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AD HOC GROUP OF EXPERTS ON
INTERNATIONAL COOPERATION
IN TAX MATTERS
Ninth meeting
New York, 3-7 May 1999

DRAFT REPORT OF THE FOCUS GROUP OF THE AD HOC GROUP OF EXPERTS ON INTERNATIONAL COOPERATION IN TAX MATTERS ON ITS SECOND MEETING[1]

(Amsterdam, 22-25 March 1999)

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[1] This draft report is the result of the Second Meeting of the Focus Group held in Amsterdam from 22 to 25 March 1999. A consolidated document encompassing these revisions will be made available during the Ninth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters.

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I. INTRODUCTION

1. In its resolution 1273 (XLIII) of 4 August 1967, the Economic and Social Council requested the Secretary-General to set up an ad hoc working group consisting of:

"experts and tax administrators nominated by Governments, but acting in their personal capacity, both from developed and developing countries and adequately representing different regions and tax systems, with the task of exploring, in consultation with interested international agencies, ways and means of facilitating the conclusion of tax treaties between developed and developing countries, including the formulation, as appropriate, of possible guidelines and techniques for use in such tax treaties which would be acceptable to both groups of countries and would fully safeguard their respective revenue interests."

2. In its subsequent resolutions 1980/13 of 28 April 1980 and 1982/45 of 27 July 1982, the Economic and Social Council emphasized the need for the Ad Hoc Group of Experts to:

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

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

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

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

3. With a view to revising and updating the United Nations Model Double Taxation Convention between Developed and Developing Countries ("UN Model Convention") and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries ("UN Manual"), the Ad Hoc Group of Experts at its Eighth Meeting (Geneva, December 1997) requested the Secretariat to organize a Focus Group and refer the results of its work to the Group of Experts at large during its Ninth Meeting.

4. Accordingly, the First Meeting of the Focus Group was held in New York on 9 and 10 December 1998. During this meeting, the Focus Group could examine only the comments and suggestions on the text of the articles of the UN Model Convention. Hence, the Second Meeting of the Focus Group was held at Amsterdam from 22 to 25 March 1999 to consider the comments and suggestions on the commentaries of the UN Model Convention.

II. OPENING OF THE MEETING

5. The Second Meeting of the Focus Group was opened by Mr. Abdel Hamid Bouab, Secretary of the Ad Hoc Group of Experts who emphasized the importance of revision and update of the UN Model Convention and laid out the plan of work for the Focus Group. Since both the UN Model Convention and the UN Manual were to be published as non-recurrent publications of the programme budget for the biennium 1998-1999, it was necessary for the Focus Group to speed up the work of revision of these documents in a time bound programme, after considering the changes taking place in the international economic environment.

III. ADOPTION OF THE AGENDA

6. The Focus Group adopted the following agenda for its Second Meeting:
   1. Approval of the draft report of the Focus Group of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on its first meeting;
   2. Review of the revision of the text of articles of the UN Model Convention undertaken by the Focus Group at its first meeting;
   3. Examination of the commentaries on the UN Model Convention in the light of the comments and suggestions received from members of the Ad Hoc Group of Experts;
   4. Consideration of the report of the Focus Group on its Second meeting.

IV. METHODOLOGY

7. Members of the Focus Group agreed to review the decisions taken in its First Meeting regarding the amendment of text of articles of the UN Model Convention and the effect of those amendments on the commentaries, and thereafter to examine the comments and suggestions on the modification of the commentaries made by the members of the Ad Hoc Group of Experts. For this purpose, it was decided by the Focus Group to go through every paragraph, page-by-page of the commentaries.

The Focus Group based its discussion on the following papers prepared by the Secretariat, namely:

1. Draft Report of the Focus Group of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (ST/SG/AC.8/1998/WP.13) dated 13 January 1999;
2. Comments and suggestions relating to the articles and commentaries of the UN Model Convention made by members of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (ST/SG/AC.8/1998/WP.11) dated 7 December 1998;
3. Modifications to be made to the commentary on the United Nations Model Double Taxation Convention between Developed and Developing Countries pursuant to the changes made to the text of the articles during the First Meeting of the Focus Group - 9 and 10 December 1998 (ST/SG/AC.8/1999/L.3) dated 3 March 1999;
4. Modifications to be made to the commentary on the United Nations Model Double Taxation Convention between Developed and Developing Countries pursuant to the comments and suggestions received from members of the Ad Hoc Group of Experts on International Cooperation in Tax Matters (ST/SG/AC.8/1999/WP.15);
5. United Nations Model Double Taxation Convention between Developed and Developing Countries (ST/SG/AC.8/1999/L.2) dated 25 February 1999.

V. PROCEEDINGS

8. The discussion was started by a member of the Focus Group who desired that before addressing the commentaries to the specific articles, it was necessary to consider the order in which the introductory sections of the UN Model Convention were set out. He suggested that the reasons for the current revision be placed first and these be followed by the other sections. While there was general agreement on this point (the redrafting would be delegated to two members of the Group and a member of the Secretariat), it led to considerable debate on another issue, namely, whether the process of revision of the UN Model Convention should be seen as a one-off event or as an on-going, dynamic process, reflecting changing economic and commercial global conditions as well as changes introduced in the OECD Model Convention. There was general support for the latter view although it was felt inappropriate to lay down detailed plans, such as, the nature or frequency of future reviews. The practicalities of the dynamic, or "ambulatory" approach were also discussed, in particular the choice between a loose-leaf format, in line with the OECD approach, or to incorporate a reference in the commentaries that the subsequent reports of the Group of Experts should be consulted for future changes. The Secretariat noted that the United Nations already had experience with loose-leaf publishing, but raised the question regarding the speed with which the necessary updates could be effected. From a budgetary perspective and the existing financial constraints, this proposition would have to be considered in greater detail.

9. This discussion led to the related issue of the on-going role of the Focus Group. One member expressed the view that the Focus Group should concentrate on those aspects which were peculiar to treaties between developed and developing countries, in particular, to identify what those were. Another member observed whether the scope of the Focus Group's activities would not be unduly restricted under the dynamic approach as formulated. However, it was pointed out that the Focus Group's role was in any event limited to the revision of the Model Convention and should be seen in the wider context of the role of the Group of Experts.

10. As regards the formatting of the commentaries, one member suggested that not only should the paragraphs be numbered, but the cross-references to the relevant paragraphs (and version) of the OECD Model Convention should also be made where the latter were

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reproduced in the UN Model Convention commentaries. The Focus Group supported this view.

11. The Focus Group noted during the Eighth Meeting, only the texts of articles 1 to 19 were examined and proposed to review the decisions taken to amend the text of specified articles, and thereafter to examine the comments and suggestions for amendment of articles 20 to 29.

12. **Article 4**

The suggestion made by one member during the First Meeting to amend the commentary to paragraph 1 of article 4 to refer to "place of incorporation" as "any other criterion of a similar nature" for being treated as a resident was reviewed. It was decided, by consensus, to amend the paragraph 1 of article 4 to include "place of incorporation" to be placed prior to "place of management" and thereafter to modify the commentary explaining the amendment.

13. **Article 7**

The decision taken in the First Meeting to amend paragraph 2 of article 7 by inserting the words at the end, "or, as the case may be, the other permanent establishments of that enterprise" was reviewed. Some members observed that the amendment, as drafted, did not bring out the intention behind the suggestion made in this behalf. It was decided to leave out the additional words referred to above and explain suitably the point made by the members in the commentary on paragraph 2 of article 7. As a result, the amendment proposed to paragraph 2 of article 7 will be withdrawn.

14. **Article 8**

The suggestion made by one member to modify the title and text of article 8 to include a reference to "other transport" to cover "road transport" was not found acceptable. It was pointed out that it was not the central purpose of the article to extend to this kind of transport. It was agreed to make a suitable reference in this behalf in the commentaries.

15. **Article 9**

A discussion took place focussed on the question of correlative adjustments in the case of fraud. It was suggested that the wording of the proposed paragraph 3 in article 9 did not accurately reflect the point since it suggested that the fraud related to the adjustment rather than the original transfer price. It was decided to modify the proposed paragraph as under:

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"3. The provisions of paragraph 2 shall not apply where legal or other administrative proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises concerned is liable to penalty with respect to fraud, gross negligence or wilful default."

The underlying intention of the aforesaid amendment will be suitably explained in the commentaries.

16. **Article 10**

The decision to omit the reference in subparagraph (a) of paragraph 2, to the minimum shareholding (earlier specified at 10 per cent) to qualify for concessional tax treatment was reviewed. It was decided to retain the threshold of "10 per cent" hitherto specified, but to add a Note below as under:

"**Note:** As regards subparagraph (a) of paragraph 2, the 10 per cent threshold which determines the level of shareholding qualifying as a direct investment is illustrative; for a discussion of some of the issues which need to be addressed during negotiations, refer to the commentaries on article 10, at paragraph..."

17. **Article 13**

The amendment proposed to article 13 by insertion of a new paragraph 4A was reviewed by the Focus Group. In relation to paragraph 4 of article 13, it was decided by the Eighth Meeting of the Ad Hoc Group of Experts, inter alia, to narrow the scope of paragraph 4 so as to exclude active businesses that own real property (for example, a hotel company), other than property management companies. One member pointed out that it was necessary to exclude from the purview of the provision of paragraph 4, not only a hotel company owning real property, but also companies whose property consists of directly or indirectly principally of immovable property used by such company in its industrial, commercial or agricultural activities or in the conduct of professional services. The modification as proposed was accepted by consensus. The revised formulation of paragraph 4A of article 13 was as under:

"4A. Nothing contained in paragraph 4 shall apply to a company, other than a company engaged in the business of management of immovable properties, the property of which

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consists directly or indirectly principally of immovable property used by such company in its industrial, commercial or agricultural activities or in the conduct of professional services."

Explanation: For the purposes of this paragraph and paragraph 4, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding seventy-five per cent of the aggregate value of all assets owned by the company."

The rationale for the insertion of new paragraphs 4A and 4B in article 13 will be suitably explained in the commentaries.

18. **Articles 14 to 21**

The amendments made to the text of these articles were approved.

19. **Article 22**

The Focus Group decided to remove the brackets in paragraphs 1, 2 and 3 and to retain those in paragraph 4.

20. **Article 24**

The Focus Group decided to amend paragraph 2 of article 24 by inserting the words (in line 4 thereof), **"in particular with respect to residence,"** after the words "concerned in the same circumstances." The amendment was intended to bring the language of paragraphs 1 and 2 of article 24, in this behalf, on par as also in line with the provisions of paragraphs 1 and 2 of Article 24 of the OECD Model Convention.

21. **Article 25**

The Focus Group accepted the suggestion of a member to amend the paragraph 4 of article 25 to insert the words **"including through a joint commission consisting of themselves or their representatives"** between the words "... with each other directly..." and "... for the purpose of reaching an agreement...". This amendment will bring the provisions of paragraph 4 of article 25 in the UN and OECD Model Conventions on par.

22. **Article 26**

The Focus Group accepted a suggestion to amend the paragraph 1 of article 26 to substitute the words "involved in," by the words **"concerned with"** to conform to the language used in the OECD Model Convention.

23. **Article 27**

The Focus Group noted the amendment of the title and the text of article 27 to substitute the words "Diplomatic Agents and Consular Officers" by the words **"Members of**

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Diplomatic Missions and Consular Posts" made during the Eighth Meeting of the Ad Hoc Group of Experts.

24. The Focus Group thereafter considered the comments and suggestions for modification of the commentaries on the UN Model Convention.

25. **Introduction**

The Focus Group, after going through each paragraph of the Introduction to the UN Model Convention decided:

(A) Under the heading "B. Historical Setting of the United Nations Model Convention," on page 6, in paragraph 4, the following portion shall be omitted, as being superfluous, namely:

"The Fiscal Committee was of the opinion that the latter represented "a definite improvement on the 1928 Model Conventions" but that "nevertheless, since the membership of the Mexico City and London meetings differed considerably, it (was) natural that the participants in the London meeting held, on various points, different views from those which inspired the model conventions prepared in Mexico."

(B) Under the heading "D. Rationale and Methodology for the 1998 Revision of the United Nations Model Convention," on page 10, for the third paragraph beginning with "First, the increasing sophistication..." and ending with "... and the transfer of technology," the following paragraph will be substituted, namely:

"First, the Group of Experts consider it convenient to give the UN Model Convention a recurrent publication character following the line or procedures approved by the Fiscal Committee of the OECD with respect to its Model Convention. In the last few years, the world has experienced extraordinary changes because of globalization. It is not possible to wait for a long time to introduce modifications in the UN Model Convention to reflect such changes. In this sense, it has been estimated reasonable, taking into account the new financial instruments, the necessity to have a permanent and fluid exchange of information, and that changes made in the OECD Model, inter alia, determine the priorities to be analyzed by the Group of Experts and submitted to the Group's Meeting in the future, making the necessary changes in the relevant articles or, as the case may be, the commentaries. On the other hand, taking into account the activities of the Group of Experts in the domain of international fiscal cooperation, there should be active efforts in the process of harmonization

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in the application of taxes, use of technical criteria and fiscal procedures, not affecting the State's legitimate powers to eliminate obstacles caused by tax provisions to the flow of foreign direct investment towards developing countries and economies in transition and also improving the international tax framework. This would require increasing the efficiency of the tax administrations in these countries with the schemes of mutual assistance and cooperation with the competent authorities in developed countries to facilitate collection of more taxes to be utilized for building a solid framework for social and economic infrastructure."

26. **Article 1**

In the commentary, on page 39, in pursuance of the amendment of the title of the article, the heading of article 1 will be changed to "Persons covered" and after the first paragraph, the following paragraph will be inserted, namely:

"The title of article 1 has been changed from "Personal scope" to "Persons covered." The first article of the Convention should normally specify the types of persons or taxpayers to whom the Convention applies. The title "Personal scope" did not convey the scope of the application of the Convention. Hence, the title of article 1 has been appropriately changed to "Persons covered" to convey the correct scope of the Convention."

27. The draft UN Model Convention makes a reference to the possibility of double taxation or non-taxation as a result of differing qualifications of partnerships by Contracting States which is followed by a discussion of tax avoidance and measures to combat it through bilateral treaties. One member expressed the view that this was something of a non sequitur as the former was simply a question of fact rather than abuse. What was missing was a suggested solution to the former problem. The Focus Group agreed to a formulation to the effect that the Contracting States could solve such double taxation or non-taxation through bilateral negotiations.

28. On the other hand, the question of anti-avoidance measures, it was agreed to insert the paragraphs 7 to 10 from OECD commentaries on Article 1 ("**Improper use of the Convention**) on page 41, after the second paragraph. **(Annex I).** The existing third and fourth paragraphs on page 41 beginning with "Double tax conventions...," and ending with "... should not be affected by the Convention" will be omitted, as it was found to be redundant.

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29. The Focus Group noted that the discussion in the OECD commentaries on treaty-abuse issues could be usefully incorporated in the UN Model Convention. Accordingly, it was decided to insert paragraphs 22 to 26 of the OECD commentaries on Article 1, after making appropriate contextual modifications, on page 42, after the third paragraph. **(Annex II).**

30. **Article 2**

In the commentary on article 2, on page 45, paragraph 3, (relating to Paragraph 4), the portion "The commentary also notes..." to "... substantive changes are made." will be omitted and in its place, the following portion will be inserted, namely:

"Prior to the amendment, the second sentence of paragraph 4 read as under:

'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.'

It was considered that the scope of this provision was very wide since, in practice, most Contracting States do not communicate with each other on each change in their tax laws. Moreover, the requirement to exchange information on changes in tax laws should extend only to significant changes in law which affect the application of the Convention. Such a provision can be found in several bilateral tax treaties. Hence, it was decided to change the second sentence of paragraph 4 as under:

"To this effect, the competent authorities of the Contracting States shall notify each other of relevant changes made to their tax law."

31. One member of the Focus Group had questioned the appropriateness of including a reference to "taxes on the total amounts of wages and salaries paid by enterprises" in paragraph 2 of article 2. Another member of the Ad Hoc Group of Experts had suggested the deletion of this expression from paragraph 2, leaving any mention to this category of taxes to the commentaries as appropriate. According to her, there were two basic reasons for this: the usual concept of income tax as appears in the legislation of several countries does not easily apply to these kinds of taxes and many countries do not have these kinds of taxes in their tax system. The Focus Group had considered these suggestions. Some participants expressed unhappiness over the wording of paragraph 2 in referring to some taxes and not to others. It was considered by the Focus Group that no further addition to the taxes enumerated was necessary but to specify such additional taxes in the commentaries. The

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Focus Group observed that the commentaries indicated that Contracting States were free to restrict the taxes to which a bilateral treaty applied.

32. The deletion of the OECD observations and reservations to article 2 prompted a discussion as to the proper approach of the Focus Group to observations and reservations to the OECD Model in general. One member pointed out that if it is proposed to retain these observations and reservations, wherever necessary, the Focus Group should examine each one (in the current version of the OECD Model) to determine whether or not it should be retained. This was agreed to as also another suggestion to include comments from non-member countries to the OECD Model in Part II of the current version. These will be reflected in Annex IIIA.

33. **Article 3**

Two changes were put forward and adopted to the text of article 3, in line with similar amendments to the OECD Model. These changes were the replacement of the word "which" in subparagraphs (b) and (d) in paragraph 1 with the word "that." Further, on page 47, paragraph 2, to conform the list of definitions in the commentaries to that in paragraph 1 of article 3, the terms "competent authorities" and "national" were added after "international traffic."

34. On page 47, in the commentary on the paragraphs of article 3, in paragraph 1, part (a) at the end of the paragraph dealing with the term "person," the words "e.g., a foundation" appeared in square brackets. Whether the reference to [e.g., a foundation] should remain as such in the context of the definition of "person" was left to be determined once the OECD had produced their next revision since this reference derived from the OECD Model.

35. On page 48, for "(f) The term "national," the following paragraph will be inserted, namely:

"(f) The term "national:"

Initially, the definition of the term "national" occurred in paragraph 2 of article 24 relating to "Non-discrimination." As a result, the definition of the term "national" would have restricted application only for the purposes of article 24. Since the term "national" has been referred to in other articles of the Convention as well, namely, article 4.2(c) and (d), article 24 and article 25, it has been considered necessary to shift the definition of the term "national" from paragraph 2 of article 24 to subparagraph (f) of paragraph 1 of article 3."

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36. **Article 4**

The Focus Group agreed to insert in paragraph 1 of article 4, "place of incorporation" before "place of management." Accordingly, on page 51, paragraph 4, in the commentary on paragraph 1 of article 4, before "place of management" and after "residence," the expression "place of incorporation" will be inserted.

37. The Focus Group agreed to substitute the last paragraph on pages 51-52 beginning with "The words, "and also..." and ending with "... of most Member states." by the following paragraph 8.1 of OECD commentary:

"8.1 It has been the general understanding of most Member states that the government of each State, as well as any political sub-division or local authority thereof, is a resident of that State for purposes of the Convention. Before 1995, the Model did not explicitly state this; in 1995, Article 4 was amended to conform to the text of the Model to this understanding."

38. One member of the Focus Group supported the addition of the second sentence in paragraph 1 of article 4 (which was omitted in the UN Model Convention) as it appears in the corresponding provision of the OECD Model Convention, which reads as under:

"This term, however, does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein."

He explained that this provision, which was an important device to combat treaty abuse, was all the more necessary now the reference to place of incorporation had been included explicitly in the first sentence. It was further argued that omitting this sentence on the grounds that it could cause problems to States applying a territorial system of taxing income was to reflect as a general rule something based on exceptional case, i.e., that of countries having a territorial system. A better approach, it was argued, would be to include the second sentence, by way of general rule, and to cater for the exceptional rule by way of an appropriate warning in the commentaries to countries applying a territorial system. The member proposed the following wording for the commentaries in this behalf, which was approved by the Focus Group, by suitable modification of the first paragraph of Paragraph 1 on page 51, as under:

"In accordance with the provisions of second sentence of paragraph 1, a person is not to be considered a "resident of a Contracting State" in the sense of the Convention if, although not domiciled in that State, he is considered to be a resident according to the domestic laws

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but is subject only to a taxation limited to the income from sources in that State or to capital situated in that State. That situation exists in some States in relation to individuals, e.g., in the case of foreign diplomatic and consular staff serving in their territory. According to its wording and spirit the provision would also exclude from the definition of a resident of a Contracting State foreign-held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies. This, however, has inherent difficulties and limitations. Thus it has to be interpreted restrictively because it might otherwise exclude from the scope of the Convention all residents of countries adopting a territorial principle in their taxation, a result which is clearly not intended. The exclusion of certain companies from the definition would not, of course, prevent Contracting States from exchanging information about their activities (cf. Paragraph 2 of the commentary on article 26). Indeed, States may feel it appropriate to develop spontaneous exchanges of information about companies which seek to obtain treaty benefits unintended by Model Conventions."

39. As regards paragraph 3 of article 4, one member suggested that the term "effective management" might be clarified in the commentaries. The following text (amended as to context) from an existing treaty was circulated and agreed as suitable to be inserted at the end of the commentaries on page 54:

"It is understood that when establishing the "place of effective management," circumstances which may, inter alia, be taken into account are the place where a company is actually managed and controlled, the place where the decision-making at the highest level on the important policies essential for the management of the company takes place, the place that plays a leading part in the management of a company from an economic and functional point of view and the place where the most important accounting books are kept." [Belarus-Netherlands Protocol paragraph II]

40. A concern was raised by a member regarding the situation of a company resident in one State under the treaty definition but with a permanent establishment in another country, such as a tax haven, whereby the company could benefit from a treaty between its State of residence and a third State in respect, for example, of withholding tax on interest paid from that third state to the permanent establishment. He expressed the view that tax treaties should be limited to the bilateral relationship which reflected the economic reality. Allowing treaty benefits under the above example was really introducing a juridical approach to treaty

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application. Moreover, it was pointed out by the same member that tax administrations in many developing countries were not in a position to control this kind of abuse -- with the result that they were reluctant to enter into treaties under which such abuse was possible. It was finally agreed that the commentaries should contain a reference to the OECD's study on this subject (reprinted as "Triangular Cases" in Volume II of the OECD Model) and to the possible solutions presented there.

41. **Article 5**

Several members of the Focus Group expressed the concern felt by some developing countries that fishing activities carried on in the exclusive economic zones of those countries should constitute permanent establishments {paragraph 2, subparagraph (f)}. One member pointed out that the commentaries should take into account the exploration and exploitation activities of all natural resources with a more comprehensive content than the existing one, so as to contemplate not only the fishing activities in territorial waters but also the exclusive economic zone of exploitation, in accordance with the International Convention on Sea. Other members desired this matter may appropriately be included in observations and reservations to the Model. In any event, another member observed, it is inappropriate to deal with this point by way of general extension through the commentaries of the meaning of the term "place of extraction" in article 5. One member expressed the contrary view that fishing activities were as much "extraction" as, for example, mining. There followed a discussion as to the basic requirements of article 5 in terms of a fixed economic presence which implied at least a minimum duration. It was also pointed out that effective taxation of such activities was dependent not only on the treaty involved but also on, for example, domestic law granting jurisdiction to tax in the exclusive economic zone. One member queried the effectiveness of such a general provision given the inherent mobility of the activity and non-residence of the taxpayer. Thereafter, an agreed text to reflect the concerns was drawn up for inclusion in the commentaries on page 59, after the second paragraph, as under:

"As mentioned above, in subparagraph (f), the expression "any other place of extraction of natural resources" should be interpreted broadly. Some members from developing countries argued that for this purpose, "fishing vessels" could be treated as the place of extraction or exploitation of natural resources, since "fish" constitutes natural resources. In their analysis, although it is true that all places or apparatus designated as "permanent

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establishment" in subparagraphs (a) to (e) in paragraph 2 have a certain degree of permanence or constitute "immovable property," yet fishing vessels can be considered as a place which is used for extraction of natural resources, which may not necessarily mean only minerals which are embedded in the earth. In fact, fishing vessels can be compared with the movable drilling platform which is used in off-shore drilling operations for gaining access to mineral oil or petrol. Where such fishing vessels are used on the high seas, they would constitute "permanent establishment" as situated in the Contracting State which exercises territorial jurisdiction over that part of the ocean in which the fishing vessels catch the fish. However, some other members took the view that such an interpretation was open to objection that it constituted too broad a reading of the natural language of the subparagraph, and that, accordingly, in their opinion, any treaty partner countries which sought to advance such a proposition in respect of fishing activities, should make that explicit by adopting it as a new and separate category in the list in paragraph 2."

42. During the First Meeting, the Focus Group considered a suggestion whether the use of facilities for the "delivery of goods" should be added to subparagraph 4(b) as an example of an activity that would not give rise to a "permanent establishment." The consensus of the Focus Group was that the commentary on the subparagraph 4(b) should be amended to reflect the conflicting views on the subject but that there was no need to make any textual change in article 5 for this purpose. It was decided to insert the following paragraph in the commentary on article 5, paragraph 4, {subparagraph (b)} on page 62, after the second paragraph as under:

"The question whether the use of facilities for the "delivery of goods" could be incorporated in subparagraph 4(b) as an activity that would not give rise to a permanent establishment has engaged the attention of the Group of Experts for a long time, primarily because the phrase "delivery of goods" is included in subparagraph 4(b) of Article 5 of the OECD Model Convention. It has been observed that many developing countries had agreed to raise the threshold of permanent establishment and that almost 75% of the bilateral tax treaties entered into by developing countries have included the "delivery of goods" in subparagraph 4(b) of article 5 in their treaties as revealed by a recent study conducted by the International Bureau of Fiscal Documentation. It cannot be ignored that the omission of "delivery of goods" in subparagraph 4(b) of article 5 in the UN Model Convention is one of

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the most important features which distinguishes it from the OECD Model Convention. On the one hand, it is contended that even if the delivery of goods is treated as an activity which gives rise to a permanent establishment, very little income, per se, could be attributed to this activity. On the other hand, if such activity of "delivery of goods" is considered as giving rise to a permanent establishment, there would be a tendency on the part of the tax authorities to try to attribute some income to this activity, whether in reality there was any income which actually arose or not. This may lead to fruitless and prolonged litigation. The Group of Experts did not think it necessary to amend the provisions of subparagraph 4(b) of article 5 to include the "delivery of goods" as an activity which may not constitute a permanent establishment. Hence, the Contracting States may consider both these divergent points of view while entering into bilateral tax treaties."

43. The Focus Group took note of the decision taken in the First Meeting to insert a new subparagraph (f) in paragraph 4 and approved the following modifications in the commentary on page 62, under Paragraph 4, in the first paragraph, as under:

1. For the words "three substantive amendments," the words "two substantive amendments will be substituted;
2. In the second and third lines, the words "and the deletion of subparagraph (f)" will be deleted;
3. On pages 62-63, paragraph 3, the second sentence "There was a general consensus to "to bilateral negotiation." will be omitted.
4. On page 63, after paragraph 1, the following paragraphs will be added, namely:

"The new subparagraph 4(f) reproduces the subparagraph 4(f) of Article 5 of the OECD Model Convention. The relevant portion of the commentary on the OECD text is as follows:

"... Moreover, subparagraph 4(f) provides that combinations of activities mentioned in subparagraphs (a) to (e) in the same fixed place of business shall be deemed not to be a permanent establishment, provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character. Thus, the provisions of paragraph 4 are designed to prevent an enterprise of one State from being taxed in the other State if it carries on in that other State, activities of a purely preparatory or auxiliary character.

As already mentioned in paragraph above, paragraph 4 is designed to provide for exceptions to the general definition of paragraph 1 in respect of fixed places of business which are engaged in activities having a preparatory or auxiliary character. Therefore, according to subparagraph (f) of paragraph 4, the fact that one fixed place of business combines any of the activities mentioned in subparagraphs (a) to (e) of paragraph 4, does not mean of itself that a permanent establishment exists. As long as the combined activity of such a fixed business is merely preparatory or auxiliary, a permanent establishment should be deemed not to exist. Such combinations should not be viewed on rigid lines, but should be considered in the light of particular circumstances. The criterion "preparatory or auxiliary character" is to be interpreted in the same way as is set out for the same criterion of subparagraph (e)... Subparagraph (f) is of no importance in a case where an enterprise maintains several fixed places of business within the meaning of subparagraphs (a) to (e) provided that they are separated from each other locally and organizationally, as in such a case each place of business has to be viewed separately and in isolation for deciding the question whether or not a permanent establishment exists. States which want to allow any combination of the items mentioned in subparagraphs (a) to (e), disregarding whether or not the criterion of the preparatory or auxiliary character of such a combination is met, are free to do so by deleting the words "provided" to "character" in subparagraph (f)."

44. The Focus Group considered two points in relation to the commentary on subparagraph (b) of paragraph 5 of article 5, namely:

(A) On page 65, it was not clear why the discussion of "in the name of" in paragraph 32 of the OECD Commentary was omitted in the relevant portion of the UN Model Convention. Since there was no reason to omit the relevant portion of the OECD commentary, it was decided to insert the following paragraph on page 65, after the first sentence in paragraph 2 under Paragraph 5 as under:

"... Also the phrase "authority to conclude contracts in the name of the enterprise" does not confine the application of the paragraph to an agent who enters into contracts literally in the name of the enterprise; the paragraph applies equally to an agent who concludes contracts which are binding on the enterprise even if those contracts are not actually in the name of the enterprise. The authority to conclude contracts must cover contracts relating to operations which constitute the business proper of the enterprise. It would be irrelevant, for instance, if

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the person had authority to engage employees for the enterprise to assist that person's activity for the enterprise or if the person were authorised to conclude, in the name of the enterprise, similar contracts relating to internal operations only."

(B) A proposal was made during the course of the First Meeting of the Focus Group in December 1998 that in subparagraph (b) of paragraph 5, the threshold could be raised by additional text and clarifying the position in the commentaries. After discussion, it was decided that no change should be made to the text of the article but the following paragraph could be added at the end of the wording of the second paragraph on page 66 as under:

"The Group of Experts understood that the subparagraph 5(b) was to be interpreted such that if all the sales-related activities take place outside the host State and only delivery, by an agent, takes place there, such a situation would not lead to a permanent establishment.. However, if sales-related activities (e.g., advertising or promotion), are also conducted in that State on behalf of the resident (whether or not by the enterprise itself or by its dependent agents) and have contributed to the sale of such goods or merchandise, a permanent establishment may exist."

45. The Focus Group took note of the new sentence replacing the second sentence in paragraph 7 of article 5 approved during their First Meeting and decided to insert in the commentary on paragraph 7 of article 5, in place of the last paragraph on page 67 and the second paragraph on page 68, the following paragraphs as under:

"Originally, the second sentence of paragraph 7 read as under:

"However, when the activities of such an agent are devoted wholly or almost wholly on behalf of the enterprise, he will not be considered an agent of an independent status within the meaning of this paragraph."

It was considered that this sentence, as worded, gave rise to anomalous situations. There was reason to believe that, as worded, wherever the number of enterprises for which an agent of an independent status was working was reduced to one, such an agent's status was changed to "agent of dependent status." It was considered necessary to remove this anomaly and doubt by rephrasing the second sentence as under:

"However, when the activities of such an agent are devoted wholly or almost wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have

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been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph."

As redrafted, it has been made clear that to determine the status of an agent as not being of "an independent status," it would be necessary to take into account the entirety of the commercial and financial relations between the enterprise and the agent which will show that they differ from those expected between independent enterprises at arm's length. Hence, as worded, the mere fact that the number of enterprises for which an agent acted as an agent of an independent status fell to one, will not change his status from being an agent of independent status to that of a dependent status."

46. **Article 7**

One member pointed out that a number of discrepancies were noticed between the draft UN Model Convention presented before the Focus Group and the original UN Model Convention, 1980 edition. According to him, these could lead to unintended interpretational problems, such as, the reference to "The Group believes that" (on page 71) instead of the original text, "it is considered." Moreover, there were a number of omissions in the new text from the original text which could give rise to similar problems. It was agreed to replace paragraph 2 on page 71 starting with "The application of the arm's length" to "parties should be allowed." by the corresponding text on page 80 of the 1980 Model Convention edition. The new paragraph to be inserted in page 71 as under:

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

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Conversely, such payments made to a permanent establishment by the head office should be excluded from the profits of the permanent establishment. On the other hand, an allocable share of such payments, e.g., interest and royalties, paid by the enterprise to third parties should be allowed."

47. A member of the Focus Group made reference to the question of force of attraction and the need to explain to the developing countries the abuses it was aimed at. He further added that it could be explained in the commentaries that there exist three basic rules for the attribution of profits to the business units or places through which enterprises act in other States. Such rules are those of unlimited force of attraction, that consists of attributing gains to the establishment no matter what activity the enterprise develops in the other State or of limited or partial force of attraction by virtue of which benefits are attributed to them in case of identical or similar goods sales made by the enterprise. The same criterion is used in the case of services. He pointed out that in the OECD Fiscal Committee has commenced an evaluation of the scope of permanent establishment concept taking into account the new modalities of international businesses by virtue of the advances made in the computing and communication fields in the last few years. The Focus Group decided to examine the matter further in the commentaries along with a note on electronic commerce for which the member raising the issue agreed to provide a suitable text.

48. Two significant points were raised by a member regarding changes to the text of commentaries on page 73 which he considered undesirable. First was the change from past to present tense in the reference to experience of the use of the force of attraction rule: this suggested the experience was still - now - recent. It was, therefore, agreed to replace "point" with "pointed." The second point was that the reference to "a consensus was reached" was not correct. It was agreed that the following original text of the 1980 edition of the Model Convention still reflected the position on this point and would be reinstated instead of the above-quoted passage:

"However, after discussion, it was proposed that the 'force of attraction' rule, should be limited so that it would apply to sales of goods or merchandise and other business activities in the following manner."

49. One member pointed out that the wording of the draft new paragraph of article 7 did not reflect the views of the members of the Focus Group who had proposed an amendment to

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the commentaries at the Focus Group's meeting in December 1998. The point related to allocation of profits between different permanent establishments as opposed to allocation between a permanent establishment and its head office. Although there was a difference of opinion as to whether this issue was or was not already covered by the terms of article 7, paragraph 2 as it currently stood, it was generally accepted that the concern should be noted in the commentaries but that the text of paragraph 2 of article 7 should not be changed. An investigation of the current U.S. Model Convention showed a different solution to the problem by stopping the relevant sentence after the words "under the same or similar conditions." It was decided that a suitable paragraph explaining the position of the point at issue may be inserted in the commentaries. Accordingly, in the commentary relating to paragraph 2 of article 7, on page 76 after the second paragraph, the following paragraph will be inserted, namely:

"Some members of the Group of Experts were of the view that the last part of paragraph 2 was too narrow, since it refers only to transactions between the permanent establishment and the home office, and does not take into account transactions between the permanent establishment and, for example, other permanent establishments of the same enterprise. It was considered that Contracting States during bilateral negotiations could adopt an alternative approach as follows:

"There shall in each Contracting State be attributed to that permanent establishment the profits that it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions."

Although the point in controversy relating to the allocation of profits between different permanent establishments as opposed to allocation between a permanent establishment and its head office was not in doubt, it was generally accepted that the concern of the Group of Experts should be clearly brought out.

Paragraph 2 as presently worded, contains the central directive on which the allocation of profits to a permanent establishment was intended to be based. This paragraph incorporates the view that was generally contained in bilateral conventions, that the profits to be attributed to a permanent establishment were those which that permanent establishment would have made if, instead of dealing with its head office, it had been dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market.

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This corresponds to the "arm's length principle" discussed in the commentary on article 9. Normally, the profits so determined would be the same profits that one would expect to be determined by the ordinary processes of business accountancy. Since the arm's length principle also extends to the allocation of profits which the permanent establishment may derive from transactions with other permanent establishments of the enterprise, the existing paragraph 2 should be construed to specifically make it applicable to such situations. As interpreted, where an enterprise of a Contracting State carries on its business activities in the other Contracting State through a permanent establishment situated therein, it would be necessary to allocate to such permanent establishment the profits which it could be in a position to make if it were a distinct enterprise engaged in the same or similar activities under the same or similar conditions and operating at arm's length, and dealing wholly independently with the enterprise of which it is a permanent establishment or the other permanent establishments of that enterprise. The U.S. Model Convention adds that for this purpose, the business profits to be attributed to the permanent establishment shall include only the profits derived from the assets or activities of the permanent establishment."

50. Some members of the Focus Group had observed that while paragraphs 12.1 and 12.2 of the OECD Model Convention had been reproduced in the UN Model Convention, the approach in this behalf was selective, in that while only paragraph 15.1 was adopted but not 15.2 to 15.4 which dealt with the same subject, but were excluded without any reason. It was decided that the following paragraphs 15.2 to 15.4 of the OECD Model Convention would be incorporated in the UN Model Convention. Hence on page 79, after paragraph 1, the following paragraphs (15.2 to 15.4) will be inserted, namely:

"Another significant problem concerning the transfer of assets, such as, bad loans, arises in relation to international banking. Debts may be transferred, for supervisory and financing purposes, from branch to head office or from branch to branch within a single bank. Such transfers should not be recognized where it cannot be reasonably considered that they take place for valid commercial reasons or they would have taken place between independent enterprises, for instance where they are undertaken solely for tax purposes with the aim of maximising the tax relief available to the bank. In such cases, the transfers would not have been expected to take place between wholly independent enterprises and therefore, would not have affected the amount of profits which such an independent enterprise might have been

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expected to make in independent dealing with the enterprise of which it is a permanent establishment.

"However, there may exist a commercial market for the transfer of such loans from one bank to another and the circumstances of an internal transfer may be similar to those which might be expected to have taken place between independent banks. An instance of such a transfer may be a case where a bank closed down a particular foreign branch and had therefore to transfer the debts concerned either back to its head office or to another branch. Another example might be the opening of a new branch in a given country and the subsequent transfer to it, solely for commercial reasons, of all loans previously granted to residents of that country by the head office or other branches. Any such transfer should be treated (to the extent it is recognised for tax purposes at all) as taking place at the open market value of the debt at the date of the transfer. Some relief has to be taken into account in computing the profits of the permanent establishment since, between separate entities, the value of the debt at the date of the transfer would have been taken into account in deciding on the price to be charged and principles of sound accounting require that the book value of the asset should be varied to take into account market values. (This question is further discussed in the report of the Committee on Fiscal Affairs entitled "Attribution of Income to Permanent Establishments.")

"Where loans which have gone bad are transferred, in order that full, but not excessive, relief for such a loss be granted, it is important that the two jurisdictions concerned reach an agreement for a mutually consistent basis for granting relief. In such cases, account should be taken of whether the transfer value, at the date of internal transfer, was the result of mistaken judgement as to the debtor's solvency or the value at that date reflected an appropriate judgement of the debtor's position at that time. In the former case, it may be appropriate for the country of the transferring branch to limit relief to the actual loss suffered by the bank as a whole and for the receiving country not to tax the subsequent apparent gain. Where, however, the loan was transferred for commercial reasons, from one part of the bank to another and did, after a certain time, improve in value, then the transferring branch should normally be given relief on the basis of the actual value at the time of the transfer. The position is somewhat different where the receiving entity is the head office of a bank in a credit country because the credit country will tax the bank on its worldwide profits and will

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therefore give relief by reference to the total loss suffered in respect of the loan between the time the loan was made and the time it was finally disposed of. In such a case, the transferring branch should receive relief for the period during which the loan was in the hands of that branch by reference to the principles above. The country of the head office will then give relief for double taxation by granting a credit for the tax borne by the branch in the host country."

51. Dealing with paragraph 3 of article 7, the Focus Group had observed in its Report of the First Meeting (paragraphs 26 and 27) that several members had pointed out that the existing provision (paragraph 3) was not worded properly resulting in loss of revenue to the developing countries. It was decided by the Focus Group that it might not be possible to make any amendment to the text of Paragraph 3 because it was difficult to lay down a monetary or other limitation for deduction of expenses relatable to the operations of permanent establishment. However, the commentaries should lay down the guidelines or principles to ensure that the deduction of expenses was on a more rational and scientific basis. The Focus Group considered the proposed amendment to the commentaries prepared by the Secretariat. One member questioned whether the wording might discourage investment. It was decided to delete the sentence beginning with "Whether such criteria." and ending with "adopted by taxpayers." A discussion also took place as to the significance of the words "wholly, exclusively and necessarily" and it was decided to delete the quotes, the phrase being considered otherwise adequately to reflect to the basic principle expressed by one member of causality. According to the member, the passage would act as a warning signal to taxpayers that developing countries would look critically at attempts to deduct non-related expenses. It was decided to insert in the commentaries relating to paragraph 3 of article 7, on page 79, after the first paragraph, the following paragraph, namely:

"The business profits of an enterprise of a Contracting State are exigible to tax in that State alone unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. The business profits of such a permanent establishment will have to be determined on the normal commercial and accounting principles in conformity with the method of accounting consistently followed by the enterprise. The profits and gains of the business would be worked out by deducting all expenses relatable to the business activity, other than the capital expenditure or expenses of a personal or non-

business nature which cannot be attributed to the business of the enterprise. Normally, many countries while considering the question of deductibility of business expenses apply the criteria of such expenditure being wholly, exclusively and necessarily for the purposes of the business. The basic objective in this behalf is to ensure that the expenditure claimed as deduction in determining the taxable profits is that such expenditure is relevant, referable and necessary for carrying out the business operations. There has to exist a close nexus between the expenditure and the business activity so that the expenditure incurred is justified by business expediency and smooth running or facilitating character of the expenditure for business operations. Unless there are specific legislative provisions placing a monetary or other ceiling limits on the allowability of business expenditure, such claims for deductibility of expenditure will have to be in its entirety, without considering the reasonability of the amount or its impact on the profitability of business operations."

52. The question of making a specific provision in paragraph 5 along the lines of the OECD Model Convention, that no profits might be attributed to mere purchase by that permanent establishment of goods or merchandise for the enterprise was discussed during the First Meeting of the Focus Group. It was decided that the rationale for not making any change in the text in this behalf may be explained in the commentaries. Accordingly, on page 84, after the fourth paragraph, and before the commentary on paragraph 4, the following paragraph will be inserted, namely:

"The question of making a specific provision in article 7, similar to that in paragraph 5 of Article 7 of the OECD Model Convention regarding non-attribution of profits to a permanent establishment for "mere purchase" by that permanent establishment of goods or merchandise for the enterprise has been engaging the attention of the Group of Experts for some time. It has been considered that since under article 5, an office or facility maintained by an enterprise in a Contracting State in the other Contracting State for mere purchase of goods or merchandise does not constitute a permanent establishment, there would be very few cases where an enterprise having a permanent establishment dealing with other business would also have a purchasing facility for the enterprise. However, it has not been considered necessary to make any change in the existing provisions and the matter may be looked into during bilateral negotiations."

53. **Article 8**

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The Focus Group decided that while the suggestion made by a member to extend the scope of article 8 by referring to "other transport" including thereby "road transport" was not acceptable, a reference in this behalf may be made in the commentaries. Accordingly, on page 88 after paragraph 6, the following paragraphs will be inserted, namely:

"A member from a developing country suggested that the provisions of article 8 may be extended to cover road transport. Since there were hardly any cases noticed by the Group of Experts in this behalf, it was considered premature to make the amendment of article 8 in the manner suggested. However, the Contracting States may, if considered necessary, refer to road transport during bilateral negotiations.

Some members from developing countries considered that the activity of transport carried out in inland waters, by definition, cannot be considered international transport and by virtue of that, the fiscal or tax power should be attributed exclusively to the source country in which the activities are carried out. Since article 8 deals with "Shipping, inland waterways transport and air transport," obviously all three modes of transport dealt with in this article involve problems of double taxation. Income derived from inland waterways transport is also subject to double taxation if a river or lake used for commercial transportation flows from more than one country with the headquarters of the establishment in one country and traffic originating in more than one country. Hence, it is possible that inland waterways transport will give rise to problems of double taxation."

54. **Article 9**

A preliminary point was raised regarding the use of the expression "permanent establishment" in the second line of paragraph 1 on page 94 under "A. General Considerations." On a closer examination, it was found that the reference to "permanent establishment" with regard to article 9 was inappropriate. The sentence referred to is as under:

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

"Permanent establishment" as defined in article 5, paragraphs 1 and 2 refers to an integral part of the enterprise which is not independent or autonomous, while article 9 speaks of "associated enterprises" which are distinct, separate and autonomous entities, which have

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an identity and independent legal existence and status from the enterprise in the home country. Hence, in the aforesaid paragraph, the reference to permanent establishment will be omitted and substituted by "associated enterprises."

55. In the July 1998 version of the UN Model Convention, there was an incorrect reference to OECD Transfer Pricing Guidelines. It is considered necessary to correctly mention the same. This reference does not exist in the revised version of the UN Model Convention. The following paragraph will be inserted on page 94, after the first paragraph, as under:

"With regard to transfer pricing of goods, technology, trade marks and services between associated enterprises and the methodologies which may be applied for determining correct prices where transfers have been made on other than arm's length terms, this Model follows the OECD principles which are set out in the OECD Transfer Pricing Guidelines (July 1995). These conclusions represent internationally agreed principles and provide valid guidelines for the application of the arm's length principle which underlies the article."

56. In paragraph 1, for the words "but for those conditions, have not so accrued," the words "but for those conditions; have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued" will be substituted. The effect of this amendment will be explained in the commentary on paragraph 1, on page 94, after the first paragraph under commentary on Paragraph 1, as under:

"The Group of Experts have made an amendment of a drafting nature in paragraph 1 bringing the language of the main portion in line with that in the OECD Model Convention. Prior to the amendment, it stated:

"... then any profits which would, but for those conditions, have not so accrued..."

This portion of paragraph 1 has been modified as under:

"... then any profits which would, but for those conditions, **have accrued to one of the enterprises, but, by reason of those conditions,** have not so accrued..."

57. A discussion took place which focussed on the question of correlative adjustments in the case of fraud. It was considered that the wording of the proposed additional paragraph to article 9 did not accurately reflect the point since it suggested that the fraud related to the adjustment rather than the original transfer price. The point was correctly explained in paragraph 33 in Working Paper 13 (Report of the First Meeting of the Focus Group). It was noted that a similar point had been included in the European Union's Arbitration Convention.

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Accordingly, the Focus Group decided to insert the following two paragraphs, the second paragraph under the heading "Paragraph 3," explaining the provisions of new paragraph 3 introduced in article 9, after the fourth paragraph on page 96, and before the commencement of article 10, as under:

"Some members of the Group of Experts had noted that a correlative adjustment under paragraph 2 could be very costly to a small country which may consider not including paragraph 2 in its treaties. Several members of the Group of Experts responded that they believed that paragraph 2 was an essential aspect of article 9. However, a country could closely examine the primary adjustment under paragraph 1 before deciding what correlative adjustment was appropriate to reflect the primary adjustment. Another member suggested that it may be desirable to eliminate the obligation that a State may have to make a correlative adjustment when the other Contracting State has previously adjusted the transfer prices. He observed that it could be convenient to change the word "shall" to "may" and that Contracting States may, during bilateral negotiations, use the word that is convenient. However, there was no consensus on this point and the language of paragraph 2 remains unchanged.

Paragraph 3

The Group of Experts has made an amendment to article 9 by inserting a new paragraph 3. Paragraph 2 of article 9 requires a country to make an "appropriate adjustment" (a correlative adjustment) to reflect a change in the transfer price made by a country under article 9, paragraph 1. The new paragraph 3 provides that the provisions of paragraph 2 shall not apply where the legal or other administrative proceedings have resulted in a final ruling that by actions giving rise to an adjustment of profits under paragraph 1, one of the enterprises is liable to penalty with respect to fraud, gross negligence or wilful default. In other words, in case a final order has been passed in a legal or administrative proceeding pointing out that in relation to the adjustment of profits under paragraph 1, one of the enterprises is visited with a penalty for fraud, gross negligence or wilful default, there would be no obligation to make the correlative adjustment under paragraph 2."

58. **Article 10**

The Focus Group noted the following changes in article 10 by the Eighth Meeting, namely:

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1. In paragraph 2, for the words, "... but if the recipient is the beneficial owner of the dividends, the tax so charged...," the words "... but if the beneficial owner of the dividends is a resident of the other Contracting State. the tax so charged..." will be substituted.

2. In paragraph 2, in subparagraph (a), for the words "... which holds directly at least 10 per cent of the capital," the words "... which holds directly at least ____ per cent of the capital will be substituted.

However, during the Second Meeting, the second decision was modified. It was decided to retain the threshold of "10 per cent" hitherto specified, but add a footnote referred to in page 5.

Consequently, the commentary on paragraph 2 will be modified. In the commentary on article 10, paragraph 2, on page 98 for the first line the following two paragraphs will be substituted and the words "with the following changes" will be omitted, as under:

"Paragraph 2

This paragraph reproduces Article 10, paragraph 2, of the OECD Model Convention with certain changes which will be explained hereunder.

The Group of Experts has amended the main provision of paragraph 2 to bring it in line with that in the OECD Model Convention. Prior to the amendment, it was provided that such dividends could also be taxed in the Contracting State of which the company paying the dividends is a resident but if the recipient is the beneficial owner of dividends, the tax was to be charged in the specified manner. This provision has been changed to provide that if the beneficial owner of the dividends is a resident of the other Contracting State, the tax would be charged in the specified manner. The same change has been made in paragraphs 2 of article 11 and 12 relating to interest and royalties respectively. The purpose of this amendment is to allow the benefits of these articles (namely, 10, 11 and 12) to a beneficial owner residing in a treaty country regardless of the residence of any broker or other intermediary collecting the income on behalf of the beneficial owner, and correspondingly, to deny treaty benefits when the beneficial owner was not a resident of the treaty country, even if the intermediary collecting the income was a resident. Although some members of the Group of Experts had expressed doubts about the effects of this change on developing countries as also the countries that taxed dividends income on a remittance basis, even on re-

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examination, it was considered that the amendment, as proposed, on the lines of the existing provision in the OECD Model Convention did not require reconsideration. These remarks apply, mutatis mutandis, to similar amendments made to paragraph 2 of article 11 (interest) and article 12 (royalties)."

59. Certain additions made to the July 1998 version of the UN Model Convention were not earlier considered. Since the revised version contained only a part of the addition, it was proposed to add the remaining portion in the commentaries on page 99, after the third paragraph, as under:

"Although the rates are fixed either partly or wholly for reasons connected with the general balance of the particular bilateral tax treaty, the following technical factors are often considered in fixing the rate:

(a) the corporate tax system of the country of source (e.g., the extent to which the country follows an integrated or classical system) and the total burden of tax on distributed corporate profits resulting from the system;

(b) the extent to which the country of residence can credit the tax on the dividends and the underlying profits against its own tax and the total tax burden imposed on the taxpayer, after relief in both countries;

(c) the extent to which matching credit is given in the country of residence for tax spared in the country of source;

(d) the achievement from the source country's point of view of a satisfactory balance between raising revenue and attracting foreign investment."

60. There followed a discussion regarding "branch tax" which needed a special mention in the commentaries according to one member of the Focus Group, particularly in view of the increasing number of countries introducing the tax and in view of the need to maintain neutrality of tax treatment between permanent establishments and subsidiaries. It was suggested by another member that the contrary view merited equal mention to the effect that the imposition of a branch tax infringed the non-discrimination article in that it distinguished between branches of residents (which were not subject to tax) and non-residents (which were). It was agreed that a note should be made of the potential infringement and the need to exclude the tax in bilateral negotiations from the scope of the non-discrimination article. It was generally considered that this issue was adequately dealt with by the text of the

commentaries as they appeared in the revised version of the UN Model Convention. However, the following addition is proposed to the commentary on page 106, under the heading "Branch profits tax," in the first paragraph, after the first sentence, as under:

"The issue was further discussed in the 1997 meeting (Eighth Meeting) of the Group of Experts and it was considered that because not all countries had branch tax (except perhaps for the USA, Canada, France and a few other countries) that paragraph might be better placed in the commentaries and not in the main text. It would be left to the Contracting States, if they so desire, during the course of bilateral negotiations to incorporate the provisions relating to the branch profits tax in their bilateral tax treaties."

61. One member of the Focus Group expressed reservations as to the desirability of incorporating article 10, paragraph 2, subparagraph (b) in bilateral treaties with developing countries in view of its irrelevance to inward investment and the speculative nature of the investments concerned, and considered if an appropriate comment might be made in the commentaries. However, the point was not pursued further.

62. **Article 11**

The Focus Group noted that during the Eighth Meeting, paragraph 2 of article 11 was amended to bring it in line with the corresponding provision of the OECD Model Convention. With a view to explaining the rationale of the amendment, the commentary on paragraph 2 will be modified. Accordingly, on page 109, under Paragraph 2, after the first paragraph, the following paragraph will be inserted, namely:

"The Group of Experts have amended the main provision of paragraph 2 to bring it in line with that in the OECD Model Convention. Prior to the amendment, it was provided that such interest could 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 was to be charged in the specified manner. This provision has been changed to provide that if the beneficial owner of the interest is a resident of the other Contracting State, the tax would be charged in the specified manner. The purpose of this amendment is to allow the benefit of this article to a beneficial owner residing in a treaty country regardless of the residence of any broker or other intermediary collecting the income on behalf of the beneficial owner, and correspondingly, to deny treaty benefits when the beneficial owner was not a resident of the treaty country, even if the intermediary collecting the income was a resident."

63. The Focus Group decided that it may not be necessary to amend the text of article 11 but it may be useful to include a paragraph in the commentaries on article 11 dealing with the anti-abuse provision relating to creation or assignment of debt claim to take advantage of article 11 and that such a provision may be included by Contracting States in their bilateral tax treaties during negotiations. Accordingly, on page 119, after the second paragraph and before the commencement of article 12, the following paragraphs will be inserted, as under:

"A member of the Group of Experts pointed out that there are many artificial devices entered into by persons to take advantage of the provisions of article 11 through, inter alia, creation or assignment of debt claims in respect of which interest is charged. While it may not be necessary to make a specific provision in article 11 in this behalf, it was considered that Contracting States may include a clause on the following lines in their bilateral tax treaties during negotiations, namely:

"The provisions of this article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid to take advantage of this article by means of that creation or assignment."

64. It was noticed that on page 118, under Paragraph 6, in the fifth paragraph, in the fifth line, after the words "... the provisions of the Convention," several lines of the extracts from paragraph 35 of the Commentary on the OECD Model Convention were inadvertently omitted. These may be inserted at the appropriate place as under:

"This paragraph permits only the adjustment of the rate at which interest is charged and not the reclassification of the loan in such a way as to give it the character of a contribution to equity capital. For such an adjustment to be possible under paragraph 6 of Article 11 it would be necessary to substitute other words for the phrase "having regard to the debt-claim for which it is paid." Nevertheless, this paragraph can affect not only the recipient but also the payer of excessive interest and if the law of the State of source permits, the excess amount can be disallowed as a deduction, due regard being had to other applicable provisions of the Convention."

65. **Article 12**

Although there is a difference in the provisions relating to tax treatment of royalties in the OECD and United Nations Model Conventions, the provisions relating to beneficial

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ownership incorporated in the OECD Model Convention commentary would be inserted in page 120, under Paragraphs 1 and 2, after the first paragraph, as under:

"In this connection, the commentary on paragraph 1 of the OECD Model Convention is relevant and reproduced below:

4. Under paragraph 1, the exemption from tax in the State of source is not available when an intermediary, such as an agent or nominee, is interposed between the beneficiary and the payer, unless the beneficial owner is a resident of the other Contracting State (the text of the Model was amended in 1995 to clarify this point, which has been the consistent position of all Member countries). States which wish to make this more explicit are free to do so during bilateral negotiations.

5. The article deals only with royalties arising in a Contracting State and beneficially owned by a resident of the other Contracting State. It does not, therefore, apply to royalties arising in a third State as well as to royalties arising in a Contracting State which are attributable to a permanent establishment which an enterprise of that State has in the other Contracting State (for these cases cf. paragraphs 4 to 6 of the commentary on Article 21). Procedural questions are not dealt with in this Article. Each State should be able to apply the procedure provided in its own law. Specific questions arise with triangular cases. (See paragraph 53 of the Commentary on Article 24).

6. The paragraph does not specify whether the exemption in the State of source should be conditional upon the royalties being subject to tax in the State of residence. This question can be settled by bilateral negotiations.

7. Attention is drawn generally to the following case: the beneficial owner of royalties arising in a Contracting State is a company resident in the other Contracting State; all or part of its capital is held by shareholders resident outside that other State; its practice is not to distribute its profits in the form of dividends; and it enjoys preferential taxation treatment (private investment company, base company). The question may arise whether in the case of such a company it is justifiable to allow in the State of source of the royalties the tax exemption which is provided in paragraph 1. It may be appropriate, when bilateral negotiations are being conducted, to agree upon special exceptions to the taxing rule laid down in this article, in order to define the treatment applicable to such companies."

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66. The Focus Group noted that the Eighth Meeting had amended the provisions of paragraph 2 of article 12 to provide that for the words "but if the recipient is beneficial owner of the royalties, the tax so charged," the words "but if the beneficial owner of the royalties is a resident of the other State, the tax so charged..." will be substituted. With the view to explaining the rationale of this amendment, the commentary on paragraph 2 will be modified. Accordingly, on page 120, under Paragraphs 1 and 2, after the first paragraph after insertion of the paragraphs under 65 above, the following paragraph will be inserted, namely:

"The Group of Experts have amended the provisions of paragraph 2 of article 12, to bring it in line with the provisions of paragraph 2 of articles 10 and 11. Prior to the amendment, it was provided that 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 will be charged in the specified manner. This provision has been changed to provide that if the beneficial owner of the royalties is a resident of the other Contracting State, the tax would be charged in the specified manner. The purpose of this amendment is to allow the benefit of this article to a beneficial owner residing in a treaty country regardless of the residence of any broker or other intermediary collecting the income on behalf of the beneficial owner, and correspondingly, to deny treaty benefits when the beneficial owner was not a resident of the treaty country, even if the intermediary collecting the income was a resident."

67. In 1992, OECD deleted the words "for the use of, or the right to use, industrial, commercial or scientific equipment" from article 12, paragraph 3 of the Model Convention. The assessment of the impact of the amendment made by OECD on the UN Model Convention is being examined in the commentary on paragraph 3 of article 12. In relation to the deletion of the words "for the use of, or the right to use, industrial, commercial or scientific equipment" from paragraph 2 of Article 12 of the OECD Model Convention, several OECD countries made reservations, because it produces exclusive allocation of the income derived from such payments to the countries where the lessor is a resident. According to a member from a developing country, this type of income, as other type of income derived from the assignment or use of capital in a national fiscal jurisdiction and in its case from shares, taking into account that in some cases, dividends result just from

portfolio investments, shall be subject to tax in the country where the capital is applied (e.g., source country). It would be desirable to note the repercussions of the deletion of the aforesaid words on the member countries of OECD. On page 126, after the second paragraph, the following paragraph will be inserted, namely:

"Paragraph 2 of Article 12 of the OECD Model Convention (corresponding to paragraph 3 of article 12 of the UN Model Convention) was amended by deleting the words "or the use of, or the right to use, industrial, commercial or scientific equipment" by the report entitled "The Revision of the Model Convention" adopted by the Council of the OECD on 23 July 1992. Canada, the Czech Republic, Hungary, Korea and Poland have reserved the right to add the words "for the use of, or the right to use, industrial, commercial or scientific equipment" to paragraph 2 (3 in the UN Model Convention), while Greece, Italy and Mexico reserve the right to continue to include the income derived from the leasing of industrial, commercial or scientific equipment and containers in the definition of "royalties" as provided in paragraph 2 of Article 12 of the 1977 version of the OECD Model Convention. New Zealand and Portugal have also reserved the right to tax at source the royalties income from leasing of industrial, commercial or scientific equipment. Similarly, Spain and Turkey have also continued to adhere in their conventions to a definition of "royalties" which includes income from leasing of industrial, commercial or scientific equipment."

68. The question "whether payments received as consideration for computer software may be classified as royalties" has been examined in paragraphs 12 to 17 of the commentary of the OECD Model Convention. The Working Party of the OECD has made certain recommendations to replace paragraphs 12 to 17 of the Commentary on Article 12 which may be seen at Annex IV. These would be incorporated in the UN Model Convention after they are finalized by the OECD.

69. **Article 13**

The Focus Group took note of the decisions taken during the Eighth Meeting relating to paragraph 4, namely:

1. To consider broadening the scope of the provision to deal with interests in partnerships, trusts and estates that own real property;

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2. To narrow the scope of this provision to exclude active businesses that own real property (for example, hotel company) other than property management companies;

3. To define the meaning of the term "principally;"

4. The question of providing lower rate of source tax (compared to the normal domestic rate) applied on gains from the alienation of shares other than real estate holding shares to be specified in the commentaries.

Accordingly, in the commentary on article 13, on page 135, after the paragraph dealing with Paragraph 4, the following paragraphs will be inserted, namely:

"Paragraphs 4A and 4B

The Group of Experts have made the following amendments to paragraph 4, namely:

1. The scope of paragraph 4 may be expanded to include interests in partnerships, trusts and estates that own immovable property;

2. The scope of paragraph 4 may also be narrowed to exclude from its scope active businesses that own immovable property, such as, a company the property of which consists directly or indirectly principally of immovable property used by such company in its industrial, commercial or agricultural activities or in the conduct of professional services. But this provision will not apply to an immovable property management company.

As seen above, paragraph 4 of article 13 provides that capital gains arising 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. The rationale for this provision is considered to be an anti-avoidance measure in cases where the ownership of shares carries the right to occupy the property. In such cases, transfer of shares of the company whose assets principally consist of immovable property results in the transfer of right, title and interest in the specified immovable property or part thereof referable to the shares which represent the ownership of such property or part thereof, respectively. In such cases, the capital gains arising on transfer of such shares are deemed to arise in the Contracting State where the immovable property is situated. This principle, however, does not apply to interests in partnerships, trusts or estates, all of which own immovable property since they do not have shares which represent rights of ownership of such property. But if these entities do own immovable properties, the amendment through

the insertion of new paragraph 4B in article 13 provides that any gains arising on alienation of such immovable property situated in a Contracting State may be taxed in that State.

At the same time, another amendment has been made in article 13 by the insertion of a new paragraph 4A to restrict the scope of paragraph 4 by excluding from the scope of paragraph 4, a company the property of which consists directly or indirectly principally of immovable property used by such company in its industrial, commercial or agricultural activities or in the conduct of professional services. However, the provisions of paragraph 4 will continue to apply to property management companies. In other words, the effect of this amendment is that the provisions of paragraph 4 will not be applicable to a company which is engaged in industrial, commercial or agricultural activities or in the conduct of professional services, and whose property, used for such activities, held directly or indirectly, consists principally of immovable property. For the purposes of this paragraph and paragraph 4, the term "principally" has been explained to mean the value of immovable property or properties which exceed seventy-five per cent of the aggregate value of all assets owned by the company. Hence, unless the value of all immovable properties owned by such company exceeds 75% of the total value of all assets, the provisions of paragraph 4 or 4A will not be applicable.

The Group of Experts had examined the question of laying down a concessional rate of tax (compared to normal domestic rate) on gains on alienation of shares, other than the shares referred to in paragraph 4, that is, not being shares of principally immovable property owning companies. Since the gains arising on alienation of shares being taxed in a concessional manner is likely to encourage investment in shares, promote foreign direct investment and portfolio investment, and thereby give impetus to the industrialisation of the country, competent authorities of the Contracting State may consider discussing this matter during bilateral negotiations and make necessary provision in the bilateral tax treaties."

70. **Article 14**

The Focus Group noted the following changes made to article 14, namely:

1. In paragraph 1, in subparagraph (b), for the words and figures "...in the aggregate 183 days in the fiscal year concerned...," the words and figures "... in the aggregate 183 days in any twelve month period commencing or ending in the fiscal year concerned." will be substituted.

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2. In paragraph 1, subparagraph (c) will be omitted.

Accordingly, on page 137,

(a) Paragraph 5 dealing with subparagraph (b) will be substituted as under:

"Subparagraph (b) as amended, extends the source country's right to tax by providing that the source country may tax if the individual is present in the country for a period or periods aggregating at least 183 days in any twelve month period either commencing or ending in the fiscal year concerned, even if there is no fixed base. Only income derived from activities exercised in that country, however, may be taxed. Prior to the amendment, the requirement of minimum stay in the Contracting State was a "period or periods amounting to or exceeding in the aggregate 183 days in the fiscal year concerned." By virtue of the amendment, the provisions of article 14, paragraph 1, subparagraph (b) have been brought on par with those of article 15, paragraph 2 subparagraph (a) relating to the minimum period of stay in the other Contracting State."

(b) Paragraph 6 dealing with subparagraph (c) will be substituted as under:

"Prior to its deletion, subparagraph (c) provided a further criterion for source country tax when neither of the two conditions specified in subparagraphs (a) and (b) is met. It was provided that if the remuneration for the services performed in the source country exceeds a certain amount (to be determined in bilateral negotiations), the source country may tax, but only if the remuneration is received from a resident of the source country or from a permanent establishment or fixed base of a resident of any other country which is situated in that country.

It was observed that any monetary ceiling limit fixed in this behalf becomes meaningless over a period of time due to inflation and would only have the effect of limiting the amount of potentially valuable services that the country will be able to import. Moreover, the provision to this effect appeared only in 6% of the existing bilateral tax treaties. It was, accordingly, decided to delete the subparagraph (c) of paragraph 1 of article 14."

71. **Article 17**

The Focus Group noted that the Eighth Meeting had made certain changes in article 17, namely:

(a) In the title of article 17, for the words "Income earned by entertainers and athletes," the words "Artistes and sportsmen" will be substituted;

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(b) In paragraphs 1 and 2, for the word "athlete," the word "sportsman" will be substituted.

Further, the Focus Group decided to substitute the gender neutral word "sportsperson" for the word "sportsman."

A. Pursuant to these changes, on page 143, for the title and first paragraph, the following will be substituted, namely:

"ARTICLE 17

ARTISTES AND SPORTSPERSONS

Article 17 of the United Nations Model Convention reproduces article 17 of the OECD Model Convention with one modification. Instead of the word "sportsman" used in the OECD Model Convention (in place of "athlete" used in the UN Model Convention earlier), it has been decided to use the gender-neutral word "sportsperson," which unlike the term "entertainer," was not followed in paragraph 1 by illustrative examples but is nevertheless likewise to be construed in a broad manner consistent with the spirit and purpose of the article."

B. On page 147, in paragraph 5, for the words "artistes and athletes," the words "artistes and sportspersons" will be substituted.

72. **Article 18**

During the Eighth Meeting, some members of the Group of Experts suggested that paragraph 2 of article 18 (alternative A) and paragraph 3 of article 18 (alternative B) should be amended to deal with the fact that social security systems have been privatized in some countries. The Focus Group decided that the question of privatization of social security systems may be looked into by examining some treaties where this issue has been dealt with and an appropriate addition may be made in the commentaries in this behalf. Accordingly, on page 149, under Paragraph 2, after the paragraph, the following paragraph will be inserted, namely:

"The Group of Experts had suggested that the provisions of paragraph 2 of article 18 (alternative A) and paragraph 3 of article 18 (alternative B) may require amendment to deal with the consequences of privatization of social security systems. This question has subsequently been examined in consultation with the International Bureau of Fiscal Documentation (IBFD).

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Until the present time, there does not appear to be any treaty text which clearly addresses the issue of privatization of social security systems. It is true that in some treaty texts, the right to tax the social security payments is attributed to the State of residence, rather than the State of source, though this does not address the issue raised above.

Privatized social security systems can be found in a number of countries in Latin America and East Europe. The concept began with Chile, which adopted a very successful privatization plan in 1981. Under this system, workers pay into a private system of savings and investment accounts instead of a traditional social security system. Similar plans have now been adopted in Argentina, Peru, Colombia, Mexico, Bolivia and El Salvador.

Privatization also seems to be a trend in Eastern Europe; Hungary started its private system at the beginning of 1998 and Poland at the beginning of 1999. Lithuania, Bulgaria, Rumania, Kazakhstan and others are reported to be following soon. Some details of the privatized social security systems of Hungary and Poland are given in Annex VI.

The problems of double taxation consequent upon the introduction of privatized social security systems have not been noticed so far. This issue is still under examination and the results of enquiry in this behalf will be brought to the notice of the Group of Experts in due course."

73. The general issue of taxation of cross border pensions was briefly dealt with during the Second Meeting of the Focus Group. The following summary of discussion in this behalf will be inserted in page 148, after the second paragraph, namely:

"Due to difficulties relating to the taxation of cross border pensions, the OECD is presently discussing whether Article 18 of the OECD Model Convention should be modified. It was recognised that the present approach of Article 18 to provide for exclusive residence taxation was in line with the more general approach of the Model Tax Convention, to give preference to residence taxation, unless the income had a particular attachment to the country of source. Any suggested change of the present rules would therefore need to be considered carefully. It has been agreed upon that particular weight should be given to any evidence indicating that the present rules may lead to double taxation or double non-taxation. Special rules may be needed with respect to cases in which contributions to pension schemes have been facilitated in the source State, but little or no tax is levied in the residence State on the pension payments, due to the fact that the treatment of pensions is highly diversified among

countries. These developments within the OECD will be taken into consideration, at the appropriate time, for the UN Model and Commentary."

74. Some members of the Focus Group had pointed out that while pages 148-149 reproduced the portion of the OECD commentary dealing with article 18, paragraphs 4 to 37 of the OECD Model Convention were not so reproduced. The Focus Group was urged to consider the substantive issue raised (tax relief in the host state for contributions to foreign pension schemes) from the point of view of developing countries, bearing in mind that incorporation of the alternative OECD treaty provisions in this area in the UN Commentaries could send a strong positive signal to potential inward investors. Accordingly, in the commentaries, on page 149, before the discussion on commentary on article 18 (alternative B), the following paragraph will be inserted, namely:

"The OECD Model Convention in the commentary on article 18 at paragraphs 4 to 37 has dealt with the question of the tax treatment of contributions to foreign pension schemes. Some members of the Group of Experts pointed out that incorporation of these paragraphs in the United Nations Model Convention dealing with this subject would send a strong positive signal to potential inward investors. It was not considered appropriate to reproduce these paragraphs in the UN Model Convention on the short ground that the issue dealt with there is about the tax treatment of contributions to foreign pension schemes in the hands of expatriate employees, which does not involve any question of double taxation with which the United Nations Model Convention is primarily concerned. However, for the sake of information on this important subject, the paragraphs 4 to 37 in commentary on Article 18 of the OECD Model Convention have been presented in Annex V."

75. **Article 20**

One member of the Focus Group pointed out that the commentary on article 20 should incorporate the full text of the paragraphs 25 to 29 of the Report of the Seventh Meeting of the Group of Experts (December 1995) (UN document ST/ESA/250) dealing with the question of deletion of paragraph 2 in article 20. The suggestion was accepted by the Focus Group. Accordingly, on page 154, after the first paragraph and before consideration of article 21, the following paragraphs will be inserted, namely:

"The question whether paragraph 2 of article 20 should be deleted from the United Nations Model Convention has engaged the attention of the Group of Experts for some time.

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In this connection, it is relevant to reproduce paragraphs 25 to 29 of the Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its Seventh Meeting held in December 1995 (ST/ESA/250):

"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 non-exempted income, be entitled to the same exemptions, reliefs, and reductions, as were allowed to residents of that country.

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.

A proponent of deleting the provision noted that article 24, paragraph 3 (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 the provision of article 24.

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 studies, of remuneration not exceeding a certain annual amount, but only to the extent that the remuneration was also not exempted in the other State.

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

76. The Focus Group examined the suggestion for renewed discussion of the case for including a Teacher's article. It was observed that the Seventh Meeting formally adopted the text of two new paragraphs with a view to their inclusion in the commentary. (Report of the Seventh Meeting, paragraph 38). The Focus Group accepted the suggestion. Accordingly, in page 154, after the paragraphs included as above, (ref. paragraph 75 above), the following paragraphs will be inserted, namely:

"Article for Teachers

During the course of discussions in the Seventh Meeting of the Ad Hoc Group of Experts, 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. 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.

There was considerable controversy among participants about the need to provide an independent article in the UN Model Convention dealing exclusively with visiting teachers. But 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. One member 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. There was general consensus for this suggestion.

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,

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tax exemption is already provided under domestic taxation laws, which may 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 the 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."

77. **Article 22**

The question of retention of the brackets around paragraphs 1 to 4 was discussed by the Focus Group. It was decided that the issue may be discussed in the commentaries. Accordingly, on page 158, after the first paragraph, the following paragraph will be inserted, namely:

"The question whether the paragraphs 1 to 4 should continue to be placed within square parentheses has been examined by the Group of Experts. There is a general agreement that parentheses were not required for the first three paragraphs but it was decided to retain them so far as paragraph 4 was concerned. There was a strong argument that the source State would have the right to tax where the property was situated in that country; that would bring it into line with the treatment of the United Nations Model Convention of other income

referred to in article 21. An argument in favor of retaining the paragraph as it was but without parentheses was based on the consideration that such a provision would be difficult to enforce by tax administrations, having regard to the inherent mobility of the kind of property normally concerned and the non-residence of the taxpayer. It has been decided, therefore, to retain the parentheses so far as paragraph 4 is concerned."

78. **Article 23**

There was a discussion about how tax sparing should be dealt with in the context of this article. It was agreed that while it might be a variation of the tax credit method for relieving double taxation separate treatment in the article was not needed. It was generally agreed that what was needed was additional emphasis in the commentaries as to the importance of preventing the abuse of tax sparing. A member from a developing country pointed out the importance of explaining the mechanics of tax sparing in the commentaries to assist developing countries in negotiating their tax treaties. There was a general discussion as to the desirability of including this kind of provision in the tax treaties. One member observed that there has been a significant change of opinion on this point even in the last four to five years (i.e., since the text currently being considered was drafted). The stand against tax sparing could no longer be said to be represented by only one country. There was discussion as to the possibility of explaining the view in the commentaries that this kind of tax incentive was an inefficient mechanism. It was also suggested by one member that a reference might be made to the OECD recent paper on the subject. Notwithstanding the views against tax sparing, a member from a developing country pointed out that tax sparing did exist and that, without needing to comment on its merits, the commentaries could indeed usefully contain a better definition. It was observed that the passage in the commentary which dealt with this issue (beginning on page 161) was substantially new and strong reservations were expressed as to whether it correctly balanced the views of developing and developed countries. It was agreed that a revision to the current wording would be drafted and discussed at a later stage by the Group. Accordingly, on page 161, paragraphs 3, 4, 5 and 6 will be omitted and in their place, the following paragraphs will l inserted, namely:

"Some experts from developing countries consider that the grant of fiscal incentives to promote foreign investment is not a significant course of such investment taking place, because tax factors are not decisive in the process of investment decisions made by

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enterprises. They estimate that the experience obtained in the last twenty years shows that the most important thing is the so called "investment climate" that is composed of other kind of factors, such as, the political, social, juridical and economic environment and stability, etc. The permanent use of fiscal incentives, in the end, undermines the tax base: can lead to the damaging effects of tax incentive competition, that then takes place between neighbouring States as they try to outdo each other's incentives, and usually leads to fiscal manipulation or abusive acts. That said, the reality is that countries remain free to adopt these tax incentives that they judge useful. Therefore, the most important aspect for developing countries when they apply their taxes, is to reserve or maintain their rights by using tax sparing or matching credit methods when they conclude bilateral tax treaties, so as to avoid transferring their revenues to the Contracting State. It is very important to take into account the position of non-member countries with respect to the application of article 23 of the OECD Model, reflected in the Commentary, taking into account the Seminar carried out by this Organization in Paris in September 1996. Such experts from developing countries may consider that when developing countries decide to use fiscal incentives, for economic or social reasons, they may have to limit those incentives to a certain period of time; avoiding the use of this fiscal tool as a general method, in other words, it must be used considering the possibility to stimulate regional or sectoral activities during a limited period of time. It is very important to analyse the possibility to introduce, in the opinion such experts, a so-called "soak-up tax." This kind of internal provision could be, in general terms, drafted in the following way:

Article ... "If as a consequence of an exemption, exclusion, incentive or special reduction of the income tax provided by the domestic law, such measures imply a transfer of national revenue to the treasury of another national State, the above-mentioned privileges are restricted by the amount of revenue that would otherwise be transferred to the other State.

But so as to give effect to this kind of internal provision, it is necessary, taking into account that bilateral tax treaties take precedence over domestic law, to introduce in bilateral negotiations a specific clause in article 23 of the UN Model or, alternatively, in a Protocol of a bilateral agreement, the following clause:

"Nothing in this agreement shall limit the application of article ... of the Income Tax Law." In other words, this clause could be used in article 23 in respect of one of the

Contracting States (In the case of ...) or in the Protocol using the formula: "With respect to article 23:," and "In the case of ...,...).

However, if a developing country decides to use a tax-sparing clause a method to avoid the transfer of its revenues, the following draft could be used:

(a) The term "tax on income paid in ...," shall be deemed to include any amount which would have been payable as ... tax, in accordance with the provisions of the Convention, for any year but for a reduction allowed in ascertaining the taxable income or an exemption from or reduction of, tax granted for that year or any part thereof under any other provision which may be enacted after the date of signature of the Convention allowing a deduction in ascertaining the taxable income or granting an exemption from or reduction of, tax which is agreed by the competent authorities of the Contracting States to be for the purpose of promoting economic development in ... for a limited period of time (as amended from time to time without affecting the general principle thereof).

(b) The provisions of subparagraph (a) shall apply for the first ... years for which the Convention is effective."

79. **Article 25**

The new wording in relation to a joint commission was noted by the Focus Group. One of the members noted two main issues in relation to this article which had been raised at the Seventh Meeting of the Ad Hoc Group of Experts and were further dealt with in the Working Paper 15. The first was transfer pricing and the need to identify special issues relevant to developing countries and the second was the question of alternative dispute resolution in relation to perceived weaknesses of this article. It was noted in this respect that the OECD was preparing a report on advance pricing agreements. The Group decided that it would be preferable to include in the commentaries the wording of the reply prepared on this point (in preference to the OECD text). To show the current thinking on the matter, the Group was in agreement with the comments in that document regarding the GATS question. Accordingly,

(a) on page 206, after the first paragraph, the following paragraph will be inserted, namely:

"In this connection, it is relevant to note paragraph 50 (c) of the Report of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on the work of its seventh meeting, namely:

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"With regard to dispute resolution: Greater cooperation must be the 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.

(b) on page 206, after the paragraph inserted as referred to in (a) above, the following paragraphs will be inserted, namely:

"It would be instructive to consider the relationship between the Mutual Agreement Procedure and the dispute resolution mechanism provided by the General Agreement on Trade in Services reproduced from paragraphs 44.1 to 44.7 of the OECD Commentary as under:

Interaction of the mutual agreement procedure with the dispute resolution mechanism provided by the General Agreement on Trade in Services

44.1 The application of the General Agreement on Trade in Services (GATS) which entered into force on 1 January 1995 and which all Member countries have signed, raises particular concerns in relation to the mutual agreement procedure.

44.2 Paragraph 3 of Article XXII of the GATS provides that a dispute as to the application of Article XVII of the Agreement, a national treatment rule, may not be dealt with under the dispute resolution mechanisms provided by Articles XXII and XXIII of the Agreement if the disputed measure "falls within the scope of international agreement between them relating to the avoidance of double taxation" (e.g., a tax convention). If there is disagreement over whether a measure "falls within the scope" of such an international agreement, paragraph 3 goes on to provide that either State involved in the dispute may bring the matter to the Council on Trade in Services, which shall refer the dispute for binding arbitration. A

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footnote to paragraph 3, however, contains the important exception that if the dispute relates to an international agreement "which exist(s) at the time of the entry into force" of the Agreement, the matter may not be brought to the Council on Trade in Services unless both States agree.

44.3 That paragraph raises two particular problems with respect to tax treaties.

44.4 First, the footnote thereto provides for the different treatment of tax conventions concluded before and after entry into force of the GATS, something that may be considered inappropriate, in particular where a convention in existence at the time of the entry into force of the GATS is subsequently re-negotiated or where a protocol is concluded after that time in relation to a convention existing at that time.

44.5 Second, the phrase "falls within the scope" is inherently ambiguous, as indicated by the inclusion in paragraph 3 of Article XXII of the GATS of both an arbitration procedure and a clause exempting pre-existing conventions from its application in order to deal with disagreements related to its meaning. While it seems clear that a country could not agree in good faith that a measure relating to a tax to which no provision of a tax convention applied fell within the scope of that convention, it is unclear whether the phrase covers all measures that relate to taxes that are covered by all or only some provisions of the tax convention.

44.6 Contracting States may wish to avoid these difficulties by extending bilaterally the application of the footnote to paragraph 3 of Article XXII of the GATS to conventions concluded after the entry into force of the GATS. Such a bilateral extension, which would supplement - but not violate in any way - the Contracting States' obligations under the GATS, could be incorporated in the Convention by the addition of the following provision:

"For the purposes of paragraph 3 of Article XXII (Consultation) of the General Agreement on Trade in Services, the Contracting States agree that notwithstanding that paragraph, any dispute between them as to whether a measure falls within the scope of this Convention may be brought before the Council for Trade in Services, as provided by that paragraph, only with the consent of both Contracting States. Any doubt as to the interpretation of this paragraph shall be resolved under paragraph 3 of Article 25 (Mutual Agreement Procedure) or, failing agreement under that procedure, pursuant to any other procedure agreed to by both Contracting States."

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44.7 Problems similar to those discussed above may arise in relation with other bilateral or multilateral agreements related to trade or investment. Contracting States are free, in the course of their bilateral negotiations, to amend the provision suggested above so as to ensure that issues relating to the taxes covered by their tax convention are dealt with through mutual agreement procedure rather than through dispute settlement mechanism of such agreements."

80. The Focus Group has approved, in regard to paragraph 4, the insertion of the words "including through a joint commission consisting of themselves or their representatives" between the words "...With each other directly" and "... for the purpose of reaching." Accordingly, on page 205, under Paragraph 4, in the first paragraph, after the expression "are new provisions," the following shall be inserted, namely:

"In the first sentence, the words "including through a joint commission consisting of themselves or their representatives" have been inserted between the words "with each other directly" and "... for the purpose of reaching," so as to bring the provision on par with that of the corresponding provision in the OECD Model Convention. The OECD commentary on that paragraph is therefore relevant:

"It provides that the competent authorities may communicate with each other directly. It would therefore not be necessary to go through diplomatic channels.

The competent authorities may communicate with each other by letter, facsimile transmission, telephone, direct meetings, or any other convenient means. They may, if they wish, formally establish a joint commission for this purpose.

As to this joint commission, paragraph 4 leaves it to the competent authorities of the Contracting States to determine the number of members and the rules of procedure of this body.

However, while the Contracting States may avoid any formalism in this field, it is nevertheless their duty to give taxpayers whose cases are brought before the joint commission under paragraph 2 certain essential guarantees, namely:

- the right to make representations in writing or orally, either in person or through a representative;
- the right to be assisted by a counsel."

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81. **Article 26**

The question of disclosure of tax information to bodies which supervise the general administration of a Government was discussed by the Focus Group. In this connection, it was observed that paragraph 12.1 of the OECD commentary on paragraph 1 of article 26 (added on 21 September 1995) was already incorporated on page 225, paragraph 6 in the UN Model Convention. The paragraph reads as under:

"Under this Article, information may not be disclosed to authorities that supervise the general administration of the Government of a Contracting State, but are not involved specifically in tax matters. In their bilateral negotiations, however, Member countries may agree to provide for disclosure to such supervisory bodies."

There followed a discussion of the procedures for informing taxpayers of requests for exchanges and the different practices of various countries were noted. A member of the Group from a developing country pointed out that it was often administratively difficult to comply with requests - even on routine matters, especially for small economies. This was supported by another member from a developing country. The first member suggested that this could be avoided if the requesting country made resources available for this. Another member of the Focus Group disagreed in that this issue should not become a matter of negotiation since it was in the interests of all tax authorities to cooperate as much as possible on this. No current action was decided upon this point.

82. **Article 27**

The Focus Group took note of the proposed amendments to the text and title of article 27 by substitution of the words "Diplomatic Agents and Consular Officers" by the words "Members of Diplomatic Missions and Consular Posts" and the comments of the OECD. The suggestion to expand the scope of the article to include the officers deputed to "Permanent Missions" attached to international organizations, such as, the United Nations was not found acceptable. It was noted that even the OECD has not found it necessary to make the change in this behalf.

83. **Article 28**

The Focus Group felt that the proposals on "treaty override" had correctly not been included in the commentaries now under consideration.

84. The Focus Group decided that the draft Report of the Focus Group on its Second Meeting should be prepared expeditiously and presented before the Ninth Meeting of the Ad Hoc Group of Experts on International Cooperation in Tax Matters to be held in New York from 3 to 7 May 1999.

ATTENDANCE

The following members of the Focus Group attended the meeting:

1) Mr. John Brian Shepherd (United Kingdom)
2) Mr. Abdelali Benbrik (Morocco)
3) Mr. Antonio Hugo Figueroa (Argentina)
4) Mr. Ernst Bunders (The Netherlands)
5) Mr. M. Iqbal Farid (Pakistan)

Mr. Antonio Hugo Figueroa served as Chairman of the Focus Group; Mr. Abdel Hamid Bouab served as Secretary and Mr. Suresh Shende as Assistant Secretary. Thcy were assisted by Mr. Barry Larking as resource person to the Secretariat.

DOCUMENTATION

The Focus Group had before it the following documents:

1) United Nations Model Double Taxation Convention between Developed and Developing Countries - ST/SG/AC.8/1999/L.2
2) Draft Report of the Focus Group of the Ad Hoc Group of Experts on International Cooperation in Tax Matters on its First Meeting - ST/SG/AC.8/1998/WP.13
3) Comments and suggestions relating to the articles and commentaries of the UN Model Convention made by members of the Ad Hoc Group of Experts on International Cooperation in Tax Matters - ST/SG/AC.8/1998/WP.11
4) Modifications to be made to the commentary on the United Nations Model Double Taxation Convention between Developed and Developing Countries pursuant to the changes made to the text of the articles during the First Meeting of the Focus Group (9 & 10 December 1998) - ST/SG/AC.8/1999/L.3
5) Modifications to be made to the commentary on the United Nations Model Double Taxation Convention between Developed and Developing Countries pursuant to the comments and suggestions received from members of the Ad Hoc Group of Experts on International Cooperation in Tax Matters - ST/SG/AC.8/1999/WP.15
6) Articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries - ST/SG/AC.8/1998/WP.1/Rev.1
7) Issues in the 31 July 1998 draft of the United Nations Model Double Taxation Convention between Developed and Developing Countries requiring the attention of the Focus Group - ST/SG/AC.8/1998/WP.2

Annex I
(See paragraph 28)

Extracts of paragraphs 7 to 10 from OECD (Commentaries on Article 1)

IMPROPER USE OF THE CONVENTION

7. The purpose of double taxation conventions is to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons; they should not, however, help tax avoidance or evasion. True, taxpayers have the possibility, irrespective of double taxation conventions, to exploit differences in tax levels between States and the tax advantages provided by various countries' taxation laws, but it is for the States concerned to adopt provisions in their domestic laws to counter such manoeuvres. Such States will then wish, in their bilateral double taxation conventions, to preserve the application of provisions of this kind contained in their domestic laws.

8. Moreover, the extension of the network of double taxation conventions still reinforces the impact of such manoeuvres by making it possible, using artificial legal constructions, to benefit both from the tax advantages available under domestic laws and the tax relief provided for in double taxation conventions.

9. This would be the case, for example, if a person (whether or not a resident of a Contracting State), acts through a legal entity created in a State essentially to obtain treaty benefits that would not be available directly. Another case would be an individual who has in a Contracting State both his permanent home and all his economic interests, including a substantial shareholding in a company of that State, and who, essentially in order to sell the shares and escape taxation in that State on the capital gains from the alienation (by virtue of paragraph 4 of Article 13), transfers his permanent home to the other Contracting State, where such gains are subject to little or no tax.

10. Some of these situations are dealt with in the Convention, e.g. by the introduction of the concept of "beneficial owner" (in Articles 10, 11 and 12) and of special provisions, for so-called artiste-companies (paragraph 2 or Article 17). Such problems are also mentioned in the Commentaries on Article 10 (paragraphs 17 and 22), Article 11 (paragraph 12), and Article 12 (paragraph 7). It may be appropriate for Contracting States to agree in bilateral negotiations that any relief from tax should not apply in certain cases, or to agree that the application of the provisions of domestic laws against tax avoidance should not be affected by the Convention.

Annex II
(See paragraph 29)

Extracts of paragraph 22 to 26 from OECD (Commentaries on Article 1)

22. Other forms of abuse of tax treaties (e.g. the use of a base company) and of possible ways to deal with them such as "substance-over-form" rules and "sub-part F type" provisions have also been analysed.

(Added on 23 July 1992: see HISTORY)

23. The large majority of OECD Member countries consider that such measures are part of the basic domestic rules set by national tax law for determining which facts give rise to a tax liability. These rules are not addressed in tax treaties and are therefore not affected by them. One could invoke the spirit of the Convention, which would be violated only if a company, which is a person within the meaning of the Convention, ended up with no or almost no activity or income being attributed to it, and the Contracting States took divergent views on the subject, with economic double taxation resulting therefrom, the same income being taxed twice in the hands of two different taxpayers (cf. paragraph 2 of Article 9). A dissenting view, on the other hand, holds that such rules are subject to the general provisions of tax treaties against double taxation, especially where the treaty itself contains provisions aimed at counteracting its improper use.

(Added on 23 July 1992: see HISTORY)

24. It is not easy to reconcile these divergent opinions, either in theory or in mutual agreement procedures on specific cases. The main problem seems to be whether or not general principles such as "substance-over-form" are inherent in treaty provisions, i.e. whether they can be applied in any case, or only to the extent they are expressly mentioned in bilateral conventions. The dissenting view argues that to give domestic rules precedence over treaty rules as to who, for tax purposes, is regarded as the recipient of the income shifted to a base company, would erode the protection of taxpayers against double taxation (e.g. where by applying these rules, base company income is taxed in the country of the shareholders even though there is no permanent establishment of the base company there). However, it is the view of the wide majority that such rules, and the underlying principles, do not have to be confirmed in the text of the convention to be applicable.

(Added on 23 July 1992: see HISTORY)

25. While these and the other counteracting measures described in the reports mentioned in paragraph 11 above are not inconsistent with the spirit of tax treaties, there is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties, as long as there is no clear evidence that the treaties are being improperly used. Furthermore, it seems desirable that counteracting measures comply with the spirit of tax treaties with a view to

avoiding double taxation. Where the taxpayer complies with such counteracting measures, it might furthermore be appropriate to grant him the protection of the treaty network.

(Added on 23 July 1992: see HISTORY)

26. The majority of Member countries accept counteracting measures as a necessary means of maintaining equity and neutrality of national tax laws in an international environment characterised by very different tax burdens, but believe that such measures should be used only for this purpose. It would be contrary to the general principles underlying the Model Convention and to the spirit of tax treaties in general if counteracting measures were to be extended to activities such as production, normal rendering of services or trading of companies engaged in real industrial or commercial activity, when they are clearly related to the economic environment of the country where they are resident in a situation where these activities are carried out in such a way that no tax avoidance could be suspected. Counteracting measures should not be applied to countries in which taxation is comparable to that of the country of residence of the taxpayer.

(Added on 23 July 1992: see HISTORY)

Annex III

Extracts of paragraph 37 to 67 from OECD (Commentaries on Article 10 paragraph 5)

37. It might be argued that where the taxpayer's country of residence, pursuant to its counteracting measures (such as sub-Part F legislation in the United States), seeks to tax profits which have not been distributed it is acting contrary to the provisions of paragraph 5. However, it should be noted that the paragraph is confined to taxation at source and, thus, has no bearing on the taxation at residence under a counteracting legislation. In addition, the paragraph concerns only the taxation of the company and not that of the shareholder.

(Replaced on 23 July 1992: see HISTORY)

38. The application of counteracting legislation may, however, pose some difficulties. If the income is attributed to the taxpayer then each item of the income would have to be treated under the relevant provisions of the Convention (business profits, interest, royalties). If the amount is treated as a deemed dividend then it is clearly derived from the base company thus constituting income from that company's country. Even then, it is by no means clear whether the taxable amount is to be regarded as a dividend within the meaning of Article 10 or as "other income" within the meaning of Article 21. Under some counteracting measures the taxable amount is treated as a dividend with the result that an exemption provided for by a tax convention, e.g. an affiliation exemption, is also extended to it (for instance, in Germany). It is doubtful whether the Convention requires this to be done. If the country of residence considers that this is not the case it may face the allegation that it is obstructing the normal operation of the affiliation exemption by taxing the dividend (in the form of "deemed dividend") in advance.

(Replaced on 23 July 1992: see HISTORY)

39. Where dividends are actually distributed by the base company, the provisions of a bilateral convention regarding dividends have to be applied in the normal way because there is dividend income within the meaning of the convention. Thus, the country of the base company may subject the dividend to a withholding tax. The country of residence of the shareholder will apply the normal methods for the elimination of double taxation (i.e. tax credit or tax exemption is granted). This implies that the withholding tax on the dividend should be credited in the shareholder's country of residence, even if the distributed profit (the dividend) has been taxed years before under counteracting legislation. However, the obligation to give credit in that case remains doubtful. Generally the dividend as such is exempted from tax (as it was already taxed under the counteracting legislation) and one might argue that there is no basis for a tax credit. On the other hand, the purpose of the treaty would be frustrated if the crediting of taxes could be avoided by simply anticipating the dividend taxation under counteracting legislation. The general principle set out above would suggest that the credit should be granted, though the details may depend on the technicalities of the counteracting

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measures and the system for crediting foreign taxes against domestic tax, as well as on the particularities of the case (e.g. time lapsed since the taxation of the "deemed dividend"). However, taxpayers who have recourse to artificial arrangements are taking risks against which they cannot fully be safeguarded by tax authorities.

(Replaced on 23 July 1992: see HISTORY)

III. Effects of special features of the domestic tax laws of certain countries

40. Certain countries' laws seek to avoid or mitigate economic double taxation i.e. the simultaneous taxation of the company's profits at the level of the company and of the dividends at the level of the shareholder. There are various ways of achieving this:

- company tax in respect of distributed profits may be charged at a lower rate than that on retained profits;
- relief may be granted in computing the shareholder's personal tax;
- dividends may bear only one tax, the distributed profits not being taxed at the level of the company.

The Committee on Fiscal Affairs has examined the question whether the special features of the tax laws of the Member countries would justify solutions other than those contained in the Model Convention.

(Renumbered and amended on 23 July 1992: see HISTORY)

A. Dividends distributed to individuals

41. In contrast to the notion of juridical double taxation, which has, generally, quite precise meaning, the concept of economic double taxation is less certain. Some States do not accept the validity of this concept and others, more numerously, do not consider it necessary to relieve economic double taxation at the national level (dividends distributed by resident companies to resident shareholders). Consequently, as the concept of economic double taxation was not sufficiently well defined to serve as a basis for the analysis, it seemed appropriate to study the problem from a more general economic standpoint, i.e. from the point of view of the effects which the various systems for alleviating such double taxation can have on the international flow of capital. For this purpose, it was necessary to see, among other things, what distortions and discriminations the various national systems could create; but it was necessary to have regard also to the implications for States' budgets and for effective fiscal verification, without losing sight of the principle of reciprocity that underlies every convention. In considering all these aspects, it became apparent that the burden represented by company tax could not be wholly left out of account.

(Renumbered on 23 July 1992: see HISTORY)

1. States with the classical system

42. The Committee has recognised that economic double taxation need not be relieved at the international level when such double taxation remains unrelieved at the national level. It therefore considers that in relations between two States with the classical system, i.e. States which do not relieve economic double taxation, the respective levels of company tax in the Contracting States should have no influence on the rate of withholding tax on the dividend in the State of source (rate limited to 15 per cent by sub sub-paragraph *b)* of paragraph 2 of Article 10). Consequently, the solution recommended in the Model Convention remains fully applicable in the present case.

(Renumbered and amended on 23 July 1992: see HISTORY)

2. States applying a split rate company tax

43. These States levy company tax at different rates according to what the company does with its profits: the high rate is charged on any profits retained and the lower rate on those distributed.

(Renumbered, heading and paragraph amended on 23 July 1992: see HISTORY)

44. None of these States, in negotiating double taxation conventions, has obtained, on the grounds of its split rate of company tax, the right to levy withholding tax of more than 15 per cent (cf. sub-paragraph *b)* of paragraph 2 of Article 10) on dividends paid by its companies to a shareholder who is an individual resident in the other State.

(Renumbered on 23 July 1992: see HISTORY)

45. The Committee considered whether such a State (State B) should not be recognised as being entitled to levy withholding tax exceeding 15 per cent on dividends distributed by its companies to residents of a State with a classical system (State A), with the proviso that the excess over 15 per cent, which would be designed to offset, in relatiion to the shareholder concerned, the effects of the lower rate of company tax on distributed profits of companies of State B, would not be creditable against the tax payable by the shareholder in State A of which he is a resident.

(Renumbered and amended on 23 July 1992: see HISTORY)

46. Most Member countries considered that in State B regard should be had to the average level of company tax, and that such average level should be considered as the counterpart to the charge levied in the form of a single-rate tax on companies resident of State A. The levy by State B of an additional withholding tax not credited in State A would, moreover, create twofold discrimination: on the one hand, dividends, distributed by a company resident of State B would be more heavily taxed when distributed to residents of State A than when distributed to residents of State B, and, on the other hand, the resident of State A would pay higher personal tax on his dividends from State B than on his dividends from State A. The idea of a "balancing tax" was not, therefore, adopted

by the Committee.

(Renumbered and amended on 23 July 1992: see HISTORY)

3. States which provide relief at the shareholder's level

47. In these States, the company is taxed on its total profits, whether distributed or not, and the dividends are taxed in the hands of the resident shareholder (an individual); the latter, however, is entitled to relief, usually as a tax credit against his personal tax, on the grounds that in the normal course at least the dividend has borne company tax as part of the company's profits.

(Renumber and heading amended on 23 July 1992: see HISTORY)

48. Internal law of these States does not provide for the extension of the tax relief to the international field. Relief is allowed only to residents and only in respect of dividends of domestic sources. However, as indicated below, some States have, in some conventions, extended the right to the tax credit provided for in their legislation to residents of the other Contracting State.

(Renumbered and amended on 23 July 1992: see HISTORY)

49. In many States that provide relief at the shareholder's level, the resident shareholder receives a credit in recognition of the fact that the profits out of which the dividends are paid have already been taxed in the hands of the company. The resident shareholder is taxed on his dividend grossed up by the tax credit; this credit is set off against the tax payable and can possibly give rise to a refund. In some double taxation conventions, some countries that apply this system have agreed to extend the credit to shareholders who are residents of the other Contracting State. Whilst most States that have agreed to such extensions have done so on a reciprocal basis, a few countries have concluded conventions where they unilaterally extend the benefits of the credit to residents of the other Contracting State.

(Renumbered and amended on 23 July 1992: see HISTORY)

50. Some States that also provide relief at the shareholder's level claim that under their systems the company tax remains in its entirety a true company tax, in that it is charged by reference solely to the company's own situation, without any regard to the person and the residence of the shareholder, and in that, having been so charged, it remains appropriated to the Treasury. The tax credit given to the shareholder is designed to relieve his personal tax liability and in no way constitutes an adjustment of the company's tax. No refund, therefore, is given if the tax credit exceeds that personal tax.

(Renumbered and amended on 23 July 1992: see HISTORY)

51. The Committee could not reach a general agreement on whether the systems of

the States referred to in paragraph 50 above display a fundamental difference that could justify different solutions at the international level.

(Renumbered and amended o 23 July 1992: see HISTORY)

52. Some Member countries were of the opinion that such a fundamental difference does not exist. This opinion leaves room for the conclusion that the States referred to in paragraph 50 above should agree to extend the tax credit to non-resident shareholders, at least on a reciprocal basis, in the same way as some of the countries referred to in paragraph 49 above do. Such a solution tends to ensure neutrality as regards dividends distributed by companies of these countries, the same treatment being given to resident and non-resident shareholders. On the other hand, it would in relation to shareholders who are residents of a Contracting State (a State with a classical system in particular) encourage investment in a State that provide relief at the shareholder's level since residents of the first State would receive a tax credit (in fact a refund of company tax) for dividends from the other State while they do not receive one for dividends from their own country. However, these effects are similar to those which present themselves between a State applying a split rate company tax and a State with a classical system or between two States with a classical system one of which has a lower company tax rate than the other (paragraphs 42 and 43 to 46 above).

(Renumbered and amended on 23 July 1992: see HISTORY)

53. On the other hand, many Member countries stressed the fact that a determination of the true nature of the tax relief given under the systems of the States referred to in paragraph 50 above reveals a mere alleviation of the shareholder's personal income tax in recognition of the fact that his dividend will normally have borne company tax. The tax credit is given once and for all *(forfaitaire)* and is therefore not in exact relation to the actual company tax appropriate to the profits out of which the dividend is paid. There is no refund if the tax credit exceeds the personal income tax.

(Renumbered and amended on 23 July 1992: see HISTORY)

54. As the relief in essence is not a refund of company tax but an alleviation of the personal income tax, the extension of the relief to non-resident shareholders who are not subject to personal income tax in the countries concerned does not come into consideration. On the other hand, however, on this line of reasoning, the question whether States which provide relief at the shareholder's level should give relief against personal income tax levied from resident shareholders on foreign dividends deserves attention. In this respect it should be observed that the answer is in the affirmative if the question is looked at from the standpoint of neutrality as regards the source of the dividends; otherwise, residents of these States will be encouraged to acquire shares in their own country rather than abroad. But such an extension of the tax credit would be contrary to the principle of reciprocity: not only would the State concerned thereby be making a unilateral budgetary sacrifice (allowing the tax credit over and above the withholding tax levied in the other State), but it would do so without receiving any

economic compensation, since it would not be encouraging residents of the other State to acquire shares in its own territory.

(Renumbered and amended on 23 July 1992: see HISTORY)

55. To overcome these objections, it might be a conceivable proposition, amongst other possibilities, that the State of source which will have collected company tax on dividends distributed by resident companies should bear the cost of the tax credit that a State which provide relief at the shareholder's level would allow, by transferring funds to that State. As, however, such transfers are hardly favoured by the States this might be more simply achieved by means of a "compositional" arrangement under which the State of source would relinquish all withholding tax on dividends paid to residents of the other State, and the latter would then allow against its own tax, not the 15 per cent withholding tax (abolished in the State of source) but a tax credit similar to that which it gives on dividends of domestic source.

(Renumbered and amended on 23 July 1992: see HISTORY)

56. When everything is fully considered, it seems that the problem can be solved only in bilateral negotiations, where one is better placed to evaluate the sacrifices and advantages which the Convention must bring for each Contracting State.

(Renumbered on 23 July 1992: see HISTORY)

57. (Deleted on 31 March 1994: see HISTORY)

58. (Deleted on 31 March 1994: see HISTORY)

B. Dividends distributed to companies

59. Comments above relating to dividends paid to individuals are generally applicable to dividends paid to companies which hold less than 25 per cent of the capital of the company paying the dividends. Moreover, the Committee on Fiscal Affairs has not covered in the Commentary the special problem of dividends paid to collective investment institutions (investment companies or investment funds).

(Renumbered and footnote deleted on 23 July 1992: see HISTORY)

60 In respect of dividends paid to companies which hold at least 25 per cent of the capital of the company paying the dividends, the Committee has examined the incidence which the particular company taxation systems quoted in paragraphs 42 and following have on the tax treatment of dividends paid by the subsidiary.

(Renumbered and amended on 23 July 1992: see HISTORY)

61. Various opinions were expressed in the course of the discussion. Opinions

diverge even when the discussion is limited to the taxation of subsidiaries and parent companies. They diverge still more if the discussion takes into account more general economic considerations and extends to the taxation of shareholders of the parent company.

(Renumbered on 23 July 1992: see HISTORY)

62 In their bilateral conventions States have adopted different solutions, which were motivated by the economic objectives and the peculiarities of the legal situation of those States, by budgetary considerations, and by a whole series of other factors. Accordingly, no generally accepted principles have emerged. The Committee did nevertheless consider the situation for the more common systems of company taxation.

(Renumbered on 23 July 1992: see HISTORY)

1. Classical system in the State of the subsidiary (paragraph 42 above)

63. The provisions of the Convention have been drafted to apply when the State of which the distributing company is a resident has a so-called "classical" system of company taxation, namely one under which distributed profits are not entitled to any benefit at the level either of the company or of the shareholder (except for the purpose of avoiding recurrent taxation of inter-company dividends).

(Renumbered and heading amended on 23 July 1992: see HISTORY)

2. Split-rate company tax system in the State of the subsidiary (paragraphs 43 to 46 above)

64. States of this kind collect company tax on distributed profits at a lower rate than on retained profits which results in a lower company tax burden on profits distributed by a subsidiary to its parent company. In view of this situation, most of these States have obtained, in their conventions, rates of tax at source of 10 or 15 per cent, and in some cases even above 15 per cent. It has not been possible in the Committee to get views to converge on this question, the solution of which is left to bilateral negotiations.

(Renumbered and heading amended on 23 July 1992: see HISTORY)

3. Imputation system in the State of the subsidiary (paragraph 47 and following)

65. In such States, a company is liable to tax on the whole of its profits, whether distributed or not; the shareholders resident of the State of which the distributing company is itself a resident are subject to tax on dividends distributed to them, but receive a tax credit in consideration of the fact that the profits distributed have been taxed at company level.

(Renumbered and heading amended on 23 July 1992: see HISTORY)

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66. The question has been considered whether States of this kind should extend the benefit of the tax credit to the shareholders of parent companies resident of another State, or even to grant the tax credit directly to such parent companies. It has not been possible in the Committee to get views to converge on this question, the solution of which is left to bilateral negotiations.

(Renumbered and footnote deleted on 23 July 1992: see HISTORY)

67. If, in such a system, profits, whether distributed or not, are taxed at the same rate, the system is not different from a "classical" one at the level of the distributing company. Consequently, the State of which the subsidiary is a resident can only levy a tax at source at the rate provided in sub-paragraph *a)* of paragraph 2.

(Renumbered on 23 July 1992: see HISTORY)

Observation on the Commentary

68. *Canada* and the *United Kingdom* do not adhere to paragraph 24 above. Under their law, certain interest payments are treated as distributions, and are therefore included in the definition of dividends.

(Renumbered and amended on 23 July 1992: see HISTORY)

Annex III-A

Non-Member Countries' Positions

POSITIONS ON ARTICLE 1 (PERSONS COVERED) AND ITS COMMENTARY

Positions on the Article

1. The *Philippines* reserves the right to tax its citizens in accordance with its domestic law.

2. *Brazil* reserves the right to extend coverage of the Convention to partnerships since partnerships are considered to be legal entities under its legislation.

POSITIONS ON ARTICLE 2 (TAXES COVERED) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

1. Wherever the terms "capital" and "movable property" appear in the Convention, *Belarus* reserves the right to replace these terms, which do not exist in its domestic law, by "property" and "property other than immovable property" respectively.

2. *Brazil* reserves its position on that part of paragraph 1 which states that the Convention should apply to taxes of political subdivisions or local authorities, as well as on the final part of the paragraph which reads "irrespective of the manner in which they are levied".

3. Since it has no tax on capital, *Brazil* reserves its right not to include any reference to such tax in paragraph 1.

4. *Romania* reserves the right to include taxes imposed on behalf of administrative-territorial units.

5. *South Africa* reserves its position on that part of paragraph 1 which states that the Convention should apply to taxes of local authorities.

Paragraph 2

6. *Brazil* wishes to use, in its conventions, a definition of income tax that is in accordance with its constitutional legislation. Accordingly, it reserves the right not to include paragraph 2 in its conventions.

7. *Estonia, Latvia, Lithuania, Romania* and *Russia* hold the view that "taxes on the total amounts of wages or salaries paid by enterprises" should not be regarded as taxes on income and therefore reserve the right not to include these words in paragraph 2.

8. *Ukraine* reserves its position on that part of paragraph 2 which states that the Convention shall apply to taxes on capital appreciation.

Paragraph 4

9. *Argentina, China, Estonia, Latvia, Lithuania, Romania, Russia, South Africa, Thailand* and *Vietnam* wish to confine the obligation to exchange information to significant or important changes in tax laws as they occur from time to time.

POSITIONS ON ARTICLE 3 (GENERAL DEFINITIONS) AND ITS COMMENTARY

Positions on the Article

1. With respect to the definition of "company", *Belarus* reserves the right to replace the concept of "body corporate", which does not exist in its domestic law, by "any legal person or any entity which is treated as a separate entity for tax purposes".

2. With respect to the definition of "national", *Lithuania* reserves the right to include in that definition the words "or other entity" to cover all entities deriving their status from the laws in force in Lithuania.

3. With respect to the definition of "national", *Romania* and *Russia* reserve the right to replace the term "nationality" by "citizenship" as the term "nationality" does not mean "citizenship" under their law.

POSITIONS ON ARTICLE 4 (RESIDENT) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

1. *Belarus, Estonia, Latvia, Lithuania, Russia, Thailand, Ukraine* and *Vietnam* reserve the right to include the place of incorporation (registration for Belarus) or a similar criterion in paragraph 1.

2. As *South Africa* does not have a concept of residence for tax purposes in view of its territorial tax system, it reserves the right to use the terms "ordinarily resident" and "place of effective management" in paragraph 1 for the purposes of identifying residents of South Africa.

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3. *Brazil* reserves the right not to include the second sentence of paragraph 1 in its conventions as the position of diplomatic staff is dealt with under its domestic law.

4. *Russia* reserves the right to amend the Article in its tax conventions in order to specify that Russian partnerships must be considered as residents of Russia in view of their legal and tax characteristics.

Paragraph 3

5. *Belarus, Thailand* and *Vietnam* reserve the right to use the place of incorporation (registration for Belarus) as the test for paragraph 3.

6. *China* reserves its position on the provisions in this and other articles of the Convention which refer directly or indirectly to the place of effective management. Instead of the term "place of effective management", China wishes to use in its conventions the term "head office".

7. *Belarus* reserves the right to replace paragraph 3 (if the other Contracting State does not agree to the use of the place of registration in this paragraph) by a provision that will refer to the mutual agreement procedure for the determination of the country of residence in the case of actual resident person other than an individual.

8. *Estonia, Latvia* and *Lithuania* reserve the right to replace paragraph 3 by a provision that will refer to the mutual agreement procedure for the determination of the country of residence in the case of a dual resident person other than an individual and, in the absence of such an agreement, that will deny benefits under the Convention to this person.

Positions on the Commentary

Paragraph 2

9. In the opinion of Vietnam the personal relations and economic relations mentioned in paragraphs 14 and 15 of the Commentary should be separated and one given priority over the other. For Vietnam, economic relations, particularly the criterion of the country where employment is exercised, is more important to determine the country of residence for treaty purposes in the case of a dual resident individual.

Paragraph 3

10. The interpretation by *Argentina, Ukraine* and *Vietnam* of the term "place of effective management" is practical day to day management, irrespective of where the overriding control is exercised.

POSITIONS ON ARTICLE 5 (PERMANENT ESTABLISHMENT) AND ITS COMMENTARY

Positions on the Article

1. Considering the special problems in applying the provisions of the Model Convention to activities carried on offshore in a Contracting State in connection with the exploration or exploitation of the sea bed, its subsoil and their natural resources, *Latvia* and *Lithuania* reserve the right to insert in a special Article provisions relating to such activities.

Paragraph 2

2. In paragraph 2, in addition to "the extraction of" natural resources, *Argentina,* the *Philippines, Russia* and *Thailand* reserve the right to refer to the "exploration for" such resources. *Argentina* also reserves the right to include in the paragraph places where fishing activities take place.

3. *Malaysia* reserves the right to add to paragraph 2 an additional sub-paragraph that would cover a farm or plantation.

4. *Thailand* and *Vietnam* reserve the right to add to paragraph 2 an additional sub-paragraph that would cover a warehouse in relation to a person supplying storage facilities for others.

5. *Ukraine* reserves the right to add to paragraph 2 an additional sub-paragraph that would cover an installation, or structure for the exploration for natural resources and a warehouse or other structure used for the sale of goods.

6. *Vietnam* reserves the right to add to paragraph 2 an additional sub-paragraph that would cover an installation, structure or equipment used for the exploration for natural resources.

Paragraph 3

7. *Argentina* reserves its position on paragraph 3 and considers that any building site or construction, assembly, or installation project that lasts more than three months should be regarded as a permanent establishment.

8. *Brazil, Thailand* and *Vietnam* reserve their position on paragraph 3 as they consider that any building site or construction, assembly or installation project which lasts more than six months should be regarded as a permanent establishment.

9. *Estonia, Latvia* and *Lithuania* reserve their position on paragraph 3 and consider that any building site, construction, assembly or installation project or a supervisory or

consultancy activity connected therewith constitutes a permanent establishment if such site, project or activity lasts for a period of more than six months.

10. *China* and *South Africa* reserve their right to negotiate the period of time after which a building site or construction, assembly, or installation project should be regarded as a permanent establishment under paragraph 3.

11. *Argentina, China, Romania, South Africa, Thailand* and *Vietnam* reserve the right to treat an enterprise as having a permanent establishment if the enterprise carries on supervisory activities in connection with a building site or a construction, assembly, or installation project that constitute a permanent establishment under paragraph 3.

12. *Argentina* reserves the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services, including consultancy services, 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 three months.

13. *Romania* reserves the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services, including consultancy services through employees or other personnel engaged by the enterprise for such purpose but only where such activities continue for the same project or a connected project for a period or periods aggregating more than a period to be negotiated.

14. *South Africa, Thailand* and *Vietnam* reserve the right to treat an enterprise as having a permanent establishment if the enterprise furnishes services, including consultancy services, 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.

Paragraph 4

15. *Argentina, Russia, Thailand, Ukraine* and *Vietnam* reserve their position on paragraph 4 as they consider that the term "delivery" should be deleted from sub-paragraphs *a)* and *b).*

16. *Argentina, Brazil, Russia* and *Thailand* reserve their position on sub-paragraph 4*f)*.

Paragraph 5

17. *Russia, Thailand, Ukraine* and *Vietnam* reserve the right to treat an enterprise as having a permanent establishment if a person acting on behalf of the enterprise habitually maintains a stock of goods or merchandise in a Contracting State from which

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the person regularly delivers goods or merchandise on behalf of the enterprise.

Paragraph 6

18. *Estonia, Latvia, Lithuania, Thailand* and *Vietnam* reserve the right to make clear that an agent whose activities are conducted wholly or almost wholly on behalf of a single enterprise will not be considered an agent of an independent status

19. *Romania, Thailand* and *Vietnam* reserve the right to provide that an insurance enterprise of a Contracting State shall, except with respect to re-insurance, be deemed to have a permanent establishment in the other Contracting State if it collects premiums in the territory of that other state or insures risks situated therein through a person other than an agent of an independent status to whom paragraph 6 applies.

Positions on the Commentary

20. *Vietnam* does not agree with the words "The twelve month test applies to each individual site or project" found in paragraph 18 of the Commentary. Vietnam considers that a series of consecutive short term sites or projects operated by a contractor would give rise to the existence of a permanent establishment in the country concerned.

POSITIONS ON ARTICLE 6 (INCOME FROM IMMOVABLE PROPERTY) AND ITS COMMENTARY

Positions on the Article

Paragraph 2

1. Given the meaning of the term "immovable property" under its domestic law, *Belarus* reserves the right to omit the second sentence of this paragraph.

2. *Estonia, Latvia* and *Lithuania* reserve the right to include in the definition of the term "immovable property" any option or similar right to acquire immovable property.

3. *Lithuania* reserves the right to modify the second sentence of the definition of the term "immovable property" to make clear that the sentence does not apply for domestic law purposes.

Paragraph 3

4. *Estonia, Latvia* and *Lithuania* reserve the right to include in paragraph 3 a reference to income from the alienation of immovable property.

5. *Estonia, Latvia* and *Lithuania* also reserve the right to tax income of shareholders

in resident companies from the direct use, letting, or use in any other form of the right to enjoyment of immovable property situated in their country and held by the company, where such right is based on the ownership of shares or other corporate rights in the company.

POSITIONS ON ARTICLE 7 (BUSINESS PROFITS) AND ITS COMMENTARY

Positions on the Article

1. *Argentina* reserves the right to include a special provision in the Protocol to the Convention that will permit it to apply its domestic law in relation to the taxation of the profits of an insurance and re-insurance enterprise.

2. *Malaysia, Thailand, Ukraine* and *Vietnam* reserve the right to add a provision to the effect that, if the information available to the competent authority of a Contracting State is inadequate to determine the profits to be attributed to the permanent establishment of an enterprise, the competent authority may apply to that enterprise the provisions of the taxation law of that State, subject to the qualification that such law will be applied, so far as the information available to the competent authority permits, in accordance with the principles of this Article.

Paragraph 1

3. *Argentina* and *Thailand* reserve the right to tax in the State where the permanent establishment is situated business profits derived from the sale of goods or merchandise which are the same as or of a similar kind to the ones sold through a permanent establishment situated in that State or from other business activities carried on in that State of the same or similar kind as those effected through that permanent establishment. They will apply this rule only as a safeguard against abuse and not as a general "force of attraction principle". thus, the rule will not apply when the enterprise proves that the sales or activities have been carried out for reasons other than obtaining a benefit under the Convention.

4. *Estonia, Latvia* and *Lithuania* reserve the right to tax in the State where the permanent establishment is situated business profits derived from the sale of goods or merchandise which are the same as or of a similar kind to the ones sold through a permananet establishment situated in that State or from other business activities carried on in that State of the same or similar kind as those effected through that permanent establishment.

Paragraph 3

5. With respect to paragraph 3. *Argentina* reserves the right to provide that a Contracting State shall not be obliged to allow the deduction of expenses incurred

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abroad which are not reasonably attributable to the activity carried on by the permanent establishment, taking into account the general principles contained in domestic legislation concerning executive and administrative expenses for assistance services.

6. *Brazil* reserves its position on the words "whether in the State in which the permanent establishment is situated or elsewhere " found in paragraph 3.

7. *Estonia, Latvia, Lithuania* and *Romania* reserve the right to add to paragraph 3 a clarification that expenses to be allowed as deductions by a Contracting State shall include only expenses that are deductibe under the domestic laws of that State.

8. *Ukraine* and *Vietnam* reserve the right to add to paragraph 3 a clarification to the effect that the paragraph refers to actual expenses incurred by the enterprise (other than interest in the case of a banking enterprise).

Paragraph 4

9. *Brazil* reserves the right not to adopt paragraph 4.

10. *Estonia* reserves the right to include a provision that will permit resort to domestic law in relation to the taxation of an insurance enterprise.

Paragraph 6

11. *Brazil* reserves the right not to adopt paragraph 6.

POSITIONS ON ARTICLE 8 (SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT) AND ITS COMMENTARY

Positions on the Article

1. *Estonia, Latvia* and *Lithuania* reserve the right in exceptional cases to apply the permanent establishment rule in relation to profits derived from the operation of ships in international traffic.

Paragraph 1

2. The *Philippines* reserves the right to provide for taxation of the profits from shipping and air transport in accordance with domestic law.

3. *Slovakia* reserves the right to tax under Article 12 profits from the leasing of ships, aircraft and containers.

4. *South Africa* reserves the right to include in paragraph 1 profits from the leasing of containers.

5. *Thailand* reserves the right to provide for taxation of the profits from shipping in accordance with domestic law.

6. *South Africa* and *Ukraine* reserve the right to include a provision that will ensure that profits from the leasing of ships or aircraft on a bare boat basis and, in the case of Ukraine, from the leasing of containers, will be treated in the same way as income covered by paragraph 1 when such profits are incidental to international transportation.

Paragraph 2

7. *Brazil, China, Malaysia, South Africa* and *Vietnam* reserve the right not to extend the scope of the Article to cover inland transportation in bilateral conventions.

Positions on the Commentary

8. *Vietnam* disagrees with the interpretation presented in paragraph 5 of the Commentary

9. *Vietnam* disagrees with the interpretation presented in paragraph 10 of the Commentary in relation to the incidental leasing of containers.

POSITIONS ON ARTICLE 9 (ASSOCIATED ENTERPRISES) AND ITS COMMENTARY

Positions on the Article

1. *Brazil, Malaysia, Russia, Thailand* and *Vietnam* reserve the right not to insert paragraph 2 in their conventions.

2. *South Africa* reserves the right to replace "shall" by "may" in the first sentence of paragraph 2 in its conventions.

POSITIONS ON ARTICLE 10 (DIVIDENDS) AND ITS COMMENTARY

Positions on the Article

1. *Argentina* and *Thailand* reserve the right to apply a 10 per cent rate of tax at source in the case referred to in sub-paragraph *a)*

2. *Brazil* reserves the right to tax all dividends referred to in paragraph 2 at a uniform rate to be negotiated.

3. *Estonia, Latvia, Lithuania* and *Romania* reserve the right not to include the requirement for the competent authorities to settle by mutual agreement the mode of

application of paragraph 2.

4. *Israel* reserves its position on the rates provided for in paragraph 2, especially with respect to dividends which are distributed out of the profits of an "approved enterprise" according to its law for the encouragement of investment.

5. *Romania* reserves the right to tax at a uniform rate to be negotiated all dividends referred to in this paragraph.

6. *Russia* and *South Africa* reserve their position on the rates of tax in paragraph 2 and the minimum percentage for the holding in sub-paragraph *a)*.

7. *Vietnam* reserves the right to tax, at a uniform rate of not less than 10 per cent, all dividends referred to in paragraph 2.

Paragraph 3

8. *Argentina* reserves the right to include a provision that will allow it to apply the thin capitalization measures of its domestic law notwithstanding any other provisions of the Convention.

9. As their legislation does not provide for such concepts as "jouissance" shares, "jouissance" rights, mining shares and founders' shares, *Belarus* and *Vietnam* reserve the right to omit them from paragraph 3.

10. *Estonia, Latvia* and *Lithuania* reserve the right to replace, in paragraph 3, the words, "income from other corporate rights" by "income from other rights".

Paragraph 5.

11. *Argentina, Romania* and *Russia* reserve the right to apply a branch profits tax.

12. *Brazil* reserves the right to levy withholding tax on profits of a permanent establishment at the same rate of tax as is provided in paragraph 2, as is the traditional rule in the Brazilian income tax system.

13. *Thailand* reserves the right to levy tax on distributions by non-resident companies of profits arising within its territory.

14. *Vietnam* reserves the right to levy its profit remittance tax at rates not exceeding 10 per cent.

POSITIONS ON ARTICLE 11 (INTEREST)
AND ITS COMMENTARY'

Positions on the Article

1. *Ukraine* reserves the right to exclude from the scope of the Article interest on a debt claim where the main purpose or one of the main purposes of any person concerned with the creation or assignment of the debt-claim in respect of which the interest is paid is to take advantage of this Article and not for *bona fide* commercial reasons.

Paragraph 2

2. *Argentina, Brazil,* the *Philippines, Romania, Slovakia, Thailand* and *Ukraine* reserve their positions on the rate provided for in paragraph 2.

3. *Brazil* reserves the right to add to its conventions a paragraph dealing with interest paid to a government of a Contracting State or one of its political subdivisions or a local authority thereof or any agency (including a financial institution) wholly owned by the said government and stating that such interest is taxable only in the State of resident of the creditor. However, if interest is paid by a government of a Contracting State or one of its political subdivisions or a local authority thereof or any agency (including a financial institution) wholly owned by the said government, such interest shall be taxable only in that Contracting State (i.e. in the State of source).

4. *Estonia, Latvia, Lithuania* and *Romania* reserve the right not to include the requirement for the competent authorities to settle by mutual agreement the mode of application of paragraph 2.

Paragraph 3

5. *Brazil, Thailand* and *Ukraine* reserve the right to regard penalty charges for late payment as interest for the purposes of this Article, in accordance with their domestic law.

6. *Malaysia* reserves the right to exclude premiums or prizes from the definition of interest, in accordance with the treatment of such payments under its domestic law.

7. *Brazil* reserves the right to consider as interest any other income assimilated to income from money lent by the tax law of the Contracting State in which the income arises.

Paragraph 4

8. *Brazil* reserves the right to provide that where interest is paid to a permanent establishment of a resident of the other Contracting State situated in a third State, the limit on the rate of taxation of interest in paragraph 2 shall not apply.

Positions on the Commentary

9. *Malaysia* does not agree with paragraph 20 of the Commentary as under Malaysian domestic legislation, premiums or prizes are not taxable.

POSITIONS ON ARTICLE 12 (ROYALTIES) AND ITS COMMNETARY

Positions on the Article

1. *Ukraine* reserves the right to exclude from the scope of this Article royalties arising from property or rights created or assigned mainly for the purpose of taking advantage of this Article and not for *bona fide* commercial reasons.

2. *Romania* reserves the right to include an additional article dealing with commissions. This article has the same structure as Article 11 on interest.

Paragraph 1

3. *Argentina, Belarus, Brazil, China, Estonia, Israel, Latvia, Lithuania, Malaysia,* the *Philippines, Romania, Russia, South Africa, Thailand, Ukraine* and *Vietnam* reserve the right to tax royalties at source.

4. *Slovakia* reserves the right to tax royalties at source but is prepared to exempt from tax copyright royalties in respect of a cultural, dramatic, musical or artistic work, but not including royalties in respect of motion picture films and works on film or videotape or other means of reproduction for use in connection with television.

Paragraph 2

5. *Argentina, Brazil, Russia* and *Thailand* reserve the right to continue to include in the definition of royalties income derived from the leasing of industrial, commercial or scientific equipment and of containers, as provided for in paragraph 2 of Article 12 of the 1977 Model Double taxation Convention.

6. *Argentina,* the *Philippines* and *Thailand* reserve the right to include fees for technical services in the definition of royalties.

7. *Brazil* reserves the right to include fees for technical assistance and technical services in the definition of "royalties".

8. *Belarus, China, Estonia, Latvia, Lithuania,* the *Philippines, Romania* and *Slovakia* reserve the right to include in the definition of royalties payments for the use of, or the right to use, industrial, commercial or scientific equipment.

9. *Belarus* reserves the right to include a reference to transport vehicles in the definition of royalties.

10. *Brazil, Estonia, Latvia, Lithuania* and *Romania* reserve the right to include in the definition of the royalties payments for transmissions by satellite, cable, optic fibre or similar technology.

11. *Malaysia, Russia* and *Vietnam* reserve the right to deal with fees for technical services in a separate article similar to Article 12.

12. *Argentina, Belarus, Brazil, China, Estonia, Latvia, Lithuania, Malaysia,* the *Philippines, Romania, South Africa, Thailand, Ukraine* and *Vietnam* reserve the right, in order to fill what they consider as a gap in the Article, to add a provision defining the source of royalties by analogy with the provisions of paragraph 5 of Article 11, which deals with the same issue in the case of interest.

Positions on the Commentary

13. *Argentina* and *Slovakia* do not adhere to the interpretation in paragraphs 14 and 15 of the Commentary. They hold the view that payments relating to software fall within the scope of the Article where less than the full rights to software are transferred, either if the payments are in consideration for the right to use a copyright on software for commercial exploitation or if they relate to software acquired for the personal or business use of the purchaser.

14. *Vietnam* does not agree with paragraph 9 of the Commentary. Even if the phrase "for the use of, or the right to use, industrial, commercial or scientific equipment" is not included in paragraph 2 and income from the leasing of equipment falls under Article 7, the fact that an enterprise of a Contracting State leases heavy equipment to a person resident in Vietnam will constitute a permanent establishment of that enterprise in Vietnam.

POSITIONS ON ARTICLE 13 (CAPITAL GAINS)
AND ITS COMMENTARY

Positions on the Article

1. *Argentina* and *Brazil* reserve the right to tax at source gains from the alienation of property situated in a Contracting State other than property mentioned in paragraphs 1, 2 and 3.

2. *Israel* and *Thailand* reserve the right to tax gains from the alienation of shares or rights that are part of a substantial participation in a resident company.

3. *Latvia* and *Lithuania* reserve the right to insert in a special Article provisions regarding capital gains relating to activities carried on offshore in a Contracting State in connection with the exploration or exploitation of the sea bed, its subsoil and their natural resources.

4. *Estonia, Latvia* and *Lithuania* reserve the right to limit the application of paragraph 3 to enterprises operating ships and aircraft in international traffic.

5. *Vietnam* reserves the right to tax gains from the alienation of shares or rights in a company that is a resident of Vietnam.

6. *Estonia, Israel, Latvia, Lithuania, Romania, Thailand, Ukraine* and *Vietnam* reserve the right to tax gains from the alienation of shares or rights of a company the assets of which consist mainly of immovable property situated in the State. Ukraine also reserves the right to tax gains from the alienation of contributions (rights) related to shares mentioned in the preceding sentence.

POSITIONS ON ARTICLE 14 (INDEPENDENT PERSONAL SERVICES) AND ITS COMMENTARY

Positions on the Article

1. *Argentina* reserves the right to levy tax in an amount not exceeding 10 per cent of the gross income in respect of professional services or other activities of an independent character performed in Argentina where there is no fixed base and to apply its domestic law where there is a fixed base.

2. *Belarus* reserves the right to include in the Article a definition of fixed base that would provide that this term means a fixed place, such as an office or room, through which the activity of an individual performing independent personal services is wholly or partly carried on.

3. *Brazil* and *Malaysia* do not use the concept of fixed base in their conventions and modify accordingly the Article and other Articles that refer to that concept.

4. *Brazil* reserves its position on the Article. When negotiating conventions, Brazil reserves the right to tax at source all payments made by its residents to non-residents.

5. *China, Romania* and *Slovakia* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on their territory for a period or periods exceeding in the aggregate 183 days in any twelve month period, even if they do not have a fixed base available to them for the purpose of performing such services or activities.

6. *Estonia, Latvia* and *Lithuania* reserve the right to restrict the Article to inviduals.

7. *Estonia, Latvia, Lithuania* and *South Africa* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on their territory for a period or periods exceeding in the aggregate 183 days in any twelve month period and deem such an individual to have a fixed base therein for the purposes of the Convention.

8. *Latvia* and *Lithuania* reserve the right to insert in a special Article provisions regarding income from independent personal services relating to activities carried on offshore in a Contracting State in connection with the exploration or exploitation of the sea bed, its subsoil and their natural resources.

9. *Malaysia* and *Vietnam* reserve the right to tax individuals performing professional services or other activities of an independent character if they are present on their territory for a period or periods exceeding in the aggregate 183 days in the calendar year.

10. *Malaysia* reserves the right to tax income in respect of an individual's professional services or other activities of an independent character if the income exceeds an amount to be negotiated.

11. The *Philippines* reserves the right to tax individuals performing professional services or other activities of an independent character if they are present on its territory for a period or periods exceeding in the aggregate 120 days in any twelve month period.

12. *Thailand* reserves the right to tax individuals performing professional services or other activities of an independent character if they are present on its territory for a period or periods exceeding a certain number of days, to be negotiated, in any twelve month period.

Positions on the Commentary

13. *Estonia, Latvia* and *Lithuania* do not agree with the interpretation presented in paragraph 3 of the Commentary and interpret the provisions of Article 14 according to the provisions of their domestic laws.

14. *Vietnam* does not agree with the interpretation presented in paragraph 3 of the Commentary. Vietnam believes that it has the right to tax income covered by the Article according to the provisions of its domestic law, not following the provisions of Article 7 and the Commentary thereon as guidance, particularly for the allowance of deductible expenses.

POSTIONS ON ARTICLE 15 (DEPENDENT PERSONAL SERVICES)
AND ITS COMMENTARY

Positions on the Article

1. *Argentina* reserves its position on subparagraph *a)* of paragraph 2 and wishes to insert in its conventions the words "in the fiscal year concerned" instead of the words "in any twelve month period commencing or ending in the fiscal year concerned".

2. *Latvia* and *Lithuania* reserve the right to insert in a special Article provisions regarding income derived from dependent personal services relating to activities carried on offshore in a Contracting State in connection with the exploration or exploitation of the sea bed, its subsoil and their natural resources.

3. *Argentina* reserves the right to insert in a special article provisions regarding income derived from dependent personal services relating to offshore hydrocarbon exploration and exploitation and related activities.

POSITIONS ON ARTICLE 16 (DIRECTORS' FEES)
AND ITS COMMENTARY

Positions on the Article

1. *Estonia, Latvia* and *Lithuania* reserve the right to tax under this Article any remuneration of a member of a board of directors or any other similar organ of a resident company.

2. *Thailand* reserves the right to extend the Article to cover the remuneration of senior employees.

POSITIONS ON ARTICLE 17 (ARTISTES AND SPORTSMEN)
AND ITS COMMENTARY

Positions on the Article

1. The *Philippines* and *Vietnam* reserve the right to exclude from the application of paragraph 1 artistes and sportsmen employed in organisations which are subsidized out of public funds.

POSITIONIS ON ARTICLE 18 (PENSIONS)
AND ITS COMMENTARY

Positions on the Article

1. *Brazil, South Africa* and *Thailand* reserve the right to provide that the Contracting State in which pensions and other similar remuneration and annuities arise has a right to tax, albeit not the exclusive right.

2. *Brazil, Romania, South Africa* and *Ukraine* reserve the right to include in paragraph 1 an explicit reference to annuities.

3. *Russia* and *Ukraine* reserve their position on this Article. When negotiating conventions, the Ukrainian and Russian authorities will request that the Contracting State in which the pensions arise be given the exclusive right to tax. *Ukraine* will insist, at a minimum, on a provision according to which pensions paid under the social security legislation of a Contracting State shall be taxable only in that State.

POSITIONS ON ARTICLE 19 (GOVERNMENT SERVICE) AND ITS COMMENTARY

Positions on the Article

1. *Malaysia* reserves the right not to include sub-paragraph 2 *b).*

2. *Russia* reserves the right to extend the application of Article 18 to pensions referred to in Article 19 in order to achieve uniformity of treatment.

POSITIONS ON ARTICLE 20 (STUDENTS) AND ITS COMMENTARY

Positions on the Article

1. *Brazil* reserves the right to add a second paragraph providing for the granting to visiting students of the same tax exemptions, reliefs or reductions as are granted to residents in respect of any subsidies, grants and payments for dependent personal services.

2. *Estonia, Latvia* and *Lithuania* reserve the right to refer to any apprentice and to a trainee in this Article.

3. *Romania* reserves the right to limit to a period of 7 years (the maximum period of studies in Romania) the exemption provided for in the Article.

4. *Romania* and *Vietnam* reserve the right to provide that remuneration for services rendered by a student or business apprentice in a Contracting State shall not be taxed in that State, provided that such services are in connection with his studies or training.

5. *Malaysia* and *Thailand* reserve the right to provide that remuneration for services rendered by a student or business apprentice in a Contracting State shall not be taxed in

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that State if such remuneration does not exceed a certain amount to be negotiated, provided that such services are in connection with his studies or training.

6. *Brazil, China, Malaysia,* the *Philippines, Romania, Thailand* and *Vietnam* reserve the right to add an article which addresses the situation of teachers, professors and researchers, subject to various conditions.

POSITIONS ON ARTICLE 21 (OTHER INCOME)
AND ITS COMMENTARY

Positions on the Article

1. *Argentina, Belarus, Brazil, Estonia, Latvia, Lithuania Malaysia, Romania, Russia, South Africa, Thailand* and *Vietnam* reserve their positions on this Article as they wish to maintain the right to tax income arising from sources in their own country.

POSITIONS ON ARTICLE 22 (CAPITAL)
AND ITS COMMENTARY

Positions on the Article

1. *Argentina* reserves the right to tax capital, other than property mentioned in paragraph 3, that is situated on its territory.

2. *China, Malaysia, Thailand* and *Vietnam* reserve their positions on the Article if and when they impose taxes on capital.

POSITIONS ON ARTICLE 23 (ELIMINATION OF DOUBLE TAXATION)
AND ITS COMMENTARY

Positions on the Article

1. *Argentina, Brazil, China, Malaysia, South Africa, Thailand* and *Vietnam* reserve the right to add tax sparing provisions in relation to the tax incentives that are provided for under their respective national laws.

2. *Argentina* and *Vietnam* reserve the right to add a matching credit for some or all of the income covered under Articles 10, 11 and 12 with the result that tax shall be deemed to have been paid, for purposes of the Article on elimination of double taxation, at a certain rate, to be negotiated, of the gross income.

3. *Brazil* reserves the right to add a matching credit for some or all of the income covered under Articles 11 and 12 with the result that tax shall be deemed to have been paid, for purposes of the Article on elimination of double taxation, at a certain rate, to be negotiated, of the gross income.

4. *Brazil* reserves the right to provide that income covered under Article 10 shall be exempt or entitled to a matching credit in the other Contracting State.

POSITIONS ON ARTICLE 24 (NON-DISCRIMINATION) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

1. *Brazil* reserves the right to omit the words "in particular with respect to residence" in paragraph 1.

2. *Brazil, Romania, Russia, Thailand* and *Vietnam* reserve their position on the second sentence of paragraph 1.

Paragraph 2

3. *Brazil* reserves the right to omit the words "in particular with respect to residence" in paragraph 2.

4. *Malaysia,* the *Philippines, Russia* and *Vietnam* reserve the right not to insert paragraph 2 in their conventions.

Paragraph 3

5. *Argentina* reserves the right to apply a branch profits tax.

6. *Brazil* reserves its position on paragraph 3 since royalties paid by a permanent establishment situated in Brazil to its head office abroad are not deductible under its law.

7. *Thailand* and *Vietnam* reserve the right to apply a profit remittance tax and a special taxation regime in respect of agricultural production activities.

Paragraph 4

8. *Vietnam* reserves its position on this paragraph in the case of interest paid to non-residents that is not subject to a withholding tax.

Paragraph 5

9. *Brazil* reserves the right to include, after the words "other similar enterprises of the first mentioned State", the words "whose capital is totally or partially, directly or indirectly, held or controlled by one or several residents of a third State".

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Paragraph 6

10. *Brazil, Malaysia,* the *Philippines, Romania, Russia, Thailand, Vietnam* and *Ukraine* reserve the right to restrict the scope of the Article to the taxes covered by the Convention.

POSITIONS ON ARTICLE 25 (MUTUAL AGREEMENT PROCEDURE) AND ITS COMMENTARY

Positions on the Article

Paragraph 1

1. *Brazil,* the *Philippines, Russia,* and *Thailand* reserve their positions on the last sentence of paragraph 1.

Paragraph 2

2. *Brazil,* the *Philippines, Slovakia* and *Thailand* reserve their positions on the second sentence of paragraph 2. These countries consider that the implementation of reliefs and refunds following a mutual agreement ought to remain linked to time-limits prescribed by their domestic laws.

Paragraph 3

3. *Brazil, Thailand* and *Ukraine* reserve their position on the second sentence of paragraph 3 on the grounds that they have no authority under their respective laws to eliminate double taxation in cases not provided for in the Convention.

Paragraph 4

4. *Brazil, China, Malaysia,* the *Philippines, Thailand* and *Ukraine* reserve the right to omit the words "including through a joint commission consisting of themselves or their representatives".

POSITIONS ON ARTICLE 26 (EXCHANGE OF INFORMATION) AND ITS COMMENTARY

Positions on the Article

1. *Brazil* reserves the right not to include the last sentence of paragraph 1 in its conventions.

2. *Brazil, Malaysia* and *Thailand* reserve the right not to include the words "The exchange of information is not restricted by Article 1 "in paragraph 1.

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Positions on the Commentary

3. *Brazil* wishes to indicate that with respect to paragraph 11 of the Commentary, it would be difficult for it, in view of its strict domestic laws and administrative practice as to the procedure to make public the information obtained under the domestic laws, to provide information requested unless a requesting State has comparable domestic laws and administrative practice as to this procedure.

4. *Malaysia* wishes to indicate that with respect to paragraph 11 of the Commentary, it would be difficult for it, in view of its strict domestic laws and administrative practice as to the procedure to make public certain information obtained under the domestic laws, to provide information requested.

5. Contrary to the interpretation put forward in paragraphs 14 to 16 of the Commentary, *Brazil* takes the view that the Article imposes no obligation on it to carry out enquiries on behalf of a Contracting State in cases where no liability to its own tax is at issue, since to carry out such enquiries would be contrary to its laws and administrative practice.

6. Contrary to the interpretation put forward in paragraphs 14 to 16 of the Commentary, *Malaysia* takes the view that the Article imposes no obligation on it to carry out enquiries on behalf of a Contracting State in cases where no liability to its own tax is at issue.

POSITIONS ON ARTICLE 28 (TERRITORIAL EXTENSION)
AND ITS COMMENTARY

Positions on the Article

1. *China* and *Thailand* reserve their position on this Article.

ANNEX IV

REVISION OF THE COMMENTARY ON ARTICLE 12 CONCERNING SOFTWARE PAYMENTS

(Text from the OECD Commentary on Article 12)

The Working Party recommends to replace paragraphs 12 to 17 of the Commentary on Article 12 by the following (deletions to the existing text appear in underline), additions in **bold).**

"12. Whether payments received as consideration for computer software may be classified as royalties poses difficult problems but is a matter of considerable importance in view of the rapid development of computer technology in recent years and the extent of transfers of such technology across national borders. **In 1992, the Commentary was amended to describe the principles by which such classification should be made. Paragraphs 12 to 17 were further amended in _____ to refine the analysis by which business profits are distinguished from royalties in computer software transactions. In most cases, the revised analysis will not result in a different outcome.**

12.1 Software may be described as a program, or a series of programs, containing instructions for a computer required either for the operational processes of the computer itself (operational software) or for the accomplishment of other tasks (application software). It can be transferred through a variety of media, for example in writing **or electronically,** on a magnetic tape or disc **disk,** or on a laser disc **disk or CD-Rom.** It may be standardised with a wide range of applications or be tailor-made for single users. It can be transferred as an integral part of computer hardware or in an independent form available for use on a variety of hardware.

12.2 The character of payments received in transactions involving the transfer of computer software depends on the nature of the rights that the transferee acquires under the particular arrangement regarding the use and exploitation of the program. The rights in computer software **programs** are a form of intellectual property. Research into the practices of OECD member countries has established that all but one protect rights in computer programs either explicitly or implicitly under copyright law. **Although the term "computer software" is commonly used to describe both the program - in which the intellectual property rights (copyright) subsist - and the medium on which it is embodied, the copyright law of most OECD member countries recognises a distinction between the copyright in the program and software which incorporates a copy of the copyrighted program.** Transfers of rights **in relation to software** occur in many different ways ranging from the alienation of the entire rights **in the copyright in a program** to the sale of a product which is subject to restrictions on the use to which it is put. The consideration paid can also take numerous forms. These factors may make it difficult to determine where the boundary lies between software payments that are properly to be

regarded as royalties and other types of payment. **The difficulty of determination is compounded by the ease of reproduction of computer software, and by the fact that acquisition of software frequently entails the making of a copy by the acquirer in order to make possible the operation of the software.**

13. Three situations are considered. The first is of payments made where less than the full rights in software are transferred. In a partial transfer of rights, the consideration is likely to represent a royalty only in very limited circumstances. One such case is where the transferor is the author of the software (or has acquired from the author his rights of distribution and reproduction) and he has placed part of his rights at the disposal of a third party to enable the latter to develop or export the software itself commercially for example by development and distribution of it.

13. The transferee's rights will in most cases consist of partial rights or complete rights in the underlying copyright (see paragraphs 13.1 and 15 below), or they may be (or be equivalent to) partial or complete rights in a copy of the program (the "program copy"), whether or not such copy is embodied in a material medium or provided electronically (see paragraphs 14 to 14.1 below). In unusual cases, the transaction may represent a transfer of "know-how" or secret formula (paragraph 14.1).

13.1 Payments made for the acquisition of partial rights in the copyright (without the transferor fully alienating the copyright rights) will represent a royalty where the consideration is for granting of rights to use the program in a manner that would, without such license, constitute an infringement of copyright. Examples of such arrangements include licenses to reproduce and distribute to the public software incorporating the copyrighted program, or to modify and publicly display the program. In these circumstances, the payment are for the right to use the copyright in the program (i.e., to exploit the rights that would otherwise be the sole prerogative of the copyright holder). It should be noted that even where a software payment is properly to be regarded as a royalty there are **may be** difficulties in applying the copyright provisions of the Article to software payments since paragraph 2 requires that software should be classified as a literary, artistic or scientific work. None of these categories seems entirely apt. **The copyright law of many countries deal with this problem by specifically classifying software as a literary or scientific work. For other countries** but treatment as a scientific work might be the most realistic approach. Countries for which it is not possible to attach software to any of those categories might be justified in adopting in their bilateral treaties an amended version of paragraph 2 which either omits all references to the nature of the copyrights or refers specifically to software.

14. In other cases, the acquisition of the software will generally be for the personal or business use of the purchaser. In other types of transactions, the rights acquired in relation to the copyright are limited to those necessary to enable the user to operate the program, for example, where the transferee is granted limited rights to reproduce the program. This would be the common situation in transactions for the acquisition of a program copy. The rights transferred in these cases are specific to the nature of computer programs. They allow the

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user to copy the program, for example onto the user's computer hard drive or for archival purposes. In this context, it is important to note that the protection afforded in relation to computer programs under copyright law may differ from country to country. In some countries the act of copying the program onto the hard drive or random access memory of a computer would, without a license, constitute a breach of copyright. However, the copyright laws of many countries automatically grant this right to the owner of software which incorporates a computer program. Regardless of whether this right is granted under law or under a license agreement with the copyright holder, copying the program onto the computer's hard drive or random access memory or making an archival copy is an essential step in utilising the program. Therefore, rights in relation to these acts of copying, where they do no more than enable the effective operation of the program by the user, should be disregarded in analysing the character of the transaction for tax purposes. The payments will Payments in these types of transactions would fall to be dealt with as commercial income in accordance with Articles 7 or 14.

14.1 The method of transferring the computer program to the transferee is not relevant. For example, it does not matter whether the transferee acquires a computer disk containing a copy of the program or directly receives a copy on the hard disk of her computer via a modem connection. It is also of no relevance that there may be restrictions on the use to which the purchaser **transferee** can put it **the software.**

14.2 The ease of reproducing computer programs has resulted in distribution arrangements in which the transferee obtains rights to make multiple copies of the program for operation only within its own business. Such arrangements are commonly referred to as "site licenses," "enterprise licenses," or "network licenses." Although these arrangements permit the making of multiple copies of the program, such rights are generally limited to those necessary for the purpose of enabling the operation of the program on the licensee's computers or network, and reproduction for any other purpose is not permitted under the license. Payments under such arrangements will be in most cases be dealt with as commercial income in accordance with Articles 7 or 14.

14.3 Another type of transaction involving the transfer of computer software is the more unusual case where a software house or computer programmer agrees to supply information about the ideas and principles underlying the program, such as logic, algorithms or programming languages or techniques. In these cases, the payments may be characterised as royalties to the extent that they represent consideration for the use of, or the right to use, secret formulas or for information concerning industrial, commercial or scientific experience which cannot be separately copyrighted. This contrasts with the ordinary case in which a program copy is acquired for operation by the end user.

15. The second situation is where the payments are made as consideration for the alienation of rights attached to the software. It is clear that where **Where** consideration is paid for the transfer of the full ownership **of the rights in the copyright,** the payment

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cannot represent a royalty and the provisions of the Article are not applicable. Difficulties can arise where there are extensive but partial alienation of rights involving:

- exclusive right of use during a specific period or in a limited geographical area;
- additional consideration related to usage;
- consideration in the form of a substantial lump sum payment.

16. Each case will depend on its particular facts but in general such payments are likely to be commercial income within Article 7 or 14 or a capital gains matter within Article 13 rather than royalties within Article 12. That follows from the fact that where the ownership of rights has been alienated in full or in part, the consideration cannot be for the use of the rights. The essential character of the transaction as an alienation cannot be altered by the form of the consideration, the payment of the consideration in installments or, in the view of most countries, by the fact that the payments are related to a contingency.

17. The third situation is where Software payments are **may be** made under mixed contracts. Examples of such contracts include sales of computer hardware with built-in software and concessions of the right to use software combined with the provision of services. The methods set out in paragraph 11 above for dealing with similar problems in relation to patent royalties and know-how are equally applicable to computer software. Where necessary the total amount of the consideration payable under a contract should be broken down on the basis of the information contained in the contract or by means of a reasonable apportionment with the appropriate tax treatment being applied to each apportioned part."

ANNEX V

COMMENTARY ON ARTICLE 18
CONCERNING THE TAXATION OF PENSIONS

(Text quoted in its entirety from
OECD Model Convention dated November 1997)

1. According to this Article, pensions paid in respect of private employment are taxable only in the State of residence of the recipient. The provision also covers widows' and orphans' pensions and other similar payments such as annuities paid in respect of past employment. It also applies to pensions in respect of services rendered to a State or a political subdivision or local authority thereof which are not covered by the provisions of paragraph 2 of Article 19.

2. Some States consider pensions paid out under a public pension scheme which is part of their social security system similar to Government pensions. Such States argue on that basis that the State of source, i.e. the State from which the pension is paid, should have a right to tax such pensions. Many conventions concluded by these States contain provisions to that effect, sometimes including also other payments made under the social security legislation of the State of source. Such payments are for instance sickness benefits, unemployment benefits and benefits on account of industrial injury. Contracting States having the view may agree bilaterally on an additional paragraph to the Article giving the State of source a right to tax payments made under its social security legislation. A paragraph of that kind could be drafted along the following lines:

> "Notwithstanding the provisions of paragraph 1, pensions and other payments made under the social security legislation of a Contracting State may be taxed in that State."

Where the State of which the recipient of such payments is a resident applies the exemption method the payments will be taxable only in the State of source while States using the credit method may tax the payments and give credit for the tax levied in the State of source. Some States using the credit method as the general method in their conventions may, however, consider that the State of source should have an exclusive right to tax such payments. Such States should then substitute the words "shall be taxable only" for the words "may be taxed" in the above draft provision.

3. The treatment under the taxation laws of the OECD Member countries of amounts paid to an employee on the cessation of his employment is highly diversified. Some States regard such a payment as a pension, private or Government as the case may be, paid as a lump sum. In such a case it would be natural to consider the income as falling under Article 18 or 19. In the tax laws of other States such a payment is looked upon as the final remuneration for the work performed. Then it should of course be treated under Article 15 or 19, as the case may be. Others again consider such a payment as a bonus which is not taxable under their

income tax laws but perhaps subjected to a gift tax or a similar tax. It has not been possible to reach a common solution on the tax treatment of payments of this kind under the Model Convention. If the question of taxing such payments should arise between Contracting States, the matter therefore has to be solved by recourse to the provisions of Article 25.

The tax treatment of contributions to foreign pension schemes

A. General comments

4. It is characteristic of multinational enterprises that their staff are expected to be willing to work outside their home country from time to time. The terms of service under which staff are sent to work in other countries are of keen interest and importance to both the employer and the employee. One consideration is the pension arrangements that are made for the employee in question.

(Replaced on 23 July 1992; see HISTORY)

5. Employees sent abroad to work will often wish to continue contributing to a pension scheme in their home country during their absence abroad. This is both because switching schemes can lead to a loss of rights and benefits, and because many practical difficulties can arise from having pension arrangements in a number of countries.

(Replaced on 23 July 1992; see HISTORY)

6. The tax treatment accorded to pension contributions of employees who are assigned to work outside their home country varies both from country to country and depending on the circumstances of the individual case. Before taking up an overseas assignment, employees commonly qualify for tax relief on pension contributions paid in the home country. When assigned abroad, employees in some cases continue to qualify for relief. Where an individual, for example, remains resident and fully taxable in the home country, pension contributions made to a pension scheme established in the home country will generally continue to qualify for relief there. But frequently, contributions paid in the home country by an individual assigned to work abroad do not qualify for relief under the domestic laws of either the home country or the host country. Where this is the case it can become expensive, if not prohibitive, to maintain membership of a pension scheme in the home country during a foreign assignment. Paragraph 11 below suggests a provision which Member countries can, if they wish, include in bilateral treaties to provide reliefs for the pension contributions of employees assigned to work outside their home country.

(Replaced on 23 July 1992; see HISTORY)

7. However, some Member countries may not consider that the solution to the problem lies in a treaty provision, preferring, for example, the pension scheme to be amended to secure deductibility of contributions in the host State. Other countries may be opposed to including the provision in treaties where domestic legislation allows deductions only for contributions paid to residents. In such cases it may be inappropriate to include the suggested provision in a bilateral treaty.

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(Added on 23 July 1992; see HISTORY)

8. The suggested provision does not address itself to contributions made to social security schemes (general State pension schemes dependent upon contribution records, whether or not contributors are employees) as the right or obligation to join a social security scheme is primarily a matter of social legislation rather than tax law. Many Member countries have entered into bilateral social security totalisation agreements which may help to avoid the problem with respect to contributions to social security schemes. The provision also does not contain provisions relating either to the deductibility by the employer of employer pension contributions in respect of employees working abroad or to the treatment of income accrued within the plan. All of these issues can be dealt with in bilateral negotiations.

(Added on 23 July 1992; see HISTORY)

9. The provision is confined to the tax treatment of contributions to pension schemes by or on behalf of individuals who exercise employments within the meaning of Article 15 away from their home State. It does not deal with contributions by individuals who render independent personal services within the meaning of Article 14. However, Member countries may wish, in bilateral negotiations, to agree on a provision covering individuals rendering services within both Article 14 and Article 15.

(Added on 23 July 1992; see HISTORY)

B. Aim of the provision

10. The aim of the provision is to ensure that, as far as possible, an employee is not discouraged from taking up an overseas assignment by the tax treatment of contributions made to a home country pension scheme by an employee working abroad. The provision seeks, first, to determine the general equivalence of pension plans in the two countries and then to establish limits to the deductibility of employee contributions based on the limits in the laws of both countries.

(Added on 23 July 1992; see HISTORY)

C. Suggested provision

11. The following is the suggested text of the provision that could be included in bilateral conventions to deal with the problem identified above:

> "a) Contributions borne by an individual who renders dependent personal services in a Contracting State to a pension scheme established in and recognised for tax purposes in the other Contracting State shall be deducted, in the first-mentioned State, in determining the individual's taxable income, and treated in that State, in the same way and subject to the same conditions and limitations as contributions made to a pension scheme that is recognised for tax purposes in that first-mentioned State, provided that:

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(i) the individual was not a resident of that State, and was contributing to the pension scheme, immediately before he began to exercise employment in that State; and

(ii) the pension scheme is accepted by the competent authority of that State as generally corresponding to a pension scheme recognised as such for tax purposes by that State.

b) For the purposes of sub-paragraph a):

(i) the term "a pension scheme" means an arrangement in which the individual participates in order to secure retirement benefits payable in respect of the dependent personal services referred to in sub-paragraph a); and

(ii) a pension scheme is recognised for tax purposes in a State if the contributions to the scheme would qualify for tax relief in that State."

(Added on 23 July 1992; see HISTORY)

12. Sub-paragraph a) of the suggested provision lays down the characteristics of both the employee and the contributions to which the provision applies. It also provides the principle that contributions borne by an individual rendering dependent personal services within the meaning of Article 15 in one Contracting State (the host State) to a defined pension scheme in the other Contracting State (the home State) are to be relieved from tax in the host State, subject to the same conditions and limitations as relief for contributions to domestic pension schemes of the host State.

(Added on 23 July 1992; see HISTORY)

13. Relief for contributions to the home country pension scheme under the conditions outlined can be given by either the home country, being the country where the pension scheme is situated or by the host country, where the economic activities giving rise to the contributions are carried out.

(Added on 23 July 1992; see HISTORY)

14. A solution in which relief would be given by the home country might not be effective, since the employee might have no or little taxable income in that country. Practical considerations therefore suggest that it would be preferable for relief to be given by the host country and this is the solution adopted in the suggested provision.

(Added on 23 July 1992; see HISTORY)

15. In looking at the characteristics of the employee, sub-paragraph a) makes it clear that, in order to get the relief from taxation in the host State, the employee must not have been resident in the host State immediately prior to working there.

(Added on 23 July 1992; see HISTORY)

16. Sub-paragraph a) does not, however, limit the application of the provision to secondees who become resident in the host State. In many cases employees working abroad who remain resident in their home State will continue to qualify for relief there, but this will not be so in all cases. The suggested provision therefore applies to non-residents working in the host State as well as to secondees to the host State who attain residence status there. In some Member countries the domestic legislation may restrict deductibility to contributions borne by residents, and these Member countries may wish to restrict the suggested provision to cater for this. Also, States with a special regime for non-residents (e.g. taxation at a special low rate) may, in bilateral negotiations, wish to agree on a provision restricted to residents.

(Added on 23 July 1992; see HISTORY)

17. In the case where individuals temporarily cease to be resident in the host country in order to join a pension scheme in a country with more relaxed rules, individual States may want a provision which would prevent the possibility of abuse. One form such a provision could take would be a nationality test which could exclude from the suggested provision individuals who are nationals of the host State.

(Added on 23 July 1992; see HISTORY)

18. As it is not unusual for employees to be seconded to a number of different countries in succession, the suggested provision is not limited to employees who are residents of the home State immediately prior to exercising employment in the host State. The provision covers an employee coming to the host State from a third country as it is only limited to employees who were not resident in the host country before taking up employment there. However, Article 1 restricts the scope of the Convention to residents of one or both Contracting States. An employee who is neither a resident of the host State nor of the home State where the pension scheme is established is therefore outside the scope of the Convention between the two States.

(Added on 23 July 1992; see HISTORY)

19. The suggested provision places no limits on the length of time for which an employee can work in a host State. It could be argued that, if an employee works in the host State for long enough, it in effect becomes his home country and the provision should no longer apply. Indeed, some host countries already restrict relief for contributions to foreign employee/employer pension schemes to cases where the seconded employees are present on a temporary basis.

(Added on 23 July 1992; see HISTORY)

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20. In addition, the inclusion of a time limit may be helpful in preventing the possibility of abuse outlined in paragraph 17 above. In bilateral negotiations, individual countries may find it appropriate to include a limit on the length of time for which an employee may exercise an employment in the host State after which reliefs granted by the suggested provision would no longer apply.

(Added on 23 July 1992; see HISTORY)

21. In looking at the characteristics of the contributions, sub-paragraph a) provides a number of tests. It makes it clear that the provision applies only to contributions borne by an individual to a pension scheme established in and recognised for tax purposes in the home State. The phrase "recognised for tax purposes" is further defined in subdivision b)(ii) of the suggested provision.

(Added on 23 July 1992; see HISTORY)

22. The second test applied to the characteristics of the contributions is that the contributions should be made to a home State scheme recognised by the competent authority of the host State as generally corresponding to a scheme recognised as such for tax purposes by the host State. This operates on the premise that only contributions to recognised schemes qualify for relief in Member countries. This limitation does not, of course, necessarily secure equivalent tax treatment of contributions paid where an employee was working abroad and of contributions while working in the home country. If the host State's rules for recognising pension schemes were narrower than those of the home State, the employee could find that contributions to his home country pension scheme were less favourably treated when he was working in the host country than when working in the home country.

(Added on 23 July 1992; see HISTORY)

23. However, it would not be in accordance with the stated aim of securing, as far as possible, equivalent tax treatment of employee contributions to give relief for contributions which do not - at least broadly - correspond to domestically recognised schemes. To do so would mean that the amount of relief in the host State would become dependent on legislation in the home State. In addition, it could be hard to defend treating employees working side by side differently depending on whether their pension scheme was at home or abroad (and if abroad, whether it was one country rather than another). By limiting the suggested provision to schemes which generally correspond to those in the host country such difficulties are avoided.

(Added on 23 July 1992; see HISTORY)

24. The suggested provision makes it clear that it is for the competent authority of the host State to determine whether the scheme in the home State generally corresponds to recognised schemes in the host State. Individual States may wish, in bilateral negotiations, to establish what interpretation the competent authority places on the term "generally corresponding;" for example how widely it is interpreted and what tests are imposed.

(Added on 23 July 1992; see HISTORY)

25. The contributions covered by the provision are limited to payments to schemes to which the employee was contributing before he began to exercise his employment in the host State. This means that contributions to new pension schemes which an employee joins while in the host State are excluded from the suggested provision.

(Added on 23 July 1992; see HISTORY)

26. It is, however, recognised that special rules may be needed to cover cases where new pension schemes are substituted for previous ones. For instance, in some Member countries the common practice may be that, if a company employer is taken over by another company, the existing company pension scheme for its employees may be ended and a new scheme opened by the new employer. In bilateral negotiations, therefore, individual States may wish to supplement the provision to cover such substitution schemes.

(Added on 23 July 1992; see HISTORY)

27. Sub-paragraph a) also sets out the relief to be given by the host State if the characteristics of the employee and the contributions fall within the terms of the provision. In brief, the relief is to be given in a way which corresponds to the manner in which relief would be given if the contributions were to a scheme established in the host State.

(Added on 23 July 1992; see HISTORY)

28. This measure of relief does not, of course, necessarily secure equivalent tax treatment given to contributions paid when an employee is working abroad and contributions paid when he is working in the home country. Similar considerations apply here to those discussed in paragraphs 22 and 23 above. The measure does, however, ensure equivalent treatment of the contributions of colleagues. The following example is considered. The home country allows relief for pension contributions subject to a limit of 18% of income. The host country allows relief subject to a limit of 20%. The suggested provision in paragraph 11 would require the host country to allow relief up to its domestic limit of 20%. Countries wishing to adopt the limit in the home country would need to amend the wording of the provision appropriately.

(Added on 23 July 1992; see HISTORY)

29. The amount and method of giving the relief would depend upon the domestic tax treatment of pension contributions by the host State. This would settle such questions as whether contributions qualify for relief in full, or only in part, and whether relief should be given as a deduction in computing taxable income (and if so, which income, e.g. only employment income or all income) or as a tax credit.

(Added on 23 July 1992; see HISTORY)

30. Being assigned to work abroad may not only mean that an employee's contributions to a pension scheme in his home country cease to qualify for tax relief. It may also mean that contributions to the pension scheme by the employer are regarded as the employee's income

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for tax purposes. In some Member countries employees are taxed on employer's contributions to domestic schemes whilst working in the home country whereas in others these contributions remain exempt. The provision, therefore, is silent on the treatment of such contributions, although Member countries may wish to extend the suggested provision in bilateral treaties, to ensure that employers contributions in the context of the employees' tax liability are accorded the same treatment that such contributions to domestic schemes would receive.

(Added on 23 July 1992; see HISTORY)

31. Subdivision b)(i) defines a pension scheme for the purposes of sub-paragraph a). It makes it clear that, for these purposes, a pension scheme is an arrangement in which the individual who makes the payments participates in order to secure retirement benefits. These benefits must be payable in respect of the exercise of the employment in the host State. All the above conditions must apply to the pension scheme before it can qualify for relief under the suggested provision.

(Added on 23 July 1992; see HISTORY)

32. Subdivision b)(i) refers to the participation of the individual in the pension scheme in order to secure retirement benefits. This definition is intended to ensure that the proportion of contributions made to secure benefits other than periodic pension payments on retirement, e.g. a lump sum on retirement, will also qualify for relief under the provision.

(Added on 23 July 1992; see HISTORY)

33. The initial definition of a pension scheme is "an arrangement." This is a widely drawn term, the use of which is intended to encompass the various forms which pension schemes may take in individual Member countries.

(Added on 23 July 1992; see HISTORY)

34. Although subdivision b)(i) sets out that participation in this scheme has to be by the individual who exercises the employment referred to in sub-paragraph a), there is no reference to the identity of the recipient of the retirement benefits secured by participation in the scheme. This is to ensure that any proportion of contributions intended to generate a widow or dependent's pension may be eligible for relief under the suggested provision.

(Added on 23 July 1992; see HISTORY)

35. The definition of a pension scheme makes no distinction between pensions paid from State-run occupational pension schemes and similar privately-run schemes. Both are covered by the scope of the provision. Any pensions, such as pensions from general State pension schemes dependent on contribution records whether or not contributors are employees, are excluded from the provision as the individual will not contribute to such schemes in order to receive benefits payable in respect of dependent personal services rendered.

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(Added on 23 July 1992, see HISTORY)

36. Subdivision b)(ii) further defines the phrase "recognised for tax purposes." As the aim of the provision is, so far as possible, to ensure that contributions are neither more nor less favourably treated for tax purposes than they would be if the employee was resident in his home State, it is right to limit the provision to contributions which would have qualified for relief if the employee had remained in the home State. The provision seeks to achieve this aim by limiting its scope to contributions made to a scheme only if contributions to this scheme would qualify for tax relief in that State.

(Added on 23 July 1992; see HISTORY)

37. This method of attempting to achieve parity of treatment assumes that in all Member countries only contributions to recognised pension schemes qualify for relief. The tax treatment of contributions to pension schemes under Member countries' tax systems may differ from this assumption. It is recognised that, in bilateral negotiations, individual countries may wish to further define the qualifying pension schemes in terms that match the respective domestic laws of the treaty partners.

(Added on 23 July 1992; see HISTORY)

Observation on the Commentary

38. France considers that the scope of the proposed provision in paragraph 11 above must be determined by taking into account not only the pension scheme to which the taxpayer contributed before his departure but also any scheme substituted therefor.

(Added on 23 July 1992; see HISTORY)

Reservations on the Article

39. Australia reserves the right to propose that all pensions be taxable only in the country of residence of the recipient.

(Amended on 23 October 1997; see HISTORY)

40. Canada reserves its position on this Article. When negotiating conventions, the Canadian authorities will propose that the country in which the pensions arise be given a limited right to tax.

(Amended on 31 March 1994; see HISTORY)

41. Finland and Sweden, when negotiating conventions, would wish to retain the right to tax pensions paid to non-residents, where such pensions are paid in respect of past services rendered mainly within their respective territory.

(Amended on 23 October 1997; see HISTORY)

42. When negotiating bilateral conventions, Belgium will propose that the State of source be given in any case the right to tax pensions and allowances paid pursuant to the social legislation of a Contracting State or under a general scheme set up by this Contracting State to supplement the benefits provided under this social legislation.

(Added on 23 July 1992; see HISTORY)

43. Denmark reserves its position on this Article, including the right to insert a provision according to which pensions paid under the social security legislation of a Contracting State shall be taxable only in that State.

(Added on 23 July 1992; see HISTORY)

44. Canada, Ireland and the United Kingdom reserve the right to include within paragraph 1 of the Article an explicit reference to "annuities" (cf. paragraph 1 above).

(Amended on 21 September 1995; see HISTORY)

45. Canada and Norway reserve the right to extend the application of Article 18 to pensions referred to in Article 19 in order to achieve uniformity of treatment.

(Added on 31 March 1994; see HISTORY)

ANNEX VI

HUNGARY - PENSION REFORM AND SOCIAL SECURITY

(Article submitted by the International
Bureau of Fiscal Documentation)

Privatization of social security system

In the summer of 1997, the parliament passed a package of legislation which radically restructured the social security system. Most of this legislation became effective on 1 January 1998.

Basically, the pension system is based on the generally accepted international norms of dual funding, whereby individuals' future pensions will be only partially funded from public social security contributions and will be supplemented or substantially replaced by private pension schemes operating on the capital cover principle.

Membership in the dual system is mandatory for all entry-level employees under the age of 42 who first join the social security system after 30 June 1998. Those who were already making social security contributions before this date could elect to choose the dual system or remain members only of the state pension system. This option to select, for employees who are not just entering the work force, will be available only until 1 September 1999. If these individuals select the dual-funding system option but then change their minds, they may retract their decision only once and then by no later than 31 December 2000.

Individuals who cannot make social security contributions ("non-contributors," e.g. foreign citizens) may become entitled to pension benefits if they contract with the relevant branch of the Hungarian social security authority to commence social security/pension contributions in order to acquire length-of-service requirements on which pension calculations are based. This "opting-in" to the pension system requires payment of an annual 31% pension contribution (equivalent to the total of the employer and employee portion under normal employment circumstances). To make such voluntary joining equivalent to the normal employee's situation, up to 6% of the 31% may be paid directly into a private pension plan.

Statutory contributions to pension funds

From:	Employer's contributions (%)	Employee's contributions (%)		
To:		Social security	Private pension funds	State (only)
01.01.1998	24	1	6	7
01.01.1999	22	2	6	8
01.01.2000	21	1	8	9

Members of private pension funds may voluntarily make additional higher contributions over and above those shown in the table.

The upper limit of assessment base for contributions payable by individuals is the amount due on twice the gross average wage, as set each year by the Hungarian Parliament. The ceiling for computing maximum contribution payments is HUF 1,852800 per annum for 1999. This ceiling also applies for determining the maximum contributions to private pension funds.

Nationals may also contribute to voluntary private pension funds, which make up the third pillar. Contributions may be made by an amount up to 4% of employment-related income.

Employers may make voluntary contributions to the private pension plans on the employees' behalf. Such additional employers' contributions are deductible by the employer, do not constitute part of the taxable income of the employee and they do not trigger a further 33% social security liability.

Tax treatment of pensions

(a) State pensions

As a general rule, pensions received from the State or pensions from abroad are exempt from tax in that they constitute part of the aggregated income, but the tax calculated on that pension is deductible from the tax that would be payable on the aggregated income. It means, therefore, if the taxpayer has other sources of taxable income as well, the pension income still remains exempt but for the purpose of calculating tax on the person's other income, the exempt amount is taken into consideration (exemption with progression).

(b) Pension benefits from mandatory private pension funds

Pension benefits received from mandatory private pension funds are considered to be taxable income which must be aggregated with income derived from other sources. The tax due on this aggregated income is, however, reduced by 50% of the tax calculated on the pension benefit received from private pension fund using the highest marginal tax rate.

(c) Pension benefits received from voluntary pension schemes

Benefits (a once-off lump-sum pension payment or a monthly pension payment) provided by voluntary pension schemes is considered to be a tax exempt income, provided the person receiving the benefit has been a member of the scheme for at least three years.

Tax treatment of pension contributions and payments for individuals

(a) Statutory contributions to state pension funds and premiums paid to mandatory private funds

With effect from 1998, 25% of the social security contribution and/or premiums paid to mandatory private pension funds is creditable against the individual's annual income tax liability. The 25% tax credit may be claimed for the whole amount irrespective of whether the individual pays 8% to the state fund or utilizes the 6%/2% split.

(b) Additional premiums paid to mandatory private pension funds

Members of private pension funds may voluntarily pay additional premiums of a maximum of 4% of employment-related income into an individual pension fund and receive a tax credit of 50% of this voluntary contribution against the current year's taxes payable.

(c) Voluntary contributions made to voluntary mutual pension schemes

Individuals are entitled to a tax credit of 50% of the contributions paid to a voluntary mutual insurance scheme. The tax credit may not exceed HUF 100,000 (HUF 130,000 for individuals reaching the retirement age before 1 January 2020).

(d) Commercial life or pension insurance

Individuals are entitled to receive a tax credit of 20% of premiums paid for a private life insurance or pension plan taken with commercial life and pension insurance institutions which are resident in Hungary (the credit may not exceed HUF 50,000).

Tax treaty aspects of privatized social security systems

The Hungarian draft Convention is based as closely as possible on the OECD Model Convention. Any differences in a particular treaty are mainly due to differences in the taxation systems of the contracting parties and to compromise solutions of negotiations with the countries. The adoption of certain provisions of the UN Model is also possible during

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negotiations in the case of developing countries. Treaties with India, Brazil, Indonesia among others contain some elements of the UN Model.

With respect to the treatment of pensions under the tax treaties, Hungary follows, in general, the OECD Model. The treaties with China, Denmark, Finland, France, India, Luxembourg, Malta, the Netherlands, Norway, Philippines, Ukraine and the United States deviate from the OECD Model and allow that any pension paid out under a public social security system of the other state to a resident of the other state be taxed in the first-mentioned state.

POLAND - NEW SOCIAL SECURITY SYSTEM

The new law on the Social Security System of 13 October 1998 was published in the Polish Journal of Laws 1998, No. 137 Item 887 and becomes generally effective on 1 January 1999.

The new social security system includes old-age pensions, disability insurance, health and maternity insurance, and injury insurance. The system covers employees, self-employed persons, and commission and agency contractors. Foreigners who have an employment contract with a Polish employer are also subject to social security contributions.

The new pension system consists of three parts ("pillars"):

- Pillar I is an obligatory public system financed by the Social Security Fund (FUS) and similar to the current system;
- Pillar II is an obligatory private pillar based on private pension funds; and
- Pillar III consists of all additional voluntary private pension plans (e.g. employee pension plans, life insurance).

Pillars I and II are obligatory for individuals born after 31 December 1968 and optional for individuals born after 31 December 1948 but before 31 December 1968. For individuals who participate in Pillars I and II (whether on a mandatory or optional basis), the obligatory pension contributions will be divided between the FUS and a chosen pension fund.

The base for assessing social security contributions is gross income. In the case of contributions for pension and disability insurance, the maximum base for assessment is the annual equivalent of 30 projected average monthly salaries in the calendar year. There is no such maximum with respect to health, maternity and injury insurance.

Social security contributions are levied at the following rates:

- 19.52% for old-age pensions;
- 13% for disability insurance;
- 2.45% for health and maternity insurance; and
- 0.40% to 8.12% for injury insurance.

Contributions to pension and disability insurance are paid in equal parts by employers and employees. Contributions to health and maternity insurance are paid by employees, and contributions to injury insurance by employers. An employee's salary is grossed up by the employer by the amount of the employee's contribution. The contributions are deductible for income tax purposes for both employers and employees.

Contributions to voluntary private pension plans (Pillar III) are not deductible for income tax purposes. The benefits derived from these plans, however, are not taxable.