified to apply if the person is present in the other State for 183 days within any period of 12 months, rather than within the "fiscal year".[278] In one treaty, (b) applies to persons present for 91 or more days in any taxable year.[279] Some treaties contain (b) but not (c).[280]

"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."

597. Only minor differences with this paragraph were noted.[281] It also appears in the OECD model.

Article 15: Dependent personal services

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

598. No differences with this paragraph were noted. It also appears in the OECD model.

"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."

599. This paragraph is also found in the OECD model, except that in the latter condition (a) requires that the recipient be present in the other State for more than 183 days during any 12-month period beginning or ending during the taxable year. Some of the treaties follow the OECD model, rather than the United Nations Model Convention, on this point.[282] One treaty adds to (b), "and whose activity does not consist of the hiring out of labour".[283] One treaty substitutes for (c) the dual condition that the remuneration not be deductible in determining the taxable profits of a permanent establishment or a fixed base which the employer has in the other State and that the remuneration be subject to tax in the residence country of the person performing the services.[284]

"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."

600. With only a few exceptions, all of the treaties (and the OECD model) contain this provision.[285] However, consistent with other articles on shipping and air, most of the treaties do not use the concept of "effective management", vesting tax jurisdiction instead in the residence country of the operator, the ship or aircraft.[286]

<u>Article 16: Directors' fees and remuneration of top-level managerial officials</u>

"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."

601. All treaties contained this paragraph, with modifications in only a few treaties.[287]

"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."

602. Almost none of the treaties contain this paragraph,[288] which is not in the OECD model.

603. One treaty contains an additional paragraph to allow day-to-day managerial or technical services to be taxed as dependent personal services.[289]

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."

604. This paragraph is contained without change in nearly all treaties.[290] It is also found in the 1963 and 1977 models of the OECD, but the 1992 OECD model substitutes "sportsman" for "athlete".[291]

"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."

605. This paragraph is contained without change in all treaties.[292]

606. Many of the treaties contain an additional provision exempting the income from tax in the State where the activities occur if the activities are supported by, variously, that State, the other State, both States, either State, or an arm of one of the States or are pursuant to a cultural exchange.[293]

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."

Article 18 B (alternative B)

"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."

Article 18 A (alternative A/article 18 B (alternative C))

"2./3. Notwithstanding the provisions of paragraph 1 (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."

607. All of the treaties contained paragraph 1, which is the sole paragraph of this article in the OECD model.[294] The United Nations Model Convention of this article is given in two alternatives, with paragraph 2 appearing only in alternative B. Paragraph 2, allowing pensions to be taxed in the residence country of the payer, is found in none of the treaties, but one treaty contains a provision that is similar in substance.[295] Paragraph 3 is also not included in the OECD model; it is included in a substantial minority of treaties reviewed.[296]

608. In some treaties, social security pensions are discussed in other provisions,[297] but in other treaties they are not mentioned.

609. In many treaties, this article includes provisions dealing with annuities. Several treaties provide that an annuity - defined as a stream of periodic payments made in exchange for adequate and full consideration in money or money's worth - may be taxed where it "arises", sometimes exclusively in that State.[298] A somewhat larger number of treaties provide that annuities - similarly defined - may be taxed only in the recipient's country of residence.[299]

610. In some treaties, this article is expanded to encompass alimony and child support. These provisions sometimes allow taxation only in the recipient's Contracting State[300] and they sometimes allow taxation in the Contracting State where the payment arose.[301]

<u>Article 19: Remuneration and pensions in respect of government service</u>

> "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."

611. This paragraph appears as in the United Nations Model Convention in most treaties, with minor changes in wording in other treaties.[302] Some German treaties extend paragraph 1 to cover remuneration paid under a development assistance programme of a Contracting State.[303] The OECD model was identical until it was amended in 1994 to substitute "salaries, wages and other similar remuneration" for "remuneration".

> "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."

612. This paragraph, which is also found in the OECD model, is contained in many, but not all, of the treaties.[304]

> "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."

613. Few changes in this paragraph were noted.[305] It is also found in the OECD model.

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."

614. Generally, only minor changes were noted with this paragraph.[306] It is also found in the OECD model.

> "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."

615. This paragraph, which is not in the OECD model, is included only occasionally.[307]

616. Other provisions are added to this article. The arrangements may be described as follows:

(a) Some treaties contain provisions limiting the period a student can enjoy the benefits of this article to such period of time as may be reasonably required to complete the education or training;[308]

(b) Some treaties contain provisions exempting students from tax in the country in which they are studying on some earnings from work done in that country. One treaty exempts up to US$ 2,000 of such earnings.[309] Another exempts remuneration for not more than 183 days of employment during a calendar year in order to obtain practical experience related to his "education or formation".[310] Others exempt a student or trainee from tax on earnings from "services in connection with his studies or training" if the earnings are "necessary for his maintenance";[311]

(c) Many treaties contain provisions on teachers and researchers, either as part of this article or in separate articles. For example, one treaty provides that if a professor, teacher or researcher is a resident of one of the Contracting States but is present in the other State for the purpose of "teaching or scientific research" at a university, school, or "scientific research institution", payments for this teaching or research are exempt from tax in the other State for a period not exceeding three years;[312]

(d) Some United States treaties include teachers and researchers in the article for students and trainees, generally subject to both a dollar ceiling and a time-limit (typically, two years for teachers and five years for students).[313]

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."

617. This paragraph, identical in the OECD model, is included unchanged in the majority of treaties.[314] Some treaties deny the benefit of this provision if the owner of the income is not subject to tax in the owner's State of residence.[315] In treaties made by the United Kingdom, paragraph 1 is often stated not to apply to income paid out of trusts and estates.[316]

"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."

618. This paragraph, identical in the OECD model, appears unchanged in most treaties,[317] but is absent from some of them.[318]

"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."

619. This paragraph is contained in some, but not all, of the treaties;[319] it is not included in the OECD model.

620. Some treaties deny the benefit of this article if taking advantage of the article was "one of the main purposes" of the transaction generating the income.[320] One such treaty also provides that where, by reason of a "special relationship" between the parties, the income is not at arm's length, the article applies only to the arm's length amounts.[321]

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.)"

621. This article, which is identical to article 22 of the OECD model, is found in a minority of the treaties examined.[322]

622. Among the treaties containing this article in some form, paragraphs 1, 2 and 4 are generally followed.

623. Even among the treaties containing article 22, paragraph 3 was not included in all treaties.[323] Where it was included, the concept of effective management was usually not used, and tax jurisdiction is awarded to, for example, the residence State of the enterprise[324] or the State in which the profits of the enterprise are taxable.[325]

624. One treaty allows capital represented by corporate shares to be taxed in a Contracting State if the company's assets consist principally of immovable property in that State or if the company is a resident of that State and the taxpayer owns at least 10 per cent of the stock.[326] Other treaties allow that State to tax shares of a company whose assets consist primarily of immovable property.[327] In the United Nations Model Convention, the latter provision is paragraph 4 of article 13 (Capital gains).

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."

625. These articles are substantially identical to the equivalent provisions of the OECD model, but none of the treaties follow either of these alternatives very closely.

626. The credit method (article 23 B) is used in most of the treaties.

627. Usually, the method of eliminating taxation is listed separately for each Contracting State.

628. The method is often different for different types of income.

629. It does not seem possible to set standard clauses for the elimination of double taxation as each country has different types of taxes and different interests.

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."

630. This article appears in nearly all of the treaties.[328] Among the treaties including the article, paragraph 1, which is identical to the OECD provision, is generally followed, except that some treaties do not include the last sentence.[329] A few treaties use the term "citizens" instead of "nationals".[330]

"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."

631. As in the OECD model, most of the treaties include this paragraph in article 3, Definitions.[331] At least one treaty melds this paragraph together with paragraph 1.[332]

"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."

632. This paragraph, identical with article 24(2) of the OECD model, is included in only a few treaties.[333]

"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."

633. This paragraph, identical with the corresponding OECD provision, is generally followed,[334] although in many treaties the last sentence is made a separate paragraph that qualifies the entire non-discrimination article, not merely paragraph 4.[335]

"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."

634. This paragraph also appears in the OECD model. Only minor changes with this paragraph were noted,[336] although the paragraph is not contained in a few of the treaties[337] and several treaties omit the second sentence.[338]

"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."

635. Only minor changes with this paragraph, also included in the OECD model, were noted.[339] A few treaties omit this paragraph.[340]

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

636. This article, also found in the OECD model, appears without change in most of the treaties,[341] but it is not contained in several treaties.[342] In other treaties, it is stated instead that the article applies only to the taxes that are the subject of the treaty.[343]

637. Some treaties add provisions, either as part of paragraph 4 or as a separate paragraph, stating that the first sentence of paragraph 4 does not bar

the imposition of a branch profits tax on profits of a permanent establishment remitted to the head office.[344]

638. One treaty contains an additional paragraph providing a non-discrimination rule for individual contributions to pension plans.[345]

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."

639. This paragraph, identical with the OECD model, is generally followed,[346] although a few treaties do not contain the last sentence[347] and a few treaties include the last sentence but with a limit of two years, rather than three.[348]

> "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."

640. This paragraph, identical with the corresponding OECD provision, is generally followed,[349] but some treaties do not include the final sentence.[350]

> "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."

641. This paragraph, identical with the corresponding provision of the OECD model, is generally followed,[351] although a few treaties do not include the last sentence.[352] One treaty adds that the competent authorities may consult to improve the exchange of information under United Nations Model Convention article 26.[353]

> "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."

642. This paragraph is generally followed for the first sentence, which is also found in the OECD model.[354] In many treaties, the last two sentences, which are not present in the OECD model, are not included[355] or are included in modified form.[356] Several treaties follow the OECD model in stating that an oral exchange of opinions may take place through a Commission consisting of representatives of the competent authorities of the Contracting States.[357]

643. A few very recent treaties allow either State to require an issue to be submitted to arbitration if it is not resolved by the competent authorities within two years after it was first raised.[358]

644. One treaty provides that the competent authorities shall "settle the mode of application of this Convention", particularly the procedures to be followed by taxpayers in obtaining "the tax reliefs or exemptions provided" by the treaty.[359]

645. One treaty adds that a Contracting State may not, after the expiry of the time-limits provided in its national laws and never after five years from the end of the taxable period in which the income connected had accrued, increase the tax base of a resident of either of the Contracting States by including items of income that have also been taxed in the other Contracting State.[360]

646. One treaty provides that the competent authorities may agree to deny the benefits of the articles on dividends, interest, and royalties to a company that became a resident of a Contracting State "for the principal purpose of enjoying benefits under this Agreement".[361]

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."

647. The corresponding provision of the OECD model does not include the words "in particular for the prevention of fraud or evasion of such taxes" at the end of the first sentence. In lieu of the fourth sentence, the OECD model adds at the end of the third sentence "and 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 covered by the Convention". The OECD model does not include the final sentence.

648. This paragraph is generally contained in the treaties[362] but several of them follow the OECD model more closely than the United Nations Model Convention.[363]

> "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, commercial or professional secret or trade process, or information, the disclosure of which would be contrary to public policy (ordre public)."

649. Only minor changes were noted with this paragraph,[364] which is identical to the corresponding provision of the OECD model.

650. Some treaties made by the United States provide that any information requested by a competent authority shall be obtained by the other State "in the same manner and to the same extent as if the tax ... were the tax of that other State".[365]

651. One treaty adds that this article applies "to taxes of every kind imposed by a Contracting State".[366]

652. One treaty omits this article.[367]

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."

653. This paragraph, also found in the OECD model, appears largely unchanged in all of the treaties.[368]

654. Some treaties include additional provisions, including:

(a) Diplomats are considered to be residents of the Contracting State that they represent if they satisfy, variously, one or two conditions: that they be taxed in the other State only on income from sources within that State (source condition) and that they be taxed as residents in the sending country (residence condition);[369]

(b) The treaty does not apply to international organizations or to diplomats of a third State, even if present in one of the Contracting States, unless they are taxed as residents in one of the States.[370]

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):" ....

655. This article, which is identical to the corresponding provision of the OECD model, is reworded in most of the treaties.[371]

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):" ....

656. Few significant changes were noted with this article,[372] which is also found in the OECD model.

657. Other provisions:

(a) Some treaties include an article on fees for technical or management services.[373] For example, one treaty contains a provision allowing source country taxation of management fees at not more than 12.5 per cent of the gross amount and defines "management fees" as fees for providing "industrial or commercial advice, or management technical services", other than services performed as employee or through a permanent establishment of the services performer, exclusive of amounts taxable in the country of source under the rules for independent personal services (United Nations Model Convention article 14).[374] Another treaty allows source country taxation of the gross amount of "management fees" - similarly defined - at not more than 10 per cent, but also allows the recipient to be taxed on the fees on a net basis;[375]

(b) Some treaties contain "limitation of relief" provisions that restrict treaty exemptions from or reductions of withholding taxes. Under these provisions, if the recipient of an item is taxed in the country of residence on only the net amount received, the exemption or rate reduction applies only to this net amount, and the remainder of the item is taxed at source under the non-treaty rules of the source country.[376] A related provision, entitled "Limitation of benefits", in treaties made by Sweden allows Sweden to tax any item, otherwise exempt from Swedish tax under the Convention, that "derives ... from a source situated outside (the other State)";[377]

(c) Many treaties made by the United States have complex "limitation on benefits" provisions. For example, the United States-Ukraine treaty provides that a resident of a Contracting State that derives income from the other State is entitled to relief from taxation under the treaty only if the resident is:

(i) An individual;

(ii) An entity that is actively engaged in business in its State of residence and the income in the other State is connected with or incidental to that business;

(iii) A company whose shares are publicly traded on a regular basis in its State of residence;

(iv) A tax-exempt not-for-profit organization, more than one half of whose beneficiaries, members or participants are residents of the organization's State of residence;

(v) An entity more than 50 per cent of the beneficial interests in which are owned by individuals, publicly traded companies, and not-for-profit organizations described in (a), (b) and (d) and not more than 50 per cent of the gross income of which is used to meet liabilities for interest, royalties, and similar items;[378]

(d) One treaty contains a provision denying the benefits of the articles on dividends, interest, and royalties to a "company of one of the Contracting States" if the tax in that State on the company's dividend, interest, or royalty income is "substantially less than the tax generally imposed ... on company profits" and at least 25 per cent of the company's "capital" is owned by persons not resident in that State;[379]

(e) Another treaty provides that it does not limit a Contracting State in applying its laws on the taxation of shareholders of non-resident companies, on tax evasion, and for "all purposes not having relation to the taxation of income";[380]

(f) Some treaties contain provisions on "offshore activities" in exploring or exploiting "the seabed and subsoil and their natural resources".[381] These provisions allow taxation at source of both income from the activities and salaries and wages of employees working in the activities;

(g) Some treaties contain a provision allowing a Contracting State to tax a partner residing in that State on partnership income or gains, even if the partnership is a resident of the other State and, under the treaty, is exempt from the first State's tax on the income or gains;[382]

(h) Some treaties contain a provision stipulating that the treaty does not affect any exclusion, exemption, deduction, credit, or other allowance provided by the domestic law of a Contracting State;[383]

(i) A few treaties contain a provision obligating each State the "lend assistance" to the other State in collecting taxes finally determined to be owing in the other State.[384] This assistance usually takes the form of collection of the other State's tax in accordance with the collection laws of the collecting State. However, a State may look to the other for collection assistance only if the taxpayer's property in the first State is not sufficient to satisfy the tax;

(j) Treaties made by the United States usually include a provision allowing each State to tax its residents and, in the case of the United States, its citizens and former citizens under its domestic law, without regard to the treaty.[385]

Notes

[60] United Nations publication, Sales No. E.80.XVI.3 and Corr. 1.

[61] Infra, text accompanying note 45.

[62] Infra, text accompanying note 48.

[63] Infra, text accompanying note 56.

[64] Infra, text accompanying notes 60-64.

[65] Infra, text accompanying note 79.

[66] Infra, text accompanying notes 80-81.

[67] Infra, text accompanying note 82.

[68] Infra, text accompanying note 89.

[69] Infra, text accompanying note 92.

[70] Infra, text accompanying notes 106 and 107. These treaties also omit cross references to (c) that appear in other articles of the Model (infra, text accompanying notes 167 and 189).

[71] Infra, text accompanying note 109.

[72] Infra, text accompanying note 114.

[73] Infra, text accompanying notes 124-126.

[74] Infra, text accompanying notes 130-131.

[75] Infra, text accompanying note 156.

[76] Infra, text accompanying note 164.

[77] Infra, text accompanying notes 170-172.

[78] Infra, text accompanying note 179.

[79] Infra, text accompanying notes 198-199.

[80] Infra, text accompanying notes 208 and 209.

[81] Infra, text accompanying note 214.

[82] Infra, text accompanying notes 216-220.

[83] Infra, text accompanying note 226.

[84] Infra, text accompanying note 228.

[85] Infra, text accompanying note 233.

[86] Infra, text accompanying note 235.

[87] Infra, text accompanying note 236.

[88] Infra, text accompanying notes 238 and 239.

[89] Infra, text accompanying notes 240-241.

[90] Infra, text accompanying note 247.

[91] Infra, text accompanying notes 252 and 253.

[92] Infra, text accompanying note 271.

[93] Infra, text accompanying note 273.

[94] Infra, text accompanying note 298.

[95] Infra, text accompanying notes 302 and 303.

[96] Infra, text accompanying notes 309.

[97] Infra, text accompanying notes 160, 176, 194, 260.

[98] Infra, text accompanying note 177.

[99] Infra, text accompanying note 318.

[100] Infra, text accompanying note 159.

[101] Infra, text accompanying note 284.

[102] Infra, text accompanying note 57.

[103] Infra, text accompanying note 322.

[104] Treaties omitting both paragraphs 1 and 2 include Finland-China, art. 2; France-Nigeria, art. 2; France-Trinidad and Tobago, art. 2; Sweden-Belarus, art. 2; United States-China, art. 2; United States-Ukraine, art. 2. Treaties omitting only paragraph 2 include United States-Tunisia, art. 2 (also omitting from paragraph 1 "or of its political subdivisions or local authorities, irrespective of the manner in which they are levied").

[105] Treaties simply omitting this language include Belgium-China, art. 2(4); France-Nigeria, art. 2(2); France-Trinidad and Tobago, art. 2(2); Ireland-Russian Federation, art. 2(4); Netherlands-Latvia, art. 2(4); Sweden-Belarus, art. 2(2); Sweden-Viet Nam, art. 2(4); United States-Tunisia, art. 2(3); United States-Ukraine, art. 2(2). Other treaties substitute a phrase such as "within a reasonable period of time after such changes", Finland-China, art. 2(2); United States-China, art. 2(2) ("within an appropriate time period").

See also United States-Ukraine, art. 2(2) (requiring the States to also notify each other of "any official published material concerning the application of the Convention, including explanations, regulations, rulings, or judicial decisions").

[106] Finland-Estonia, art. 2(2); Finland-Ukraine, art. 2(4).

[107] Sweden-Belarus, art. 2(3).

[108] For example, Belgium-China, art. 3(1)(c) (also defining "tax"); Denmark-Egypt, art. 3(1)(a); Finland-China, art. 3(1)(c); France-Nigeria, art. 3(1)(d); France-Trinidad and Tobago, art. 3(1)(c); Ireland-Russian Federation, art. 3(1)(a); Netherlands-Latvia, art. 3(1)(a); Norway-Zimbabwe, art. 3(1)(c); Sweden-Belarus, art. 3(1)(c); Sweden-Viet Nam, art. 3(1)(c); United States-China, art. 3(1)(c); United States-Ukraine, art. 3(1)(a). Typical language is: "The terms 'a Contracting State' and 'the other Contracting State' mean country X or country Y, as the context requires."

[109] For example, Ireland-Russian Federation, art. 3(1)(d) ("an individual, an enterprise, a company and any other body of persons incorporated under the laws of a Contracting State and deemed to be a legal entity for tax purposes in that State").

[110] Norway-Zimbabwe, art. 3(1)(d); United States-Tunisia, art. 3(1)(a); United States-Ukraine, art. 1(e).

[111] United States-China, art. 3(1)(e).

[112] Finland-Estonia, art. 3(1)(g); Finland-Ukraine, art. 3(1)(h); France-Nigeria, art. 3(1)(h); Luxembourg-Indonesia, art. 3(1)(f); Netherlands-Latvia, art. 3(1)(g); Netherlands-Nigeria, art. 3(1)(g); Spain-India, art. 3(1)(i); Sweden-Belarus, art. 3(1)(g); Sweden-Botswana, art. 3(1)(g); Sweden-Viet Nam, art. 3(1)(h); Turkey-Hungary, art. 3(1)(j); United Kingdom-Ghana, art. 3(1)(h); United Kingdom-Mexico, art. 3(1)(h). See also Ireland-Russian Federation, art. 3(1)(g) ("operated by a resident of a Contracting State"); United States-China, art. 3(1) (no definition of "international traffic"); United States-Tunisia, art. 3(1)(g) (defining term to include "any transport by a ship or aircraft"); United States-Ukraine, art. 3 (1)(g) (same).

[113] After "unless the context otherwise requires", some treaties made by the United States (United States-Tunisia, art. 3(2); United States-Ukraine, art. 3(2)) add "(and subject if necessary to the provisions of article 25 (Mutual agreement procedure))".

[114] Finland-Estonia, art. 4(1); France-Nigeria, art. 4(1); Finland-Ukraine, art. 4(1); Netherlands-Nigeria, art. 4(1); Sweden-Belarus, art. 4(1); United States-China, art. 4(1); United States-Tunisia, art. 4(1); United States-Ukraine, art. 4(1). See also Ireland-Russian Federation, art. 4(1) ("Place of registration as a legal entity, place of effective management").

[115] Germany-Costa Rica, art. 4(1). See also Sweden-Vietnam, art. 4(1) ("Nationality"); United States-China art. 4(1) ("Citizenship"); United States-Tunisia, art. 4(1) (same); United States-Ukraine, art. 4(1) (same).

[116] For example, Australia-Viet Nam, art. 4(2); Denmark-Egypt, art. 4(1); Finland-Pakistan, art. 4(1); Finland-Estonia, art. 4(1); Germany-Costa Rica, art. 4(1); Luxembourg-Indonesia, art. 4(1); Netherlands-Latvia, art. 4(1); Spain-India, art. 4(1); Sweden-Botswana, art. 4(1)(a); Sweden-Belarus, art. 4(1); United Kingdom-Ghana, art. 4(1); United Kingdom-Mexico, art. 4(1).

[117] Sweden-Belarus, art. 4(1)(b); Sweden-Botswana, art. 4(1)(a).

[118] Australia-Viet Nam, art. 4(3).

[119] Belgium-China, art. 4(2); Finland-China, art. 4(2); United States-China, art. 4(2).

[120] See Finland-China, art. 4(3) ("place of head office or effective management"). In the Sweden-Egypt treaty, a company is deemed to be a resident of the country of which it is a "national", and the place of effective management is looked to only if it is not a national of either State (Sweden-Egypt, art. 4(3)).

[121] Finland-Estonia, art. 4(3) (providing further that "in the absence of such agreement, for the purposes of the Convention, the person shall in each Contracting State be deemed not to be a resident of the other Contracting State"); France-Nigeria, art. 4(3); Netherlands-Nigeria, art. 4(3); Netherlands-Latvia, art. 4(3) (in resolving that issue, competent authorities take into account "its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors"; in absence of agreement, entity is denied various treaty benefits); Sweden-Belarus, art. 4(3); United States-China, art. 4(3) (in absence of agreement, entity is deemed not resident in either State); United States-Tunisia, art. 4(3); United States-Ukraine, art. 4(3). Also see Sweden-Egypt, art. 4(3) (vesting tie-breaking power in competent authorities only for persons other than individuals and entities).

[122] Finland-Ukraine, art. 4(3).

[123] Belgium-China, art. 4(3).

[124] Turkey-Hungary, art. 4(3).

[125] But see United States-Ukraine, art. 5(1) (restating definition as follows: "fixed place of business through which a resident of a Contracting State, whether or not a legal entity, either wholly or in part carries on its business activities in the other Contracting State").

[126] Finland-Pakistan, art. 5(2)(f); Spain-India, art. 5(2)(g) (only if operated to provide storage facilities for others).

[127] Finland-Pakistan, art. 5(2)(g).

[128] Denmark-Egypt, art. 5(2)(h); Finland-Ukraine, art. 5(2)(f); Spain-India, art. 5(2)(i). See also Sweden-Belarus, art. 2(g) ("a building used for selling goods").

[129] Australia-Viet Nam, art. 5(2)(g); Denmark-Egypt, art. 5(2)(g).

[130] Luxembourg-Indonesia, art. 5(2)(g); Spain-India, art. 5(2)(h); Sweden-Egypt, art. 5(2)(g).

[131] Luxembourg-Indonesia, art. 5(2)(h); Spain-India, art. 5(2)(i) (but only if so used for more than three months); Sweden-Botswana, art. 5(g) (at least six months). See France-Trinidad and Tobago, art. 5(2)(i) (drilling rig or ship for exploring or developing natural resources).

[132] United Kingdom-Ghana, art. 2(h) and (i). See France-Nigeria, art. 5(2)(h) (installation of machinery or related supervisory activities where charges for installation exceed 10 per cent of free on board (f.o.b.) price of machinery).

[133] Finland-China, art. 3(a); France-Trinidad and Tobago, art. 2(j); Sweden-Egypt, art. 5(3); Sweden-Viet Nam, art. 5(3); United States-Ukraine, art. 3 (also covering "an installation or drilling rig or ship used for exploration or development of natural resources").

[134] Finland-Ukraine, art. 5(3) (but exploration for natural resources is a permanent establishment if it continues for more than six months); Germany-Costa Rica, art. 5(3); Sweden-Belarus, art. 2(h).

[135] Germany-Costa Rica, art. 5(2)(k) (six months during any 12-month period).

[136] Australia-Viet Nam, art. 5(2)(h); United States-Tunisia, art. 3 ("183 days in any 365-day period (including the period of any supervisory activity connected therewith)").

[137] France-Nigeria, art. 2(g); Netherlands-Nigeria, art. 5(3)(a).

[138] Luxembourg-Indonesia, art. 5(3).

[139] Treaties with services provisions include Netherlands-Nigeria, art. 5(3) (providing also that installation of machinery incident to sale is not a permanent establishment unless activities continue for more than six months); Finland-China, art. 3(b); Sweden-Viet Nam, art. 5(4).

[140] Australia-Viet Nam, art. 5(3)(a) and (b); Belgium-China, art. 5(4)(a) and (b); Denmark-Egypt, art. 4(a) and (b); Finland-China, art. 5(4)(a) and (b); Finland-Estonia, art. 5(4)(a) and (b); Finland-Pakistan, art. 5(4)(a) and (b); France-Nigeria, art. 5(3)(a) and (b); France-Trinidad and Tobago, art. 5(3)(a) and (b); Ireland-Russian Federation, art. 5(4)(a) and (b); Germany-Costa Rica, art. 5(4)(a) and (b) ("delivery under a sale contract"); Netherlands-Latvia, art. 5(4)(a) and (b); Netherlands-Nigeria, art. 5(4)(a) and (b); Sweden-Belarus, art. 5(3)(a) and (b); Turkey-Hungary, art. 5(3)(a) and (b); United Kingdom-Ghana, art. 5(3)(a) and (b); United Kingdom-Mexico, art. 5(4)(a) and (b); United States-China, art. 5(4)(a) and (b); United States-Tunisia, art. 5(5)(a) and (b); United States-Ukraine, art. 5(4)(a) and (b).

[141] Finland-Ukraine, art. 5(4)(a) and (b); Sweden-Egypt, art. 5(4)(a) and (b).

[142] For example, Australia-Viet Nam, art. 5(3)(e); Belgium-China, art. 4(4)(f); Denmark-Egypt, art. 4(f); Finland-China, art. 5(4)(f); Finland-Estonia, art. 5(4)(f); Finland-Pakistan, art. 5 (4)(g); Finland-Ukraine, art. 5(4)(f); France-Trinidad and Tobago, art. 5(3)(f); Germany-Costa Rica, art. 5(4)(f); Ireland-Russian Federation, art. 5(4)(f); Luxembourg-Indonesia, art. 5(4)(f); Netherlands-Viet Nam, art. 5(4)(f); Netherlands-Latvia, art. 5(4)(f); Norway-Gambia, art. 5(4)(f); Norway-Zimbabwe, art. 5(4)(f); Sweden-Egypt, art. 5(4)(f); Sweden-Belarus, art. 5(3)(f); Turkey-Hungary, art. 5(3)(f); Sweden-Viet Nam, art. 5(5)(f); United Kingdom-Ghana, art. 5(3)(f); United Kingdom-Mexico, art. 5(4)(g); United States-China, art. 5(4)(f); United States-Tunisia, art. 5(5)(f); United States-Ukraine, art. 5(4)(f).

[143] Australia-Viet Nam, art. 5(3)(e).

[144] Luxembourg-Indonesia, art. 5(4)(e).

[145] Finland-Pakistan, art. 5(4)(f).

[146] United Kingdom-Mexico, art. 5(4)(f).

[147] France-Nigeria, art. 5(4); Netherlands-Nigeria, art. 5(5).

[148] This provision is reworded, without apparent substantive difference, in a few treaties. Ireland-Russian Federation, art. 5(5); United States-Ukraine, art. 5(5).

A few treaties follow the 1963 OECD model in providing that a dependent agent is not a permanent establishment if the agent's "activities are limited to the purchase of goods or merchandise for the enterprise". Australia-Viet Nam, art. 5(a); France-Nigeria, art. 5(6)(a); Spain-India, art. 5(4)(a).

[149] Denmark-Pakistan, art. 5(5)(b); Finland-Ukraine, art. 5(5); France-Trinidad and Tobago, art. 5(4)(b); Norway-Zimbabwe, art. 5(5)(b); Spain-India, art. 5(4)(b); Sweden-Botswana, art. 5(5)(b) (in this treaty, the "unless" clause of (a) is moved to the end of the paragraph, so that it modifies both (a) and (b)); Sweden-Viet Nam, art. 5(6)(b).

[150] Denmark-Pakistan, art. 5(c); France-Nigeria, art. 5(6)(b).

[151] Australia-Viet Nam, art. 5(b).

[152] Denmark-Pakistan, art. 5(7); Norway-Zimbabwe, art. 5(6); Sweden-Viet Nam, art. 5(7); United States-Tunisia, art. 5(8) (no explicit exclusion for reinsurance).

[153] It is not found in the Netherlands-Nigeria treaty.

[154] Netherlands-Viet Nam, art. 5(6).

[155] Denmark-Egypt, art. 5(6); France-Nigeria, art. 5(5); Ireland-Russian Federation, art. 5(6); Sweden-Belarus, art. 5(5); Sweden-Viet Nam, art. 5(8); United States-Tunisia, art. 5(6); United States-Ukraine, art. 5(6).

[156] Norway-Zimbabwe, art. 5(7); United States-China, art. 5(6).

[157] Finland-Pakistan, art. 5(6); Norway-Gambia, art. 5(6).

[158] Spain-India, art. 5(5).

[159] France-Nigeria, art. 5/(7) (small changes in wording).

[160] Australia-Viet Nam, art. 6(2) (also containing a provision, article 6(3), providing that real property is located where the land, deposits, or resources are located); United States-China, art. 6; United States-Tunisia, art. 6.

[161] Finland-Estonia, art. 6(2).

[162] Germany-Costa Rica, art. 3(1)(d).

[163] Germany-Costa Rica, art. 6(2).

[164] For example, United States-Ukraine, art. 6(5).

[165] Finland-Estonia, art. 6(4); Finland-Pakistan, art. 6(4); Finland-Ukraine, art. 6(4); France-Nigeria, art. 6(5). See United States-Ukraine, art. 6(3) (substituting "leasing or subleasing" for "letting").

[166] The treaties that have subparagraphs (b) and (c) include Denmark-Pakistan, art. 7(1); Germany-Costa Rica, art. 7(1); Norway-Zimbabwe, art. 7(1); United Kingdom-Ghana, art. 7(1).

[167] Finland-Estonia, art. 7(1).

[168] See Australia-Viet Nam, art. 7(2) (adding at the end of this paragraph "or with other enterprises with which it deals"); United States-Tunisia, art. 7(2) (adding at the end "and with any other associated enterprises"); United States-Ukraine, art. 7(2) (adding at the end "and any other enterprise that is an associated enterprise within the meaning of article 9").

[169] Treaties containing the second and third sentences include Australia-Viet Nam, art. 7(3); Belgium-China, art. 7(3); Denmark-Pakistan, art. 7(3)(b); Finland-China, art. 7(3); France-Nigeria, art. 7(3); Norway-Zimbabwe, art. 7(3); Spain-India, art. 7(3); Sweden-Viet Nam, art. 7(3); United Kingdom-Ghana, art. 7(3); United States-China, art. 7(3); United States-Tunisia, art. 7(3); United States-Ukraine, art. 7(3) (including second, but not third, sentence).

[170] United Kingdom-Ghana, art. 7(3). Another treaty restricts the deduction for executive and general administrative expenses to those "allowed under the provisions of the domestic law of the Contracting State in which the permanent establishment is situated". Denmark-Pakistan, art. 7(3)(a).

[171] Spain-India, art. 7(3).

[172] The treaties omitting the provision include Australia-Viet Nam, art. 7; France-Nigeria, art. 7; France-Trinidad and Tobago, art. 7; Netherlands-Nigeria, art. 7; Sweden-Botswana, art. 7; United States-Tunisia, art. 7; United States-Ukraine, art. 7.

In the Germany-Costa Rica treaty, the provision is modified to apply if it is "impossible or excessively difficult to determine, in certain special cases, the profits to be attributed to a permanent establishment", and to allow the "total profits" to be apportioned in such cases (Germany-Costa Rica, art. 7(4)).

[173] The treaties omitting the provision include Australia-Viet Nam, art. 7; France-Nigeria, art. 7; Netherlands-Nigeria, art. 7.

[174] Australia-Viet Nam, art. 7(4); Belgium-China, art. 7(5); Denmark-Egypt, art. 7(5); Denmark-Pakistan, art. 7(5); Finland-China, art. 7(5); Finland-Estonia, art. 7(5); Finland-Pakistan, art. 7(5); Finland-Ukraine, art. 7(5); France-Trinidad and Tobago, art. 7(4); Ireland-Russian Federation, art. 7(5); Netherlands-Latvia, art. 7(5); Netherlands-Viet Nam, art. 7(5); Norway-Gambia, art. 7(5); Spain-India, art. 7(4); Sweden-Belarus, art. 7(5); Sweden-Botswana, art. 7(4); Sweden-Egypt, art. 7(4); Turkey-Hungary, art. 7(4); United Kingdom-Ghana, art. 7(4); United Kingdom-Mexico, art. 7(6); United States-China, art. 7(5); United States-Tunisia, art. 7(4); United States-Ukraine, art. 7(5).

In some treaties, this provision is supplemented by a statement that the source country may tax where the permanent establishment "is also used as a sales outlet for the goods or merchandise so purchased" (France-Nigeria, art. 7(4); Netherlands-Nigeria, art. 7(4)).

[175] Netherlands-Nigeria, art. 7(5).

[176] Australia-Viet Nam, art. 7(7).

[177] United Kingdom-Mexico, art. 7(3).

[178] United Kingdom-Mexico, art. 7(6).

[179] Finland-Ukraine, art. 7(4).

[180] Germany-Costa Rica, art. 7(4).

[181] Australia-Viet Nam, art. 7(5); Sweden-Viet Nam, art. 7(4); United States-Tunisia, art. 7(8).

[182] United States-Tunisia, art. 7(7).

[183] Australia-Viet Nam, art. 7(8).

[184] Treaties using the effective management concept include Denmark-Egypt, art. 8(1) (alternative A); Denmark-Pakistan, art. 8(1), (3) (generally following alternative B); France-Kuwait, art. 7(1); France-Trinidad and Tobago, art. 8(1); Germany-Namibia, art. 8(1); Netherlands-Bangladesh, art. 8(1); Netherlands-Mexico, art. 8(1); Norway-Zimbabwe, art. 8(1); Sweden-Venezuela, art. 8(1); Switzerland-Mexico, art. 8(1); Switzerland-Romania, art. 8(1). See Belgium-China, art. 8(1) ("place of general management"); Finland-China, art. 8(1) ("place of head office or effective management").

The Norway-Gambia treaty includes paragraph 1, with the effective-management touchstone, but states further that if "total profits" cannot be taxed by the country in which effective management is located, the profits may be taxed in the operator's country of residence (Norway-Gambia, art. 8(1)). If the operator is a partnership including partners from both countries, the profits are taxable solely at the locus of effective management, except that if effective management is not located solely in one of the countries, each country may tax the profit shares of the partners resident in that country (Norway-Gambia, art. 8(5)).

The United States-Tunisia treaty allows Tunisia to tax international shipping and air transport income of an enterprise whose place of effective management is in Tunisia and allows the United States to tax if the enterprise was created under the law of the United States or one of its states (United States-Tunisia, art. 8(1)).

The United States-China treaty has no article on shipping and air transport.

[185] Australia-Viet Nam, art. 8(1), (2), (4) (other State can tax income from operations "confined solely to places in (the) other State", and carriage of persons or goods from one place to another in other State are treated as operations solely in that State); Ireland-Russian Federation, art. 8(1); France-Nigeria, art. 8(1) (but allowing non-residence State to tax earnings "derived" from that State at rate not exceeding 1 per cent); Netherlands-Nigeria, art. 8(1); United Kingdom-Ghana, art. 8(1); United Kingdom-Mexico, art. 8(1).

Under the Finland-Pakistan treaty, an enterprise of either State is taxable only in that State on profits from the operation of aircraft in international traffic, but may be taxed in the other State at one half of the latter's normal tax rate on international shipping profits "from sources" in that State (Finland-Pakistan, art. 8(1), (2)).

[186] For example, Finland-Estonia, art. 8(1); Finland-Ukraine, art. 8(1); Luxembourg-Indonesia, art. 8(1); Netherlands-Latvia, art. 8(1); Spain-India, art. 8(1), 9(1); Sweden-Belarus, art. 8(1); Sweden-Botswana, art. 8(1); Sweden-Viet Nam, art. 8(1).

[187] For example, Canada-Estonia, art. 8(4)(a); Canada-Latvia, art. 8(4)(a); Denmark-Egypt, art. 8(3); Finland-Ukraine, art. 8(2); Netherlands-Nigeria, art. 8(1), (2); Sweden-Egypt, art. 8(3); Sweden-Venezuela, art. 8(4); United Kingdom-Ghana, art. 8(2); United Kingdom-Mexico, art. 8(2); United Kingdom-Viet Nam, art. 8(2)(a); United Kingdom-Kazakstan, art. 8(2)(a); United States-Czech Republic, art. 8(2); United States-Tunisia, art. 8(2); United States-Ukraine. art. 8(2).

[188] For example, Canada-Estonia, art. 8(4)(b); Canada-Latvia, art. 8(4)(b); Denmark-Egypt, art. 8(3); Finland-Ukraine, art. 8(2); France-Trinidad and Tobago, art. 8(1); Norway-Gambia, art. 8(4); Spain-India, art. 9(3); Sweden-Egypt, art. 8(3); United Kingdom-Ghana, art. 8(2); United Kingdom-Mexico, art. 8(2); United Kingdom-Viet Nam, art. 8(2)(b); United Kingdom-Kazakstan, art. 8(2)(b); United Kingdom-Uzbekistan, art. 8(2)(b); United States-Czech Republic, art. 8(3); United States-Kazakstan, art. 8(2)(b); United States-Tunisia, art. 8(2); United States-Ukraine, art. 8(2).

[189] Some of the treaties instead use phrases such as "in connection with the transport of goods or merchandise in international traffic" (Spain-India, art. 9(3); Sweden-Egypt, art. 8(3)).

Under the Ireland-Russian Federation treaty, the residence State has the sole right to tax all income from the rental of ships, aircraft, land vehicles, containers, barges and related equipment in international traffic and incidental income from the rental of these items, whether in international or local traffic (Ireland-Russian Federation, art. 8(2)).

The United Kingdom-Mexico treaty excludes profits from provisions of accommodations and from inland surface transport of passengers and goods for a consignee (United Kingdom-Mexico, art. 8(2)).

[190] Treaties with the provision include Norway-Zimbabwe, art. 8(2).

[191] Norway-Gambia, art. 8(7).

[192] For example, Belgium-China, art. 8; France-Nigeria, art. 8; Netherlands-Latvia, art. 8; Sweden-Belarus, art. 8.

[193] Denmark-Pakistan, art. 8.

[194] Denmark-Latvia, art. 8(3); Denmark-Lithuania, art. 8(3); Norway-Latvia, art. 8(3).

[195] The words "have accrued to one of the enterprises, but, by reason of those conditions", are omitted from the official printing of the United Nations Model Convention, probably by error.

[196] Australia-Viet Nam, art. 9(1) (substituting in para. 1 the words "which might be expected to operate between independent enterprises dealing wholly independently with one another", and providing that the article does not "affect the application of any law of a Contracting State relating to the determination of the tax liability of a person"); Sweden-Russian Federation, art. 9(1) (substituting "of a person" for "of an enterprise" in (a), and "any other person" for "an enterprise of the other Contracting State" in (b)).

[197] Netherlands-Latvia, art. 9(1); Netherlands-Viet Nam, art. 9(1).

[198] For example, Denmark-Pakistan, art. 9(2); Finland-China, art. 9(2); France-Nigeria, art. 9(2). See Ireland-Russian Federation, art. 9(2) (rewording para. 2 without substantive difference).

[199] Treaties not including paragraph 2 include Belgium-China, art. 9; Germany-Namibia, art. 9; France-Trinidad and Tobago, art. 9; Norway-Gambia, art. 9; Spain-Republic of Korea, art. 9.

[200] Norway-Zimbabwe, art. 9(2); Sweden-Viet Nam, art. 9(2).

[201] Denmark-Egypt, art. 9(2); Denmark-Latvia, art. 9(2); Denmark-Lithuania, art. 9(2); Netherlands-Mexico, art. 9(2); Norway-Latvia, art. 9(2); Sweden-Bolivia, art. 9(2); Sweden-Lithuania, art. 9(2); Switzerland-Romania, art. 9(2); Turkey-Hungary, art. 9(2).

[202] Denmark-Egypt, art. 9(3) (and in no event more than five years after taxable year); Luxembourg-Indonesia, art. 9(3); Switzerland-Mexico, art. 9(3); Switzerland-Romania, art. 9(3); United Kingdom-Mexico, art. 9(3).

[203] Canada-Zimbabwe, art. 9(4); Canada-Latvia, art. 9(4); Canada-Estonia, art. 9(4); Denmark-Egypt, art. 9(4); Switzerland-Mexico, art. 9(3); Switzerland-Romania, art. 9(3); Netherlands-Mexico, art. 9(3); United Kingdom-Mexico, art. 9(4); United States-Czech Republic, art. 9(3); United States-Slovakia, art. 9(3).

[204] United States-Ukraine, art. 9(3); United States-Kazakstan, art. 9(3).

[205] Australia-Viet Nam, art. 10(1); Ireland-Russian Federation, art. 10(1); United States-Kazakstan, art. 19(1); United States-Ukraine, art. 10(1).

[206] The treaty omitting this paragraph is United Kingdom-Mexico. See United Kingdom-Ghana, art. 10(2), (6) (reduced rates apply only if the beneficial owner of the dividends is subject to tax in his home country, but a charity is deemed to be taxed in its home country).

[207] For example, Germany-Costa Rica, art. 10(1) (5 per cent, 15 per cent); Finland-Ukraine, art. 10(1) (5 per cent, 15 per cent); Finland-Estonia, art. 10(1) (5 per cent, 15 per cent); France-Nigeria, art. 10(2) (12.5 per cent, 15 per cent); France-Trinidad and Tobago, art. 10(2) (10 per cent, 15 per cent); Netherlands-Latvia, art. 10(2) (5 per cent, 15 per cent); Netherlands-Nigeria, art. 10(2) (12.5 per cent, 15 per cent); Norway-Gambia, art. 10(1) (5 per cent, 15 per cent); Norway-Zimbabwe, art. 10(2) (15 per cent, 20 per cent); Luxembourg-Indonesia, art. 10(2) (10 per cent, 15 per cent); Sweden-Belarus, art. 10(2) (5 per cent (zero if recipient owns 100 per cent of shares and distributed profits are from active business and are subject to corporation tax in source country), 10 per cent); Turkey-Hungary, art. 10(2) (10 per cent,

15 per cent); United Kingdom-Ghana, art. 10(2) (7.5 per cent, 15 per cent); United States-Tunisia, art. 10(2) (14 per cent, 20 per cent); United States-Ukraine, art. 10(2) (5 per cent, 15 per cent).

Some treaties made by Viet Nam establish three rates. Sweden-Viet Nam, art. 10(2) (5 per cent if the beneficial owner is a company (other than a partnership) owning at least 70 per cent of the stock or investing at least US$12 million, 10 per cent if the beneficial owner is a company owning at least 25 per cent but not qualifying for the 5 per cent rate, 15 per cent in all other cases); Netherlands-Viet Nam, art. 10(2) (5 per cent if the shareholder is a company that either owns at least 50 per cent of the stock or has invested at least $10 million in its shares and 10 per cent if the shareholder owns at least 25 per cent but does not qualify for the 5 per cent rate).

[208] For example, Germany-Costa Rica, art. 10(1) (10 per cent); Finland-Estonia, art. 10(1) (25 per cent); Finland-Ukraine, art. 10(1) (20 per cent); France-Nigeria, art. 10(2) (10 per cent); France-Trinidad and Tobago, art. 10(2) (10 per cent); Japan-Singapore, art. 10(2) (25 per cent); Luxembourg-Indonesia, art. 10(2) (25 per cent); Netherlands-Nigeria, art. 10(2) (10 per cent); Netherlands-Latvia, art. 10(2) (25 per cent); Norway-Gambia, art. 10(1) (25 per cent); Norway-Zimbabwe, art. 10(2) (25 per cent); Sweden-Belarus, art. 10(2) (30 per cent); Sweden-Gambia, art. 10(2) (80 per cent for zero rate on dividends, 15 per cent for 5 per cent rate); Sweden-Namibia, art. 10(2) (more than 50 per cent; also residents of other State must own more than 50 per cent of recipient's capital); Sweden-Russian Federation, art. 10(2) (100 per cent or, for joint venture, 30 per cent); Turkey-Hungary, art. 10(2) (25 per cent); United Kingdom-Ghana, art. 10(2) (10 per cent); United Kingdom-Viet Nam, art. 10(2) (50 per cent for 7 per cent rate, 10 per cent for 10 per cent rate); United States-Tunisia, art. 10(2) (25 per cent); United States-Ukraine, art. 10(2) (10 per cent of the voting stock, but in case of Ukraine, only if non-residents of Ukraine own at least 20 per cent).

[209] For example, Canada-Zimbabwe, art. 10(2) (15 per cent for Canada; 20 per cent for Zimbabwe); Denmark-Egypt, art. 10(2) (15 per cent and 20 per cent by Denmark; 15 per cent by Egypt); Sweden-Egypt, art. 10. Under the Australia-Viet Nam treaty, the maximum rate for Australia is 15 per cent, and the maximum rate for Viet Nam is 10 per cent, and no lesser rate is provided for dividends received by companies (Australia-Viet Nam, art. 10(2)).

Several treaties made by Finland reduce Finland's tax on dividends paid to residents of the other country to zero or 5 per cent so long as Finland provides an imputation credit to its residents. Finland-Estonia, art. 10(2); Finland-Pakistan, art. 10(2); Finland-Ukraine, art. 10(2).

[210] For example, Switzerland-Mexico, art. 10(2); Norway-Latvia, art. 10(2).

[211] For example, United States-Ukraine, art. 10(2).

[212] For example, Japan-Singapore, art. 10(2); United Kingdom-Kazakstan, art. 10(2); United Kingdom-Uzbekistan, art. 10(2).

[213] Netherlands-Viet Nam, art. 10(2); Sweden-Viet Nam, art. 10(2); United Kingdom-Viet Nam, art. 10(2)(a).

[214] Belgium-China, art. 10(2); Denmark-Pakistan, art. 10(2); Finland-China, art. 10(2); Ireland-Russian Federation, art. 10(2) (10 per cent); Spain-India, art. 11(2) (15 per cent); Sweden-Botswana, art. 10(2) (15 per cent, but

providing that if Botswana makes any treaty with a lower rate for dividends, that rate will become the rate for this treaty); Switzerland-Romania, art. 10(2); United Kingdom-Russian Federation, art. 10(2); United States-China, art. 10(2) (10 per cent).

[215] For example, Belgium-China, art. 10(2); Finland-China, art. 10(2); France-Nigeria, art. 10(2); France-Trinidad and Tobago, art. 10(2); Sweden-Belarus, art. 10(2); Sweden-Viet Nam, art. 10(2); United States-China, art. 10(2); United States-Tunisia, art. 10(2); United States-Ukraine, art. 10(2).

[216] For example, Australia-Viet Nam art. 10(3); Belgium-China, art. 10(3); Denmark-Egypt, art. 10(3); Denmark-Pakistan, art. 10(3); Finland-China, art. 10(3); Finland-Estonia, art. 10(4); France-Nigeria, art. 10(6); France-Trinidad and Tobago, art. 10(3); Ireland-Russian Federation, art. 10(3); Luxembourg-Indonesia, art. 10(3); Netherlands-Nigeria, art. 10(3); Spain-India, art. 11(3); Sweden-Botswana, art. 10(3); Sweden-Belarus, art. 10(3); United Kingdom-Ghana, art. 10(3); United States-China, art. 10(3).

Some treaties add a statement that "dividends" also include distributions under participating debt arrangements if characterized as dividends under the law of the State in which they arise (United States-Czech Republic, art. 10(4); United States-Kazakstan, art. 10(3); United States-Ukraine, art. 10(3)).

[217] See France-Trinidad and Tobago, art. 10(4) (omitting language referring to fixed base).

[218] See Australia-Viet Nam, art. 10(5) (restating provision without changing its essence) Ireland-Russian Federation, art. 10(5) (restating final clauses without substantive change); United States-Tunisia, art. 10(5) (allowing source State to tax dividends paid to non-residents from profits of permanent establishment in source State if at least 50 per cent of all gross income is gross income of permanent establishment).

[219] Canada-Latvia, art. 10(6) (5 per cent); Canada-Estonia, art. 10(6) (5 per cent); Denmark-Egypt, art. 10(6); France-Trinidad and Tobago, art. 10(6) (10 per cent maximum rate); Germany-Costa Rica, art. 10(5) (allowing Costa Rica to so tax German companies at rate not exceeding 5 per cent); Luxembourg-Indonesia, art. 10(6) (allowing Indonesian tax not exceeding 10 per cent of after-tax profits of Luxembourg corporation); Turkey-Hungary, art. 10(4) (maximum rate same as for intercompany dividends); United States-Tunisia, art. 10(5) (allowing Tunisian tax not exceeding 14 per cent of after tax profits of United States company's permanent establishment in Tunisia); United States-Ukraine, art. 10(5) (maximum rate of 5 per cent); United States-Czech Republic, art. 10(6) (5 per cent); United States-Kazakstan, art. 10(5) (5 per cent); United States-Slovakia, art. 10(6) (5 per cent).

[220] France-Nigeria, art. 10(5); Netherlands-Latvia, art. 10(8) (denying only reduced rate for intercorporate dividends); United Kingdom-Ghana, art. 10(7).

[221] Some treaties add at the end of this paragraph "if such resident is the beneficial owner of the interest" (Denmark-Pakistan, art. 11(1)).

[222] Germany-Namibia, art. 11(1); France-Kuwait, art. 9(1); Ireland-Russian Federation, art. 11(1); Sweden-Russian Federation, art. 11(1); United Kingdom-Russian Federation, art. 11(1); United States-Czech Republic, art. 11(1); United

States-Kazakstan, art. 11(1); United States-Slovakia, art. 11(1); United States-Tunisia, art. 11(1).

[223] Australia-Viet Nam, art. 11(2) (10 per cent); Belgium-China, art. 11(2) (10 per cent); Canada-Estonia, art. 11(2) (10 per cent); Canada-Latvia, art. 11(2) (10 per cent); Denmark-Egypt, art. 11(2); Denmark-Latvia, art. 11(2) (10 per cent); Denmark-Lithuania, art. 11(2) (10 per cent); Denmark-Pakistan, art. 11(2) (15 per cent); Germany-Costa Rica, art. 11(1) (5 per cent for interest on loans made for terms longer than five years and 10 per cent in all other cases); Finland-China, art. 11(2) (10 per cent); France-Nigeria, art. 11(2) (12.5 per cent); France-Trinidad and Tobago, art. 11(2) (10 per cent); Japan-Singapore, art. 11(2) (10 per cent); Netherlands-Latvia, art. 11(2) (10 per cent); Netherlands-Nigeria, art. 11(2) (12 per cent); Norway-Latvia, art. 11(2) (10 per cent); Norway-Zimbabwe, art. 11(2) (10 per cent); Spain-India, art. 12(2) (15 per cent); Spain-Republic of Korea, art. 11(2) (10 per cent); Sweden-Belarus, art. 11(2) (5 per cent); Sweden-Botswana, art. 11(2), (8) (15 per cent, except that if Botswana ever makes a treaty with a lower rate, that lower rate shall thereafter apply); Sweden-Egypt, art. 11(2) (15 per cent); Sweden-Lithuania, art. 11(2) (10 per cent); Sweden-Viet Nam, art. 11(2) (10 per cent); Switzerland-Romania, art. 11(2) (10 per cent); Turkey-Hungary, art. 11(2) (10 per cent); United Kingdom-Kazakstan, art. 11(2) (10 per cent); United Kingdom-Uzbekistan, art. 11(2) (5 per cent); United States-China, art. 11(2) (10 per cent); United States-Tunisia, art. 11(2) (15 per cent).

Some treaties provide different tax rate ceilings, depending on the status of the beneficial owner or the debt obligation (Finland-Pakistan, art. 11(2) (10 per cent for interest received by banks and 15 per cent for all other interest); Sweden-Gambia, art. 11(2) (5 per cent on some credit purchases; otherwise 15 per cent); Switzerland-Mexico, art. 11(2) (10 per cent on interest paid to banks; otherwise 15 per cent); United Kingdom-Mexico, art. 11(2) (5 per cent for interest received by bank or insurance company or by any person on publicly traded debt securities; 10 per cent for interest paid by bank to non-bank or by purchaser of goods to seller; 15 per cent for all other interest)).

[224] For example, Belgium-China, art. 11(2); Denmark-Pakistan, art. 11(2); Finland-China, art. 11(2); France-Nigeria, art. 11(2); France-Trinidad and Tobago, art. 11(2); Spain-India, art. 12(2); Sweden-Belarus, art. 11(2); Sweden-Bolivia, art. 11(2); Sweden-Botswana, art. 11(2); Sweden-Gambia, art. 11(2); Sweden-Lithuania, art. 11(2); Sweden-Viet Nam, art. 11(2); United States-China, art. 11(2); United States-Tunisia, art. 11(2).

[225] Australia-Viet Nam, art. 11(3) (rewording definition without substantive change); France-Trinidad and Tobago, art. 11(4) (excluding items subject to dividends article); Ireland-Russian Federation, art. 10(2) (excluding dividends); Luxembourg-Indonesia, art. 11(3) (adding "as well as income assimilated to income from money lent by the taxation law of the State in which the income arises, including interest on deferred payment sales"); United States-Ukraine, art. 11(2) (excluding dividends, but including "other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises").

[226] For example, Belgium-China, art. 11(4); France-Nigeria, art. 11(3); France-Trinidad and Tobago, art. 11(4); United States-China, art. 11(3).

[227] For example, Australia-Viet Nam, art. 11(4); Belgium-China, art. 11(5); Canada-Estonia, art. 11(5); Canada-Latvia, art. 11(5); Denmark-Egypt, art. 11(4); Denmark-Latvia, art. 11(5); Denmark-Lithuania, art. 11(5); Finland-China, art. 11(5); France-Nigeria, art. 11(4); France-Trinidad and Tobago, art. 11(5); Ireland-Russian Federation, art. 11(4); Japan-Singapore, art. 11(6); Netherlands-Latvia, art. 11(6); Sweden-Belarus, art. 11(5); Sweden-Botswana, art. 11(5); Sweden-Lithuania, art. 11(5); Sweden-Russian Federation, art. 11(3); Sweden-Viet Nam, art. 11(5); Switzerland-Romania, art. 11(5); United Kingdom-Kazakstan, art. 11(4); United Kingdom-Uzbekistan, art. 11(4); United Kingdom-Russian Federation, art. 11(3); United Kingdom-Viet Nam, art. 11(4); United States-China, art. 11(5); United States-Czech Republic, art. 11(4); United States-Kazakstan, art. 11(5); United States-Slovakia, art. 11(4); United States-Tunisia, art. 11(5); United States-Ukraine, art. 11(3).

[228] For example, Denmark-Egypt, art. 11; Ireland-Russian Federation, art. 11; Sweden-Russian Federation, art. 11; United Kingdom-Russian Federation, art. 11; United States-Czech Republic, art. 11; United States-Ukraine, art. 11.

[229] But see United Kingdom-Ghana, art. 11(6) (substituting "for whatever reason" for "having regard to the debt-claim for which it is paid").

[230] For example, Belgium-China, art. 11(3) (including interest received by State-owned banks); Canada-Estonia, art. 11(3); Canada-Latvia, art. 11(3); Denmark-Latvia, art. 11(3); Denmark-Lithuania, art. 11(3); Denmark-Pakistan, art. 11(3) (including central banks); Germany-Costa Rica, art. 11(2); Finland-China, art. 11(3) (including central banks and other State-owned banks); Finland-Estonia, art. 11(3) (including central banks); Finland-Ukraine, art. 11(3) (including central banks); France-Nigeria, art. 11(3); France-Trinidad and Tobago, art. 11(3) (including central banks); Japan-Singapore, art. 11(3); Luxembourg-Indonesia, art. 11(3), (4) (including "local authorities" and central banks); Netherlands-Latvia, art. 11(3) (including central banks and other State-owned banks); Netherlands-Nigeria, art. 11(3) (including agencies and political subdivisions of other State); Netherlands-Viet Nam, art. 11(3); Norway-Gambia, art. 11(3); Norway-Zimbabwe, art. 11(3); Spain-India, art. 12(3)(a) (including central banks); Spain-Republic of Korea, art. 11(3)(a); Sweden-Botswana, art. 11(2) (including central banks and local authorities of other State); Sweden-Belarus, art. 11(3) (including central banks); Sweden-Egypt, art. 11(3) (including local authorities and government-owned banks); Sweden-Lithuania, art. 11(3); Sweden-Namibia, art. 11(3)(b); Sweden-Viet Nam, art. 11(3) (including central banks); Turkey-Hungary, art. 11(3) (including central banks and export-import bank); United Kingdom-Ghana, art. 11(10); United Kingdom-Kazakstan, art. 11(10); United Kingdom-Mexico, art. 11(4) (including central banks); United Kingdom-Uzbekistan, art. 11(10); United Kingdom-Viet Nam, art. 11(8); United States-China, art. 11(3) (including central banks and other State-owned banks); United States-Kazakstan, art. 11(3)(a); United States-Tunisia, art. 11(3).

[231] For example, Canada-Estonia, art. 11(3); Canada-Latvia, art. 11(3); Denmark-Latvia, art. 11(3); Finland-Estonia, art. 11(3); Finland-Ukraine, art. 11(3); France-Nigeria, art. 11(3) ("loan or credit supported by the Government"); Japan-Singapore, art. 11(3); Netherlands-Latvia, art. 11(3); Norway-Gambia, art. 11(3); Norway-Zimbabwe, art. 11(3) (limited to loans for "development purposes"); Sweden-Lithuania, art. 11(3); Switzerland-Romania, art. 11(3); United Kingdom-Kazakstan, art. 11(10); United Kingdom-Uzbekistan, art. 11(11); United Kingdom-Viet Nam, art. 11(4); United States-China, art. 11(3) (loans "indirectly financed" by government); United States-Kazakstan, art. 11(3).

See also Finland-Pakistan, art. 11(3) (exempting from Pakistan tax interest received by FinnFund and Finnish Export Credit Bank); France-Trinidad and Tobago, art. 11(3) (loan "made or endorsed by an institution of a Contracting State with responsibility for public financing of external trade"); Sweden-Belarus, art. 11(3) (loans "approved by the Government" of the borrowers State of residence; loans made or guaranteed by institutions of "public character" for exports or development; loans by any bank for exports or development); Sweden-Botswana, art. 11(2) (exempting interest on "loan granted or guaranteed by a financial institution of a public character with the objective of promoting exports and development, if the credit granted or guaranteed contains an element of subsidy"); United Kingdom-Ghana, art. 11(8) (exempting from tax in Ghana interest on loans made, guaranteed, or insured by United Kingdom Export Credits Guarantee Department); United Kingdom-Mexico, art. 11(4) (exempting interest on loans made, insured, or guaranteed by export financing agencies).

[232] Canada-Zimbabwe, art. 11(3); Netherlands-Mexico, art. 11(3); Sweden-Bolivia, art. 11(3)(b); Sweden-Gambia, art. 11(3)(b); Sweden-Venezuela, art. 11(3)(a); Switzerland-Mexico, art. 11(3); United Kingdom-Mexico, art. 11(4); United States-Kazakstan, art. 11(3)(a); United States-Tunisia, art. 11(3)(c) (interest paid by Tunisia on debt held by United States residents).

[233] Canada-Estonia, art. 11(3)(d); Canada-Latvia, art. 11(3)(d); Denmark-Latvia, art. 11(3)(d); Denmark-Lithuania, art. 11(3)(d); Finland-Estonia, art. 11(3)(c); Netherlands-Bangladesh, art. 11(3)(d); Netherlands-Latvia, art. 11(3); Spain-Republic of Korea, art. 11(3)(b); Sweden-Belarus, art. 11(3); Sweden-Bolivia, art. 11(3)(d); Sweden-Namibia, art. 11(3)(c).

[234] Netherlands-Latvia, art. 11(3)(d)(ii) (one year); United States-Tunisia, art. 11(3)(b) (seven years).

[235] Canada-Zimbabwe, art. 11(3)(b); Netherlands-Mexico, art. 11(3)(d).

[236] Finland-Ukraine, art. 11(3); France-Nigeria, art. 11(7); Netherlands-Mexico, art. 11(8); United Kingdom-Ghana, art. 11(9); United Kingdom-Kazakstan, art. 11(9); United Kingdom-Mexico, art. 11(11); United Kingdom-Russian Federation, art. 11(6); United Kingdom-Uzbekistan, art. 11(9); United Kingdom-Viet Nam, art. 11(7).

[237] United Kingdom-Ghana, art. 11(8); United Kingdom-Kazakstan, art. 11(8); United Kingdom-Mexico, art. 11(10); United Kingdom-Uzbekistan, art. 11(8).

[238] Treaties made by the United Kingdom sometimes allow the rate reduction under paragraph 2 only if the recipient is taxed on the royalties in its country of residence, but provide that charities are deemed to be subject to residence country taxation (for example, United Kingdom-Ghana, art. 12(2), (8); United Kingdom-Viet Nam, art. 12(2)).

[239] For example, Belgium-China, art. 12(2); Denmark-Pakistan, art. 12(2); France-Nigeria, art. 12(2); France-Trinidad and Tobago, art. 12(2); Japan-Singapore, art. 12(2); Norway-Latvia, art. 12(2); Sweden-Botswana, art. 12(2); Sweden-Belarus, art. 12(2); Sweden-Viet Nam, art. 12(2); United Kingdom-Ghana, art. 12(2); United Kingdom-Kazakstan, art. 12(2); United Kingdom-Uzbekistan, art. 12(2); United Kingdom-Viet Nam, art. 12(2); United States-China, art. 11(2); United States-Tunisia, art. 12(2); United States-Ukraine, art. 12(2).

[240] Luxembourg-Indonesia, art. 12(1), (2); Spain-India, art. 13(1), (2); Sweden-Egypt, art. 12(1), (2).

[241] For example, Australia-Viet Nam, art. 12(2) (10 per cent); Belgium-China, art. 12(2) (10 per cent); Canada-Estonia, art. 12(2) (10 per cent); Canada-Latvia, art. 12(2) (10 per cent); Denmark-Egypt, art. 12(2) (20 per cent); Denmark-Pakistan, art. 12(2) (12 per cent); Finland-China, art. 12(2) (10 per cent); France-Nigeria, art. 12(2) (12.5 per cent); France-Trinidad and Tobago, art. 12(2), (3) (10 per cent, but copyright royalties exempt); Japan-Singapore, art. 12(2) (10 per cent); Luxembourg-Indonesia, art. 12(2) (12.5 per cent for royalties and 10 per cent for fees for technical services); Netherlands-Viet Nam, art. 12(2) (5 per cent, 10 per cent, or 15 per cent); Norway-Gambia, art. 12(2) (12.5 per cent); Norway-Zimbabwe, art. 12(2) (10 per cent); Sweden-Botswana, art. 12(2) (15 per cent); Sweden-Egypt, art. 12(2) (14 per cent); Switzerland-Romania, art. 12(2) (10 per cent); Turkey-Hungary, art. 12(2) (10 per cent); United Kingdom-Ghana, art. 12(2) (12.5 per cent); United Kingdom-Kazakstan, art. 12(2) (10 per cent); United Kingdom-Mexico, art. 12(2) (10 per cent); United Kingdom-Uzbekistan, art. 12(2) (5 per cent); United Kingdom-Viet Nam, art. 12(2) (10 per cent); United States-China, art. 11(2) (10 per cent); United States-Tunisia, art. 12(2) (15 per cent); United States-Ukraine, art. 12(2) (10 per cent).

[242] Denmark-Latvia, art. 12(2); Denmark-Lithuania, art. 12(2); Finland-Estonia, art. 12(2); Finland-Ukraine, art. 12(2) (same); Netherlands-Latvia, art. 12(2); Norway-Latvia, art. 12(2); Spain-India, art. 13(2) (10 per cent and 20 per cent).

[243] Sweden-Gambia art. 12(2) (5 per cent for patent royalties; 12 per cent for others); Sweden-Lithuania, art. 12(2) (5 per cent for patent royalties; 10 per cent for others); Sweden-Namibia, art. 12(2) (5 per cent for patent royalties; 15 per cent for others); Sweden-Viet Nam, art. 12(2) (5 per cent for patents, know-how, and equipment, 15 per cent for others). See Sweden-Belarus, art. 12(2) (3 per cent for royalties for patent or know-how, 5 per cent for equipment, 10 per cent for all others); Sweden-Venezuela, art. 12(2) (10 per cent for copyright royalties; 7 per cent for others); United States-Czech Republic, art. 12(2) (zero for copyright royalties; 10 per cent for others).

[244] France-Kuwait, art. 10(1); Ireland-Russian Federation, art. 12(1); Sweden-Russian Federation, art. 12(1); United Kingdom-Russian Federation, art. 12(1). See also Sweden-Belarus, art. 12(7) (providing that if Belarus makes treaty with any other OECD country either exempting or providing lower rate of source taxation for patent royalties, the exemption or lower rate will thereafter apply under Sweden-Belarus treaty).

[245] A minority of the treaties follow the OECD model in omitting this language (for example, Denmark-Egypt, art. 12(3)).

[246] For such broadening modifications, see Australia-Viet Nam, art. 12(3); Belgium-China, art. 12(3) (adding "know-how"); Finland-China, art. 12(3) (adding "know-how"); Ireland-Russian Federation, art. 12(2); Japan-Singapore, art. 12(3) (including receipts from bareboat charters of boats if not covered by article on shipping and air transport); Luxembourg-Indonesia, art. 12(3); Sweden-Egypt, art. 12(3); United States-China, art. 12(3) (adding "technical know-how"); United States-Tunisia, art. 12(3) (adding "technical or economic studies" and "technical assistance"); United States-Ukraine, art. 12(3) (adding "computer programs").

But see Finland-Estonia, art. 12(7) (providing that if Estonia makes a treaty with any other OECD country excluding any item covered by this definition, the narrower definition will thereafter apply under the Finland-Estonia treaty); France-Trinidad and Tobago, art. 12(4)(b) (excluding royalties "in respect of the operation of mines, quarries or other natural resources"); Sweden-Bolivia, art. 12(3) (omitting "or for information concerning industrial, commercial or scientific experience").

[247] Netherlands-Mexico, art. 12(3); United States-Czech Republic, art. 12(3); United States-Slovakia, art. 12(3); United States-Tunisia, art. 12(3).

[248] Luxembourg-Indonesia, art. 12(4) (payments to non-employees for "any services of a managerial, technical or consultancy nature rendered in the Contracting State of which the payer is a resident"); Spain-India, art. 13(4) (same but without reference to managerial services or requirement that services be performed in payer's country of residence); Sweden-Egypt, art. 12(4) (payments for non-employee services "of a technical, managerial or consultancy nature").

[249] For example, Australia-Viet Nam, art. 12(4); Belgium-China, art. 12(4); Canada-Estonia, art. 12(4); Canada-Latvia, art. 12(4); Denmark-Egypt, art. 12(4); Finland-China, art. 12(4); France-Nigeria, art. 12(3); France-Trinidad and Tobago, art. 12(5); Ireland-Russian Federation, art. 12(3); Japan-Singapore, art. 12(6); Netherlands-Latvia, art. 12(5); Sweden-Belarus, art. 12(4); Sweden-Lithuania, art. 12(4); Sweden-Viet Nam, art. 12(4); United Kingdom-Kazakstan, art. 12(4); United Kingdom-Viet Nam, art. 12(4); United States-China, art. 11(4); United States-Tunisia, art. 12(4); United States-Ukraine, art. 12(4).

[250] United Kingdom-Kazakstan, art. 12(6); United States-Czech Republic, art. 12(6)(b); United States-China, art. 5(b); United States-Kazakstan, art. 12(6); United States-Slovakia, art. 12(6)(b); United States-Tunisia, art. 12(6); United States-Ukraine, art. 12(6).

[251] For example, Belgium-China, art. 12(5) (adding "administrative subdivision" in first sentence after "that State itself"); Netherlands-Latvia, art. 12(5) (omitting "that State itself, a political subdivision, a local authority or" from first sentence).

[252] See United Kingdom-Kazakstan, art. 12(6) (adding "for whatever reason" after "exceeds" in the first sentence).

[253] For example, Canada-Estonia, art. 12(7); Canada-Latvia, art. 12(7); Denmark-Latvia, art. 12(7); Denmark-Lithuania, art. 12(7); Finland-Estonia, art. 12(7) (applicable to treaties made with other OECD member countries); Norway-Latvia, art. 12(7); Sweden-Botswana, art. 12(2); Sweden-Gambia, art. 12(7); Sweden-Lithuania, art. 12(7); Sweden-Namibia, art. 12(7).

[254] Finland-Ukraine, art. 12(7); France-Nigeria, art. 12(6); Netherlands-Mexico, art. 12(7); United Kingdom-Ghana, art. 12(7); United Kingdom-Kazakstan, art. 12(8); United Kingdom-Mexico, art. 12(7); United Kingdom-Russian Federation, art. 12(5); United Kingdom-Uzbekistan, art. 12(7); United Kingdom-Viet Nam, art. 12(7).

[255] See Australia-Viet Nam, art. 13(1) (adding "Income, profits or" at beginning of this paragraph and paragraphs 2, 3, and 4); Sweden-Russian Federation, art. 13(1) (substituting "Income" for "Gains").

[256] France-Nigeria, art. 13(1).

[257] France-Trinidad and Tobago.

[258] Australia-Viet Nam, art. 13(3); France-Nigeria, art. 13(2); Japan-Singapore, art. 13(3); Netherlands-Nigeria, art. 13(3); Netherlands-Viet Nam, art. 13(4); Sweden-Bolivia, art. 13(3); Sweden-Botswana, art. 13(3); Sweden-Gambia, art. 13(3); Sweden-Lithuania, art. 13(3); Sweden-Namibia, art. 13(3); Sweden-Russian Federation, art. 13(3); United Kingdom-Ghana, art. 13(4); United Kingdom-Mexico, art. 13(4); United States-China, art. 12(3).

See Belgium-China, art. 13(3) (substituting "place of general management" for "place of effective management"); Finland-China, art. 13(3) ("place of head office or effective management"); Finland-Estonia, art. 13(3) (gains of an enterprise of a Contracting State may be taxed only by that State); Netherlands-Latvia, art. 13(3) ("enterprise of a Contracting State"); United States-Tunisia, art. 13(4) (for Tunisia, place of effective management; for United States, place of incorporation).

[259] For example, Belgium-China, art. 13(3); Denmark-Egypt, art. 13(3); Denmark-Pakistan, art. 13(3); Ireland-Russian Federation, art. 13(3); Finland-China, art. 13(3); Netherlands-Nigeria, art. 13(3); Netherlands-Latvia, art. 13(3); Norway-Zimbabwe, art. 14(3); United States-China, art. 12(3). Treaties with this clause include Netherlands-Bangladesh, art. 13(3); Sweden-Gambia, art. 13(3).

[260] Norway-Gambia, art. 13(4).

[261] Luxembourg-Indonesia, art. 13; Sweden-Viet Nam, art. 13; United States-Ukraine, art. 13.

[262] See Ireland-Russian Federation, art. 13(2)(c) (allowing Contracting State to tax gains on sales of shares if at least 50 per cent of company's assets consist of immovable property in that State or of shares in other companies meeting this 50 per cent requirement); Netherlands-Viet Nam, art. 13(4) (restricting the paragraph to apply only to a shareholder owning "all or virtually all of the shares" and only if the disposition is not in a corporate reorganization, amalgamation, division, or similar transaction); Sweden-Venezuela, art. 13(4).

[263] Denmark-Latvia, art. 13(1); Finland-Estonia, art. 13(1); France-Kuwait, art. 13(1)(a); Netherlands-Mexico, art. 13(1); Norway-Latvia, art. 13(1); Sweden-Bolivia, art. 13(1); Sweden-Botswana, art. 13(1); Sweden-Lithuania, art. 13(1); Sweden-Namibia, art. 13(1); Sweden-Viet Nam, art. 13(1); United Kingdom-Ghana, art. 13(2). See United States-Tunisia, art. 13(2) (defining "immovable property" to include "United States real property interest," which includes shares in United States real property holding corporation); United States-Ukraine, art. 13(2) (same).

[264] Canada-Estonia, art. 13(4); Canada-Latvia, art. 13(4); Japan-Singapore, art. 13(4)(a); Netherlands-Mexico, art. 13(1); United Kingdom-Kazakstan, art. 13(2)(a); United Kingdom-Russian Federation, art. 13(2)(a); United Kingdom-Uzbekistan, art. 13(2)(a).

[265] Canada-Estonia, art. 13(4) (but excluding property, other than rental property, used in business); Canada-Latvia, art. 13(4) (same); Netherlands-

Mexico, art. 13(1); United States-Czech Republic, art. 13(2); United States-Kazakstan, art. 13(2); United States-Ukraine, art. 13(2).

[266] Canada-Estonia, art. 13(4) (b) ("substantial interest" in partnership, trust, or estate); Canada-Latvia, art. 13(4) (b) (same); Canada-Zimbabwe, art. 13(4); Ireland-Russian Federation, art. 13(2) (c) (partnerships); Japan-Singapore, art. 13(4); Spain-Republic of Korea, art. 13(3) (other legal persons) Switzerland-Mexico, art. 13(3) (other legal persons); United Kingdom-Ghana, art. 13(2) (partnerships and trusts); United Kingdom-Kazakstan, art. 13(2)(b) (partnerships and trusts); United Kingdom-Mexico, art. 13(2) (partnerships and trusts); United Kingdom-Russian Federation, art. 13(2)(b) (partnerships and trusts); United Kingdom-Viet Nam, art. 13(2)(b) (partnerships and trusts); United States-Czech Republic, art. 13(2); United States-Kazakstan, art. 13(2); United States-Slovakia, art. 13(2); United States-Ukraine, art. 13(2) (partnerships, trust, and estates).

[267] Treaties without the provision include Germany-Costa Rica, art. 13; France-Nigeria, art. 13; Ireland-Russian Federation, art. 13; Norway-Zimbabwe, art. 14; Sweden-Viet Nam, art. 13.

[268] Belgium-China, art. 13(5) (25 per cent); Denmark-Egypt, art. 13(5); Denmark-Pakistan, art. 14(5) (30 per cent); France-Kuwait, art. 11(3) (25 per cent); Japan-Singapore, art. 13(4)(b) (25 per cent ownership within previous 12 months, and alienated shares must be at least 5 per cent); Netherlands-Mexico, art. 13(4) (25 per cent, but no tax if shares were alienated in a reorganization, merger, or corporate division); Spain-Republic of Korea, art. 13(3) (25 per cent, but tax may not exceed 10 per cent of the gain); Spain-India, art. 14(5) (10 per cent); United Kingdom-Mexico, art. 13(6) (25 per cent interest at any time during the 12 months preceding the sale); United States-China, art. 12(5) (25 per cent); United States-Kazakstan, art. 13(3) (25 per cent).

[269] Netherlands-Nigeria, art. 13(4) (no minimum ownership, but gains realized in a corporate organization, reorganization, amalgamation, or division may not be taxed); Norway-Gambia, art. 13(4) (no minimum ownership or other restriction); Norway-Zimbabwe, art. 13(4) (same).

[270] For example, France-Nigeria, art. 13.

[271] Turkey-Hungary, art. 13(4).

[272] Belgium-China, art. 13(6).

[273] Finland-China, art. 13(5); United States-China, art. 12(6).

[274] For example, Canada-Estonia, art. 13(7) (five years); Canada-Latvia, art. 13(7) (five years); Canada-Zimbabwe, art. 13(7) (six years); Denmark-Latvia, art. 13(7) (10 years); Denmark-Lithuania, art. 13(7) (10 years); Netherlands-Latvia, art. 13(5) (applicable for five years, but only to gains on the alienation of shares); Norway-Latvia, art. 13(6) (five years); Sweden-Botswana, art. 13(5) (10 years, but only for gains on dispositions of shares); Sweden-Russian Federation, art. 13(4) (five years); Sweden-Viet Nam, art. 13(4) (five years, but only for gains on shares); United Kingdom-Ghana, art. 13(6) (for five years, applicable to all capital gains); United Kingdom-Mexico, art. 13(6) (same); United Kingdom-Russian Federation, art. 13(6) (same); United Kingdom-Uzbekistan, art. 13(6) (same).

[275] United Kingdom-Mexico, art. 13(5).

[276] See France-Trinidad and Tobago, art. 15(1) (allowing taxation at source if remuneration in source State exceeds 9,000 European currency units or taxpayer is present in that State for at least 183 days; dropping "fixed base" rule).

[277] For example, Australia-Viet Nam, art. 14(1); Finland-Ukraine, art. 14(1); France-Nigeria, art. 14(1); Ireland-Russian Federation, art. 14(1); Netherlands-Nigeria, art. 14(1); Turkey-Hungary, art. 14(1); United Kingdom-Ghana, art. 14(1); United States-Ukraine, art. 14(1).

[278] Denmark-Latvia, art. 14(1); Denmark-Lithuania, art. 14(1); Finland-Estonia, art. 14(1); Japan-Singapore, art. 14(1)(b) (consecutive 12-month period); Netherlands-Latvia, art. 14(1); Norway-Zimbabwe, art. 15(1); Sweden-Botswana, art. 14(1); Sweden-Gambia, art. 14(1)(b); Sweden-Lithuania, art. 14(1); Sweden-Namibia, art. 14(1)(b); Sweden-Viet Nam, art. 14(1); Switzerland-Mexico, art. 14(1)(b); United Kingdom-Kazakstan, art. 14(1)(b) (consecutive 12 months); United States-Czech Republic, art. 14(1)(b); United States-Kazakstan, art. 14(1)(c) (consecutive 12 months); United States-Slovakia, art. 14(1)(b). See Finland-China, art. 14(1)(b) (substituting "calendar year" for "fiscal year"); Sweden-Russian Federation, art. 13(1)(b) (period in (b) extended to 12 months); United States-China, art. 14(1) (substituting "calendar year" for "fiscal year").

[279] Luxembourg-Indonesia, art. 14(1).

[280] Belgium-China, art. 15(1); Denmark-Egypt, art. 14(1); Finland-China, art. 14(1); Luxembourg-Indonesia, art. 14(1); Spain-India, art. 15(1); Sweden-Botswana, art. 14(1); Sweden-Russian Federation, art. 14(1)(b); United Kingdom-Mexico, art. 14(1). See United States-Tunisia, art. 14(1)(c) (allowing taxation at source whenever compensation exceeds US$ 7,500, whether or not received from a resident, permanent establishment, or fixed base in source country).

[281] See Ireland-Russian Federation, art. 14(2) (defining "independent services", rather than "professional services"); United States-Tunisia, art. 14(2) ("personal services in an independent capacity"); United States-Ukraine, art. 14(2) ("independent personal services").

[282] Finland-Estonia, art. 15(2); Finland-Pakistan, art. 15(2); Finland-Ukraine, art. 15(1)(a); France-Nigeria, art. 15(2)(a); Netherlands-Latvia, art. 15(2)(a); Norway-Zimbabwe, art. 14(2)(a); Sweden-Belarus, art. 15(2)(a); Sweden-Botswana, art. 15(2); Sweden-Viet Nam, art. 15(2)(a). See Belgium-China, art. 15(2) (substituting "calendar year" for "fiscal year" in (a)); Finland-China, art. 15(2) (same); United States-China, art. 14(2)(a) (same).

The treaties following the United Nations Model Convention on this point include France-Kuwait, art. 15(2)(a); Germany-Namibia, art. 15(2)(a) (using "tax year" rather than "fiscal year"); Netherlands-Bangladesh, art. 15(2)(a); United States-Ukraine, art. 15(2)(a) ("tax year").

[283] Norway-Zimbabwe, art. 16(2)(b).

[284] Australia-Viet Nam, art. 15(1).

[285] Treaties not containing this provision include United States-China, art. 14.

[286] Australia-Viet Nam, art. 15(3); Finland-Estonia, art. 15(3); Finland-Ukraine, art. 15(3); France-Nigeria, art. 15(3); Luxembourg-Indonesia, art. 15(3); Netherlands-Nigeria, art. 15(3); Spain-India, art. 15(3); Sweden-Botswana, art. 15(3); United Kingdom-Ghana, art. 15(3); United Kingdom-Mexico, art. 15(3). See Norway-Gambia, art. 16(3) (where profits of enterprise are taxable); Turkey-Hungary, art. 15(3) (country where registered office of enterprise is located).

Some treaties provide that if the operator of a ship or aircraft is an enterprise of a Contracting State, compensation for employment aboard the ship or aircraft is taxable only in that State (Sweden-Belarus, art. 15(3); Sweden-Viet Nam, art. 15(3)).

Some treaties vest exclusive tax jurisdiction in the employee's country of residence (Netherlands-Latvia, art. 15(3); United States-Ukraine, art. 15(3)).

The treaties using the effective management approach include France-Kuwait, art. 12(3); Netherlands-Bangladesh, art. 15(3); Switzerland-Romania, art. 15(3). See Belgium-China, art. 15(3) ("place of general management"); Finland-China, art. 15(3) ("place of head office or effective management").

[287] See Belgium-China, art. 16 (adding at end that this paragraph also applies to payments for "the exercising of functions similar to those mentioned"); Finland-China, art. 16 (adding "or any other similar organ of a company" after "Board of Directors"); Ireland-Russian Federation, art. 16 (adding "or similar body"); Netherlands-Latvia, art. 16 (adding "or any other similar organ"); United States-Tunisia, art. 16 (excluding "fixed or contingent payments derived in his capacity as an officer or employee" and allowing other State to tax only amounts that "cannot be taken as a deduction by the corporation but is treated in that other State as a distribution of profits"); United States-Ukraine, art. 16 (excluding remuneration for services rendered in company's State of residence).

[288] Treaties with the provision include Denmark-Egypt, art. 16(2); Denmark-Pakistan, art. 17(2); Norway-Zimbabwe, art. 17(2).

[289] Luxembourg-Indonesia, art. 16(2).

[290] See United States-Tunisia, art. 17(1) (exempting this income if it does not exceed US$ 7,500).

[291] Some very recent treaties make this substitution, namely, Netherlands-Latvia, art. 17(1); Sweden-Belarus, art. 17(1).

[292] See United States-Tunisia, art. 17(2) (adding provision defining when income "accrues" to another person).

[293] Belgium-China, art. 17(3) (cultural exchange); Canada-Estonia, art. 17(4) (public funds); Canada-Latvia, art. 17(4) (public funds); Denmark-Latvia, art. 17(3) (public funds); Denmark-Lithuania, art. 17(3) (public funds); Germany-Costa Rica, art. 17(3) (other State or "an institution of public interest recognized in that other State"); Finland-China, art. 17(3) (cultural exchange); Finland-Estonia, art. 17(3) ("public funds of the other Contracting State", but tax can be imposed under provisions for permanent establishments or independent or dependent personal services); Finland-Ukraine, art. 17(3) (same); France-Trinidad and Tobago, art. 18(3) (public funds of residence State of artist or athlete or cultural exchange); Japan-Singapore, art. 17(1) (cultural

exchange); Luxembourg-Indonesia, art. 17(3) (public funds); Netherlands-Latvia, art. 17(3) (public funds of residence State of athlete or artist); Netherlands-Viet Nam, art. 17(3) (other State); Norway-Gambia, art. 18(3) (other State); Norway-Latvia, art. 17(3) (public funds); Spain-India, art. 18(3) ("public funds" of State of artist's or athlete's residence); Spain-Republic of Korea, art. 17(3) (cultural exchange); Sweden-Botswana, art. 17(3) (other State); Sweden-Lithuania, art. 17(3) (public funds); Sweden-Russian Federation, art. 17(3) (cultural arrangement); Sweden-Viet Nam, art. 17(3) (public funds of residence State of artist or athlete "according to the cultural exchange programme between the two Contracting States"); Switzerland-Romania, art. 17(3) (public funds); Turkey-Hungary, art. 17(3) ("public funds" of either State or cultural agreement); United Kingdom-Ghana, art. 18(3) (cultural arrangement); United States-Czech Republic, art. 17(3) (public funds); United States-China, art. 16(1) (cultural exchange); United States-Slovakia, art. 18(3) (public funds); United States-Ukraine, art. 17(3) (public funds of residence State of artist or athlete or "pursuant to a specific arrangement agreed to by the Governments").

[294] See Australia-Viet Nam, art. 18(1) (adding to paragraph 1 "including government pensions"); Sweden-Bolivia, art 18(1) (adding Social Security payments and annuities); Sweden-Botswana, art. 18(1) (adding Social Security disbursements); Sweden-Russian Federation, art. 18(1) (adding Social Security payments and annuities); Sweden-Venezuela, art. 18(1) (adding Social Security payments and annuities).

Under some treaties, pensions "arising" in a Contracting State are taxable only in that State. Denmark-Egypt, art. 18(1); Denmark-Pakistan, art. 19(1); France-Nigeria, art. 19(1) (country where "such income is derived"). Other treaties provide that such pensions "may be taxed" where they arise (Sweden-Belarus, art. 18(1)).

[295] Netherlands-Nigeria, art. 18(a). See Finland-Estonia, art. 18(3) (allowing pensions to be taxed in State where they arise only if recipient was formerly a resident of that State and is now a resident of the other State and usually only if recipient is a national of the taxing State but not of the State of present residence; maximum tax is 15 per cent of gross amount); Netherlands-Latvia, art. 18(2) (allowing pensions "in consideration of past employment" to be taxed where that employment took place if they are "not of a periodical nature"); Netherlands-Viet Nam, art. 18(2) (same).

[296] Treaties with the provision include Belgium-China, art. 18(2); Canada-Zimbabwe, art. 19(5); Denmark-Latvia, art. 18(2); Denmark-Lithuania, art. 18(2); Denmark-Pakistan, art. 19(1); Finland-China, art. 18(2); France-Kuwait, art. 13A(2); France-Trinidad and Tobago, art. 19(2); Finland-Estonia, art. 18(2); Netherlands-Bangladesh, art. 18(3); Netherlands-Latvia, art. 18(3); Netherlands-Mexico, art. 18(3); Norway-Zimbabwe, art. 19(2); Sweden-Belarus, art. 18(1); Sweden-Lithuania, art. 18(2); United States-Czech Republic, art. 19(1)(b); United States-China, art. 17(2); United States-Kazakstan, art. 18(1)(b); United States-Slovakia, art. 19(1)(b); United States-Tunisia, art. 18(1)(b); United States-Ukraine, art. 19(2).

[297] See Netherlands-Viet Nam, art. 19(4) (covering social security payments in article on government service, providing that social security payments may be taxed by payer country but not barring taxation in recipient's country of residence); Sweden-Gambia, art. 18(1); Sweden-Namibia, art. 18(1); Sweden-Russian Federation, art. 18(1); Sweden-Venezuela, art. 18(1).

[298] Denmark-Egypt, art. 18(1) (annuity may be taxed only where it arises); Denmark-Pakistan, art. 19(1) (same); France-Nigeria, art. 19(1) ("State from which such income is derived"); Netherlands-Nigeria, art. 18(2), (3); Sweden-Belarus, art. 18(1) (annuity "may be taxed" where it arises); Sweden-Bolivia, art. 18(1); Sweden-Gambia, art. 18(1); Sweden-Namibia, art. 18(1); Sweden-Russian Federation, art. 18(1); Sweden-Venezuela, art. 18(1).

See Finland-Estonia, art. 18(3) (allowing annuities to be taxed in State where they arise only if recipient was formerly a resident of that State and is now a resident of the other State and usually only if recipient is a national of the taxing State but not of the State of present residence; maximum tax is 15 per cent of gross amount). Finnish treaties generally clarify that payments in exchange for "services rendered" are not an annuity; idem, Finland-Pakistan, art. 18(3); Finland-Ukraine, art. 18(1), (3).

[299] E.g., Australia-Viet Nam, art. 18(1), (2); Canada-Estonia, art. 18(1) (other State can also tax); Canada-Latvia, art. 18(1) (same); Denmark-Latvia, art. 18(1); Denmark-Lithuania, art. 18(1); France-Trinidad and Tobago, art. 19(1), (3); Ireland-Russian Federation, art. 18(1), (2); Japan-Singapore, art. 18(1); Netherlands-Bangladesh, art. 18(1) (but other State can tax if the payment is not periodic); Netherlands-Latvia, art. 18(1) (but lump-sum payment is taxable at source); Netherlands-Mexico, art. 18(1) (but other State can tax non-periodic payments); Norway-Latvia, art. 18(1); Sweden-Botswana, art. 18(1), (2); Sweden-Egypt, art. 18(1), (2); United Kingdom-Ghana, art. 18(3); United Kingdom-Mexico, art. 18(1), (2); United Kingdom-Kazakstan, art. 18(1); United Kingdom-Viet Nam, art. 18(1); United States-Czech Republic, art. 19(2); United States-Kazakstan, art. 18(3); United States-Slovakia, art. 19(2); United States-Tunisia, art. 18(2).

See Netherlands-Viet Nam, art. 18(2), (3) (generally vesting sole tax jurisdiction in country of residence, but allowing an annuity to be taxed where it "arises" if "a lump sum is paid"); Turkey-Hungary, art. 18 (vesting country of residence with sole tax jurisdiction over "life annuities", but not defining this term).

[300] Canada-Zimbabwe, art. 19(4); Denmark-Egypt, art. 18(2) (but only if recipient is taxed on alimony in residence State); Denmark-Pakistan, art. 19(2) (same); Norway-Gambia, art. 19(2) (but allowing alimony paid by a resident of one State to a resident of the other State to be taxed only by the former "to the extent it is not allowable as a relief to the payer"); United States-Czech Republic, art. 19(3); United States-Kazakstan, art. 18(4); United States-Slovakia, art. 19(3); United States-Tunisia, art. 18(3).

Treaties made by the United States often provide that child support payments are exempt in both States (United States-Czech Republic, art. 19(3); United States-Slovakia, art. 19(3); United States-Tunisia, art. 18(4)).

[301] Australia-Viet Nam, art. 18(3) (covering "alimony or other maintenance payment").

[302] See Denmark-Egypt, art. 19(2) (extending paragraph 1 to apply to employees of central bank and other "general organisations engaged in public services"); France-Nigeria, art. 18(1) (restating (b) to provide that remuneration for services in the other State are taxable solely in that State only if "the recipient is a resident and a national of that other State, provided that he did not become a resident of that other State solely for the purpose of rendering the services"); Germany-Costa Rica, art. 19(1)

(restating (b) to provide that if the services are rendered in the other State, the other State has exclusive tax jurisdiction unless the recipient is a national of the State for whose Government the services are performed); United States-Czech Republic, art. 14(1) (combining paragraphs 1 and 2 with somewhat different wording); United States-Slovakia, art. 14(1) (same); United States-Tunisia, art. 19(1) (restating paragraph 1 to apply only if recipient is a citizen of State for which the services are performed).

303 Germany-Costa Rica, art. 19(4); Germany-Namibia, art. 19(3).

304 Treaties omitting paragraph 2 include Australia-Viet Nam, arts. 18, 19 (covering "government pensions" in article on pensions, and omitting paragraph 2 of this article); Denmark-Egypt, art. 19; Denmark-Pakistan, art. 20; France-Nigeria, art. 18; Germany-Costa Rica, art. 19(1) (extending paragraph 1 to cover pensions for government service); Ireland-Russian Federation, art. 19; Netherlands-Nigeria, art. 19(2) (containing (a), but omitting (b)); Sweden-Bolivia, art. 19; Sweden-Russian Federation, art. 19; Sweden-Venezuela, art. 19; United States-Czech Republic, art. 19; United States-Slovakia, art. 19.

305 See Australia-Viet Nam, art. 19(2) (rewording this paragraph); France-Nigeria, art. 18(2) (adding "or any instrumentality of government thereof for the purpose of profits"); Netherlands-Latvia, art. 19(3) (adding "or an agency or wholly owned entity of such State, subdivision or authority"); United States-Ukraine, art. 18(3) (rewording this paragraph without substantive change).

306 See Belgium-China, art. 21 (omitting final clause, beginning "provided"); Denmark-Pakistan, art. 21 (rewording and extending paragraph's coverage, including "any amount representing remuneration for services rendered" in country of services); Germany-Costa Rica, art. 20(2) (rewording and extending paragraph's coverage); Netherlands-Nigeria, art. 21(1) (rewording the paragraph, extending exemption to cover up to US$ 2,000 earned in the country where the studies take place, and restricting the exemption to "such period of time as may be reasonable or customarily required"); Sweden-Egypt, art. 20 (rewording paragraph without major change).

307 Treaties with this provision include Canada-Zimbabwe, art. 21(2); Denmark-Egypt, art. 20(2); Norway-Zimbabwe, art. 21(2); Sweden-Bolivia, art. 20(2) (requiring student to be present in the other State for at least six months); Sweden-Gambia, art. 20(2); Sweden-Namibia, art. 20(2). See Netherlands-Nigeria, art. 21(2) (providing separate exemption for grants and allowances from either State, from scientific, educational, religious or charitable organizations, or under technical assistance programme of either State).

308 Denmark-Egypt, art. 20(3) (in no event more than five years); United States-China, art. 20; United States-Ukraine, art. 20(2) (in no event more than five years).

309 Netherlands-Nigeria, art. 21(1). See Finland-China, art. 21(c) (similar provision applicable for no more than seven years or, if less, period reasonably required to complete study); France-Trinidad and Tobago, art. 21 (similar provision, with no monetary ceiling and time limitation of seven years); Netherlands-Bangladesh, art. 20; Spain-Republic of Korea, art. 20(1) (similar provision applicable for no more than five years); United States-Czech Republic, art. 21; United States-China, art. 20 (similar provision, limited to US$ 5,000 annually); United States-Slovakia, art. 21; United States-Tunisia, art. 20 (US$ 4,000 annually).

[310] Turkey-Hungary, art. 20(3).

[311] Finland-Pakistan, art. 20(2); Finland-Ukraine, art. 20(2); France-Nigeria, art. 20(2). See Denmark-Pakistan, art. 21 (no requirement that the services be in connection with the studies or training).

[312] Netherlands-Nigeria, art. 20 (limiting exemption for research to research "undertaken ... in the public interest").

For similar provisions, see Belgium-China, art. 20 (applicable for three years); Denmark-Egypt, art. 21 (two years); Finland-China, art. 20 (three years); France-Kuwait, art. 16 (two years); France-Nigeria, art. 21 (two years, but for research, only if research is "in the public interest"); France-Trinidad and Tobago, art. 22 (same); Germany-Costa Rica, art. 20(1) (applicable for two years, but extending to visits to museums or "other cultural institution(s)" or "under an official programme of cultural exchange"); Ireland-Russian Federation, art. 21 (two years, but for research, only if "in the public interest"); Luxembourg-Indonesia, art. 20(1); Netherlands-Bangladesh, art. 20 (two years); Netherlands-Latvia, art. 20 (two years, but for research, only if "in the public interest"); Spain-Republic of Korea, art. 21 (two years); Sweden-Egypt, art. 21 (two years, applicable only to visits to a "university, college or other establishment for higher education or scientific research", limiting the research exemption to research "in the public interest", and conditioning the exemption on the payments being taxed in the residence country); Sweden-Russian Federation, art. 20(2) (two years); Turkey-Hungary, art. 20(2) (two years, applicable if the teacher or instructor is a "national" of a Contracting State and covering teaching and scientific research); United Kingdom-Ghana, art. 22 (two years, covering only service at a university or "other recognized educational institution" and, in the case of research, limited to research "in the public interest").

[313] United States-Czech Republic, art. 21; United States-Kazakstan, art. 19; United States-Slovakia, art. 21; United States-Ukraine, art. 20 (for students, trainees and researchers only).

[314] See Germany-Costa Rica, art. 21(1) (adding "irrespective of source"); United Kingdom-Mexico, art. 21(1) (adding "beneficially owned by" after "Items of income").

Some treaties combine paragraphs 1 and 3 (Denmark-Latvia, art. 22(1); Denmark-Lithuania, art. 22(1); Norway-Latvia, art. 22(1); Sweden-Lithuania, art. 22(1); Sweden-Venezuela, art. 21(1)).

This article is omitted in Switzerland-Mexico.

[315] United Kingdom-Ghana, art. 23.

[316] United Kingdom-Ghana, art. 23; United Kingdom-Kazakstan, art. 21(1); United Kingdom-Mexico, art. 21(1); United Kingdom-Russian Federation, art. 21(1); United Kingdom-Viet Nam, art. 21(1).

[317] But see Australia-Viet Nam, art. 21(3) (paragraph reworded); Germany-Costa Rica, art. 21(1) ("beneficial owner" substituted for "recipient").

[318] For example, Netherlands-Nigeria, art. 22.

[319] Treaties with this paragraph, or some variant thereof, include Australia-Viet Nam, art. 21(2) (reworded); Belgium-China, art. 22(1) (combining this paragraph with paragraph 1); Denmark-Egypt, art. 22(3); Finland-China, art. 22(3); Finland-Estonia, art. 21; Finland-Pakistan, art. 21(1); Japan-Singapore, art. 21(3); Netherlands-Mexico, art. 21(3); Netherlands-Nigeria, art. 22(2); Norway-Zimbabwe, art. 22(3); Sweden-Botswana, art. 21 (allowing other State to tax "if such income is derived from sources within (that) State"); Sweden-Egypt, art. 22(2) (same); Sweden-Namibia, art. 22(3); Sweden-Viet Nam, art. 21(2) (same); United States-China, art. 21(3).

Several Canadian treaties contain this paragraph, but limit the rate of tax to 15 per cent for some income from trusts and estates (Canada-Estonia, art. 21(2); Canada-Latvia, art. 21(2); Canada-Zimbabwe, art. 22(1)).

See France-Nigeria, art. 22 (restating paragraph 1 to provide that income of resident of Contracting State arising in other State is taxable "in accordance with the domestic laws of each Contracting State"); France-Trinidad and Tobago, art. 23 (same).

[320] United Kingdom-Kazakstan, art. 21(3); United Kingdom-Mexico, art. 21(4); United Kingdom-Uzbekistan, art. 21(3).

[321] United Kingdom-Mexico, art. 21(5).

[322] Treaties not containing the article include Australia-Viet Nam, Belgium-China, Denmark-Egypt, Denmark-Pakistan, Finland-China, France-Nigeria, France-Trinidad and Tobago, Ireland-Russian Federation, Netherlands-Nigeria, Netherlands-Viet Nam, Sweden-Belarus, Sweden-Botswana, Sweden-Viet Nam, Turkey-Hungary, United Kingdom-Ghana, United Kingdom-Mexico, United States-China, United States-Tunisia.

[323] Treaties omitting paragraph 3 include Luxembourg-Indonesia, art. 22.

[324] Canada-Estonia, art. 22(3); Canada-Latvia, art. 22(3); Canada-Zimbabwe, art. 23(3); Denmark-Latvia, art. 23(3); Denmark-Lithuania, art. 23(3); Finland-Estonia, art. 22(3); Finland-Ukraine, art. 22(4); Norway-Latvia, art. 23(3); Norway-Latvia, art. 23(3); Spain-India, art. 24(3); Sweden-Lithuania, art. 23(3); United States-Czech Republic, art. 23(3); United States-Kazakstan, art. 22(3); United States-Slovakia, art. 23(3); United States-Ukraine, art. 23(3). See Netherlands-Latvia, art. 23(3) ("operated by an enterprise of a Contracting State").

[325] Norway-Gambia, art. 24(3). However, this treaty grants jurisdiction to tax containers and related equipment to the State where effective management is located (Norway-Gambia, art. 24(4)).

[326] Spain-India, art. 24(4), (5).

[327] Finland-Estonia, art. 22(1); Finland-Ukraine, art. 22(2).

[328] Treaties without non-discrimination articles include Australia-Viet Nam; France-Kuwait.

[329] Canada-Estonia, art. 24(1); Canada-Latvia, art. 24(2); Canada-Zimbabwe, art. 25(1); France-Nigeria, art. 24(1); Sweden-Viet Nam, art. 24(1); Switzerland-Mexico, art. 22(1); Turkey-Hungary, art. 23(1); United Kingdom-Ghana, art. 26(1); United Kingdom-Mexico, art. 25(1); United Kingdom-Kazakstan,

art. 23(1); United Kingdom-Russian Federation, art. 24(1); United Kingdom-Uzbekistan, art. 25(1); United Kingdom-Viet Nam, art. 23(1); United States-Tunisia, art. 24(1).

See Finland-Pakistan, art. 23(5)(b) (providing that this article does not affect "any provisions of the law of a Contracting State regarding the imposition of a tax on a non-resident person"); Sweden-Russian Federation, art. 23(1) (stating that paragraph does not entitle residents of other State to benefits granted by special agreements to residents of a third State).

[330] Ireland-Russian Federation, art. 24(1); Finland-Ukraine, art. 24(1); Sweden-Russian Federation, art. 23(1); United States-Ukraine, art. 25(1).

See United Kingdom-Kazakstan, art. 25(1) (paragraph applies to nationals and "any legal person, partnership, association or other entity").

[331] Treaties including this definition in article 24 include Denmark-Egypt, art. 24(2); Denmark-Pakistan, art. 25(1); United States-Tunisia, art. 24(2).

[332] Ireland-Russian Federation, art. 24(1).

[333] Treaties with this provision include Denmark-Egypt, art. 24(3); Denmark-Pakistan, art. 25(3); Netherlands-Latvia, art. 26(2) (adding "in particular with respect to residence" after "the same circumstances"); Norway-Latvia, art. 25(2); Norway-Zimbabwe, art. 25(2); Sweden-Lithuania, art. 24(2); United Kingdom-Kazakstan, art. 25(2); United Kingdom-Uzbekistan, art. 25(2). See Ireland-Russian Federation, art. 24(1) (not including this paragraph, but adding to the second sentence of paragraph 1 "and, if so permitted by the law of the Contracting State concerned, to stateless persons who are residents of that Contracting State").

[334] See Spain-India, art. 26(2) (adding "in the same circumstances or under the same conditions" at the end of the first sentence).

[335] Canada-Estonia, art. 24(3); Canada-Latvia, art. 24(3); Canada-Zimbabwe, art. 25(3); Finland-Pakistan, art. 23(5)(a); Finland-Ukraine, art. 24(6); France-Nigeria, art. 24(4); Ireland-Russian Federation, art. 24(3); Netherlands-Nigeria, art. 24(3); Netherlands-Viet Nam, art. 24(6); Norway-Zimbabwe, art. 25(6); Sweden-Bolivia, art. 24(5); Sweden-Botswana, art. 24(5); Sweden-Egypt, art. 24(3); Sweden-Gambia, art. 24(5); Sweden-Namibia, art. 24(5); Sweden-Russian Federation, art. 24(3); Turkey-Hungary, art. 23(4); United Kingdom-Ghana, art. 26(5); United Kingdom-Kazakstan, art. 25(6); United Kingdom-Mexico, art. 25(5); United Kingdom-Russian Federation, art. 25(5); United Kingdom-Uzbekistan, art. 25(6); United Kingdom-Viet Nam, art. 23(5); United States-Tunisia, art. 24(6); United States-Ukraine, art. 25(6).

See Sweden-Viet Nam, art. 24 (including both separate paragraph and second sentence of para. 4).

[336] Denmark-Pakistan, art. 25(5) (adding "fees for technical services" to first sentence); France-Trinidad and Tobago, art. 25(3) (adding "management charges" to first sentence, and adding sentence clarifying that this paragraph does not limit France in applying "its domestic law regarding 'thin-capitalization'"); Luxembourg-Indonesia, art. 24(4) (omitting "Except where the provisions of paragraph 1 of article 9, paragraph 6 of article 11, or paragraph 6 of article apply"); Norway-Zimbabwe, art. 25(4) (adding "technical fees" to first sentence).

[337] France-Nigeria, art. 24; Ireland-Russian Federation, art. 24; Netherlands-Nigeria, art. 24; Sweden-Russian Federation, art. 24.

[338] Belgium-China, art. 24(3); Denmark-Egypt, art. 24(5); Denmark-Pakistan, art. 25(5); Finland-China, art. 24(3); Sweden-Viet Nam, art. 24(3); United States-China, art. 24(3); United States-Tunisia, art. 24(4).

[339] See United States-Ukraine, art. 25(4) (substituting "A company that is a resident of" for "Enterprises of").

[340] Ireland-Russian Federation, art. 24; Sweden-Russian Federation, art. 24.

[341] See United States-Tunisia, art. 24(7) (applying this article to "all taxes imposed by a Contracting State or a political subdivision or local authority thereof"); United States-Ukraine, art. 25(7) ("taxes of every kind and description imposed by a Contracting State or a political subdivision or local authority thereof").

[342] Finland-China, art. 24; Luxembourg-Indonesia, art. 24; Spain-India, art. 26; United States-China, art. 23.

[343] Canada-Estonia, art. 24(5); Canada-Latvia, art. 24(5); Canada-Zimbabwe, art. 25(6); Denmark-Egypt, art. 24(7); Ireland-Russian Federation, art. 24(4); Luxembourg-Indonesia, art. 24(5); Netherlands-Viet Nam, art. 24(7); Sweden-Russian Federation, art. 24(5); Sweden-Viet Nam, art. 24(7); Switzerland-Mexico, art. 23(6); United Kingdom-Kazakstan, art. 25(7); United Kingdom-Mexico, art. 25(6); United Kingdom-Russian Federation, art. 24(6); United Kingdom-Uzbekistan, art. 25(7); United Kingdom-Viet Nam, art. 24(6).

[344] Netherlands-Viet Nam, art. 24(2) (at a rate not exceeding 10 per cent); Norway-Zimbabwe, art. 25(2) (5 per cent or any lower rate agreed to by Zimbabwe in a treaty with any other OECD member); Sweden-Viet Nam, art. 24(5) (applicable only to "Vietnamese profit remittance tax"; maximum rate of 10 per cent); United Kingdom-Viet Nam, art. 23(2); United States-Czech Republic, art. 25(5); United States-Kazakstan, art. 25(5); United States-Slovakia, art. 25(4); United States-Ukraine, art. 25(5).

[345] Netherlands-Latvia, art. 26(6).

[346] See Finland-Ukraine, art. 25(1) (substituting "citizen" for portion of last sentence beginning with "resident or, if his case comes ..."); Sweden-Viet Nam, art. 25(1) (omitting "or, if his case comes under paragraph 1 of article 24, to that of the Contracting State of which he is a national" at end of first sentence); United Kingdom-Ghana, art. 27(1) (omitting everything beginning with "or, if his case comes under paragraph 1 of article 24, to that of ..."); United States-Ukraine, art. 26(1) (making same substitution as Finland-Ukraine).

[347] Turkey-Hungary, art. 25(1); United Kingdom-Kazakstan, art. 26(1); United Kingdom-Russian Federation, art. 25(1); United Kingdom-Uzbekistan, art. 26(1); United Kingdom-Viet Nam, art. 24(1); United States-Kazakstan, art. 25(1); United States-Tunisia, art. 25(1); United States-Ukraine, art. 26(1).

[348] Canada-Estonia, art. 25(1); Canada-Latvia, art. 25(1); Canada-Zimbabwe, art. 26(1); Sweden-Venezuela, art. 25(1); Switzerland-Mexico, art. 23(1).

[349] See Finland-China, art. 25(2) (adding after first sentence "In the event the competent authorities reach an agreement, taxes shall be imposed, and refund

or credit of taxes shall be allowed by the Contracting States in accordance with such agreement").

350 Belgium-China, art. 25(2); Canada-Estonia, art. 25(2); Canada-Latvia, art. 25(2); Canada-Zimbabwe, art. 26(2); Denmark-Pakistan, art. 26(2); Luxembourg-Indonesia, art. 25(2); Netherlands-Mexico, art. 24(2); Netherlands-Nigeria, art. 25(2); Spain-Republic of Korea, art. 25(2); Sweden-Venezuela, art. 25(2); Switzerland-Mexico, art. 23(2); Switzerland-Romania, art. 25(2); Turkey-Hungary, art. 25(2); United Kingdom-Ghana, art. 27(2); United Kingdom-Kazakstan, art. 26(2); United Kingdom-Russian Federation, art. 26(2); United Kingdom-Uzbekistan, art. 26(2); United Kingdom-Viet Nam, art. 24(2).

351 See Spain-Republic of Korea, art. 25(3) (adding "and for the avoidance or abuse of the Convention" at the end of the second sentence).

Some United States treaties add an additional sentence describing five types of matters of interpretation or application that might be covered by competent authority agreement (United States-Kazakstan, art. 25(3); United States-Ukraine, art. 26(3)).

352 Belgium-China, art. 25(3); Canada-Estonia, art. 25(4); Canada-Latvia, art. 25(4); Canada-Zimbabwe, art. 26(4); France-Nigeria, art. 25(3); Ireland-Russian Federation, art. 26(3); Netherlands-Mexico, art. 24(3); Sweden-Venezuela, art. 25(3); Switzerland-Mexico, art. 23(3); United Kingdom-Ghana, art. 27(3); United Kingdom-Kazakstan, art. 26(3); United Kingdom-Russian Federation, art. 26(3); United Kingdom-Uzbekistan, art. 26(3); United Kingdom-Viet Nam, art. 24(3).

353 Spain-India, art. 27(1). This provision replaces the final sentence of United Nations Model Convention article 26(1).

354 See Denmark-Egypt, art. 28(3) (providing in another article that the competent authorities "may communicate with each other directly for the purpose of applying the Convention").

355 For example, Australia-Viet Nam, art. 24(4); Canada-Estonia, art. 25(5); Canada-Latvia, art. 25(5); Denmark-Latvia, art. 26(4); Denmark-Lithuania, art. 26(4); Denmark-Pakistan, art. 26(4); Finland-China, art. 25(4); France-Nigeria, art. 25(4); Ireland-Russian Federation, art. 26(4); Japan-Singapore, art. 25(4); Netherlands-Latvia, art. 27(4); Netherlands-Nigeria, art. 25(4); Norway-Gambia, art. 28(4); Turkey-Hungary, art. 25(4); Sweden-Belarus, art. 24(4); Sweden-Botswana, art. 25(5); Sweden-Lithuania, art. 24(3); Sweden-Russian Federation, art. 24(3); Sweden-Venezuela, art. 25(4); Switzerland-Romania, art. 25(4); United Kingdom-Ghana, art. 27(4); United Kingdom-Kazakstan, art. 26(4); United Kingdom-Russian Federation, art. 25(4); United Kingdom-Uzbekistan, art. 26(4); United Kingdom-Viet Nam, art. 24(4); United States-Czech Republic, art. 26(4); United States-China, art. 24(5); United States-Kazakstan, art. 25(4); United States-Slovakia, art. 26(4); United States-Tunisia, art. 25(5); United States-Ukraine, art. 26(4).

356 Finland-China, art. 25(4) (rewording second sentence and omitting the third); France-Trinidad and Tobago, art. 26(4) (including second, but not third, sentence); Luxembourg-Indonesia, art. 25(4) (including second sentence, but not final sentence); Sweden-Viet Nam, art. 25(4) (including second, but not third, sentence).

[357] Denmark-Pakistan, art. 26(4); Finland-China, art. 25(4); Finland-Estonia, art. 25(4); Finland-Pakistan, art. 24(4); Norway-Gambia, art. 28(4); Turkey-Hungary, art. 25(4); Spain-India, art. 27(4); United States-Tunisia, art. 25(4).

[358] Netherlands-Latvia, art. 27(5); United States-Kazakstan, art. 25(5). The Netherlands-Latvia treaty also contains a provision requiring the Contracting States to release information to the arbitration board (Netherlands-Latvia, art. 28(2)).

[359] France-Trinidad and Tobago, art. 26(5).

[360] Sweden-Egypt, art. 25(4).

[361] United States-Tunisia, art. 25(4).

[362] See Germany-Costa Rica, art. 26(1) (omitting from first sentence "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"); Spain-India, art. 28(1) (adding "(including copies of documents when relevant)" after "such information" in first sentence); Luxembourg-Indonesia, art. 28(1) (adding at end of first sentence "and to facilitate the administration of statutory provisions against legal avoidance"); Netherlands-Nigeria, art. 26(1) (adding "(being information with such authorities have in proper order at their disposal)" in first sentence after "such information"); Sweden-Belarus, art. 25(1) (adding "The exchange of information shall be carried out at request with respect to particular cases").

[363] Canada-Estonia, art. 26(1); Canada-Latvia, art. 27(1); Canada-Zimbabwe, art. 27(1); Denmark-Latvia, art. 27(1); Denmark-Lithuania, art. 27(1); France-Kuwait, art. 20A; Germany-Namibia, art. 26(1); Japan-Singapore, art. 26(1); Netherlands-Mexico, art. 25(1); Spain-Republic of Korea, art. 26(1); Netherlands-Latvia, art. 28(1); Sweden-Bolivia, art. 25(1); Sweden-Gambia, art. 26(1); Sweden-Lithuania, art. 25(1); Sweden-Namibia, art. 25(1); Sweden-Russian Federation, art. 25(1); Sweden-Venezuela, art. 26(1); United States-Czech Republic, art. 27(1); United States-Kazakstan, art. 26(1); United States-Slovakia, art. 27(1).

Treaties made by the United Kingdom commonly include language relating to fraud prevention, but otherwise follow the OECD model more closely (United Kingdom-Kazakstan, art. 27(1); United Kingdom-Russian Federation, art. 26(1); United Kingdom-Uzbekistan, art. 27(1); United Kingdom-Viet Nam, art. 26(1).

[364] Some treaties omit "(ordre public)" from (c) (Denmark-Egypt, art. 26(2); Finland-China, art. 26(2); Ireland-Russian Federation, art. 25(2); Sweden-Viet Nam, art. 26(2); United States-China, art. 25(2); United States-Ukraine, art. 27(2)).

One makes this paragraph a separate article qualifying both this article and a unique article obligating each State to lend assistance in collecting taxes imposed by the other (Netherlands-Latvia, art. 30).

[365] United States-Czech Republic, art. 27(3); United States-Kazakstan, art. 27(3); United States-Slovakia, art. 27(3); United States-Tunisia, art. 26(3); United States-Ukraine, art. 27(3) (also requiring other State to provide

depositions of witnesses and authenticated copies of "complete original documents").

[366] United States-Ukraine, art. 27(4).

[367] Switzerland-Romania.

[368] See France-Nigeria, art. 27(1) (adding "their personal domestics" and "members of permanent missions to international organizations"); Ireland-Russian Federation, art. 27 (substituting "persons" for "diplomatic agents or consular officers"); United States-Ukraine, art. 28 (adding "employees of a consular establishment").

[369] France-Nigeria, art. 27(2) (source condition); Germany-Costa Rica, art. 27(2) (must satisfy source and residence conditions); Netherlands-Latvia, art. 31(2) (residence condition); Norway-Gambia, art. 30(2) (source and residence conditions); Netherlands-Nigeria, art. 27(2) (source condition); Netherlands-Viet Nam, art. 27(2) (residence condition); Sweden-Egypt, art. 27(2) (residence condition).

[370] Netherlands-Latvia, art. 31(3); Netherlands-Viet Nam, art. 27(3); Sweden-Egypt, art. 27(3).

[371] For example, Belgium-China, art. 28; Denmark-Pakistan, art. 30; Finland-China, art. 28; France-Nigeria, art. 29; France-Trinidad and Tobago, art. 30; Ireland-Russian Federation, art. 28; Netherlands-Latvia, art. 33; Norway-Zimbabwe, art. 29; Sweden-Belarus, art. 27; Sweden-Viet Nam, art. 28; United States-China, art. 27; United States-Tunisia, art. 28; United States-Ukraine, art. 29.

[372] Some treaties allow termination only after the treaty has been in force for at least five years (Belgium-China, art. 29; Denmark-Egypt, art. 31; Ireland-Russian Federation, art. 29; Sweden-Viet Nam, art. 29; United States-China, art. 28; United States-Tunisia, art. 29; United States-Ukraine, art. 30).

[373] As noted above in the discussion of article 12, some treaties include similar provisions in the article on royalties.

[374] Norway-Gambia, art. 14. See Sweden-Botswana, art. 21 (allowing taxation at source of "technical fees" defined as fees for non-employee services "of an administrative, technical, managerial or consultancy nature performed outside" the recipient's residence country; tax limited to 15 per cent of gross amount if fees are also taxed in residence country); Denmark-Pakistan, art. 13 (similar; maximum rate of 12 per cent of gross amount); Norway-Zimbabwe, art. 13 (similar; maximum rate of 10 per cent); Sweden-Namibia, art. 21 (similar; maximum rate of 15 per cent).

[375] United Kingdom-Ghana, art. 17 (article inapplicable if "one of the main purposes of any person concerned with the creation or assignment of the rights" is to take advantage of the article). See France-Trinidad and Tobago, art. 14 (allowing source country tax, not exceeding 10 per cent of gross amount, on "management charges", defined as "charges made for the provision of management services", including "personal services and technical and managerial skills").

[376] Norway-Gambia, art. 26; United Kingdom-Ghana, art. 24; United Kingdom-Mexico, art. 24.

[377] Sweden-Botswana, art. 28; Sweden-Namibia, art. 28.

[378] United States-Ukraine, art. 22. Similar provisions appear in United States-Czech Republic, art. 17; United States-Kazakstan, art. 21; United States-Slovakia, art. 17.

[379] France-Trinidad and Tobago, art. 13.

[380] Denmark-Egypt, art. 28(2).

[381] Denmark-Pakistan, art. 22; Netherlands-Latvia, art. 25; Norway-Gambia, art. 22; Sweden-Lithuania, art. 28.

[382] Canada-Estonia, art. 28(2); Canada-Latvia, art. 28(1); Canada-Zimbabwe, art. 29(2); United Kingdom-Kazakstan, art. 24; United Kingdom-Mexico, art. 23; United Kingdom-Uzbekistan, art. 24.

[383] Denmark-Egypt, art. 28(1) (also applying to allowances under agreements made by a Contracting State); Luxembourg-Indonesia, art. 27 (also applicable to allowances under an arrangement for "economic or technical cooperation between the Contracting States"); Sweden-Botswana, art. 28 (also applicable to allowances under any "agreement entered into by a Contracting State"); United States-Czech Republic, art. 1; United States-Kazakstan, art. 1; United States-Slovakia, art. 1; United States-Tunisia, art. 22(1) (also applicable to allowances under any "agreement entered into by a Contracting State"); United States-Ukraine, art. 1(2) (same).

[384] Finland-Estonia, art. 27; Netherlands-Latvia, art. 29.

[385] United States-Czech Republic, art. 1(3); United States-Kazakstan, art. 1(3); United States-Slovakia, art. 1(3); United States-Tunisia, art. 22(2); United States-Ukraine, art. 1(3).

Annex

LIST OF TREATIES REVIEWED

OECD country	Developing country	Publication date (month/day/year)	Effective date (month/day/year)
Australia	Viet Nam	4/13/92	1/1/93 Viet Nam 7/1/93 Australia
Belgium	China	4/18/85	1/1/88
Denmark	Egypt	2/9/89	1/1/91
Denmark	Latvia	12/10/93	1/1/94
Denmark	Lithuania	10/13/93	1/1/94
Denmark	Pakistan	10/22/87	1/1/88
Germany	Costa Rica	1/25/93	Not yet effective
Germany	Namibia	12/2/93	Not yet effective
Finland	China	5/12/86	1/1/88
Finland	Estonia	3/23/93	1/01/94
Finland	Pakistan	12/30/94	Not yet effective
Finland	Ukraine	10/14/94	Not yet effective
France	Kuwait	2/7/94	1/1/81
France	Nigeria	2/27/90	1/1/92
France	Trinidad and Tobago	8/5/87	1/1/90
Ireland	Russian Federation	4/29/94	Not yet effective
Japan	Singapore	9/9/94	Not yet effective
Luxembourg	Indonesia	1/14/93	1/1/95
Netherlands	Bangladesh	7/13/93	1/1/95 Netherlands 7/1/95 Bangladesh
Netherlands	Latvia	3/14/94	Not yet effective
Netherlands	Mexico	9/27/93	1/1/95
Netherlands	Nigeria	12/11/91	1/1/93
Netherlands	Ukraine	9/7/93	Not yet effective
Netherlands	Viet Nam	1/24/95	Not yet effective
Norway	Gambia	4/27/94	Not yet effective
Norway	Latvia	7/19/93	1/1/94
Norway	Zimbabwe	3/9/89	1/1/92
Spain	India	2/08/93	Not yet effective

OECD country	Developing country	Publication date (month/day/year)	Effective date (month/day/year)
Spain	Republic of Korea	1/17/94	1/1/95
Sweden	Belarus	3/10/94	Not yet effective
Sweden	Bolivia	1/14/94	Not yet effective
Sweden	Botswana	10/19/92	1/1/93 Sweden 7/1/93 Botswana
Sweden	Egypt	12/26/94	Not yet effective
Sweden	Gambia	12/8/93	1/1/95
Sweden	Lithuania	9/27/93	1/1/94
Sweden	Namibia	7/16/93	Not yet effective
Sweden	Russian Federation	6/14/93	Not yet effective
Sweden	Venezuela	9/8/93	Not yet effective
Sweden	Viet Nam	3/24/94	Not yet effective
Switzerland	Mexico	8/3/93	1/1/95
Switzerland	Romania	10/25/93	1/1/94
Turkey	Hungary	3/10/93	Not yet effective
United Kingdom	Ghana	1/20/93	Not yet effective
United Kingdom	Kazakstan	3/21/94	Not yet effective
United Kingdom	Mexico	6/2/94	4/6/94
United Kingdom	Russian Federation	2/15/94	Not yet effective
United Kingdom	Uzbekistan	10/15/93	4/1/95 United Kingdom 1/1/95 Uzbekistan
United Kingdom	Viet Nam	4/9/94	4/1/95 United Kingdom 1/1/95 Viet Nam
United States	China	4/30/84	1/1/87
United States	Czech Republic	9/16/93	1/1/93
United States	Kazakstan	10/24/93	Not yet effective
United States	Slovakia	10/8/93	1/1/93
United States	Tunisia	6/17/85	1/1/91
United States	Ukraine	3/4/94	Not yet effective

كيفية الحصول على منشورات الأمم المتحدة

يمكن الحصول على منشورات الأمم المتحدة من المكتبات ودور التوزيع في جميع أنحاء العالم . استعلم عنها من المكتبة التي تتعامل معها أو اكتب إلى : الأمم المتحدة ، قسم البيع في نيويورك أو 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.

Litho in United Nations, New York
30153—February 1997—2,145
ISBN 92-1-159091-4

United Nations publication
Sales No. E.96.XVI.2
ST/ESA/250