United Nations E/C.18/2014/5*

Economic and Social Council

Distr.: General
5 August 2014

Original: English

Committee of Experts on International Cooperation in Tax Matters
Tenth session
Geneva, 27-31 October 2014
Item 3 (b) (v) of the provisional agenda**
Discussion of substantive issues related to international cooperation in tax matters: other issues: capacity-building

Capacity development programme in international tax cooperation

Note by the Secretariat

1. The paper contained in the annex to the present note was prepared by Brian J. Arnold, Senior Adviser, Canadian Tax Foundation, at the request of the Financing for Development Office of the Department of Economic and Social Affairs of the Secretariat, pursuant to Economic and Social Council resolutions 2014/12 and 2013/24. In those resolutions, the Council recognized the progress made by the Office in its work in developing, within its mandate, a capacity development programme in international tax cooperation aimed at strengthening the capacity of the ministries of finance and national tax authorities in developing countries to develop more effective and efficient tax systems, which support the desired levels of public and private investment, and to combat tax evasion, and requested the Office, in partnership with other stakeholders, to continue its work in this area and to further develop its activities.

2. The paper supplements the United Nations Course on Double Tax Treaties, which is a comprehensive training tool for national tax authorities and ministries of finance in developing countries, based on the United Nations Model Double Taxation Convention between Developed and Developing Countries. The course, developed by the Financing for Development Office as part of its capacity development programme on international tax cooperation, underwent a series of technical reviews by members of the Committee of Experts on International Cooperation in Tax Matters and its Advisory Group on Capacity Development, in accordance with its mandate to make recommendations on capacity-building and the provision of technical assistance to developing countries in the area of international cooperation in tax matters.

* Reissued for technical reasons on 24 September 2014.
** E/C.18/2014/1.

14-58790* (E) 250914

Annex

An introduction to tax treaties*

I. Introduction

1. Tax treaties represent an important aspect of the international tax rules of many countries. Over 3,000 bilateral income tax treaties are currently in effect, and the number is growing. The overwhelming majority of those treaties is based in large part on the 2011 United Nations Model Double Taxation Convention between Developed and Developing Countries (United Nations Model Convention) and the Organization for Economic Cooperation and Development (OECD) Model Tax Convention on Income and on Capital (OECD Model). These model treaties are available on the OECD and United Nations websites and are discussed below.

2. The following provides a brief introduction to the basic aspects of tax treaties. Its focus is on issues such as the types of treaties dealing with tax matters, as well as the legal nature, purposes and interpretation of treaties, rather than on their substantive provisions.

II. Legal nature and effect of tax treaties

3. Treaties are agreements between sovereign nations. Article 2 of the Vienna Convention on the Law of Treaties, which applies to all treaties, provides:

> A treaty is an international agreement (in one or more instruments, whatever called) concluded between States and governed by international law.

4. Tax treaties are often called either “agreements” or “conventions.” As article 2 of the Vienna Convention indicates, the name used is not important.

5. Bilateral tax treaties confer rights and impose obligations on the two contracting States, but not on third parties, such as taxpayers. However, tax treaties are obviously intended to benefit the taxpayers of the contracting States. Whether they do so or not depends on the domestic law of each State. In some States, treaties are self-executing: that is, once the treaty is concluded, it confers rights on the residents of the contracting States. In other States, some additional action is necessary (for example, the provisions of the treaty must be enacted into domestic law) before benefits under a treaty can be given to residents of the contracting States.

6. Under article 26 of the Vienna Convention, treaties are binding on the contracting States and must be performed by them in good faith. This is the *pacta sunt servanda* principle. If a country does not respect its tax treaties, other countries may have no interest in entering into tax treaties with it.

7. Most tax treaties are bilateral. There are very few multilateral income tax treaties (for example, the Multilateral Convention on Mutual Administrative Assistance in Tax Matters), but the possibility of a multilateral treaty has been promoted by tax scholars for many years and is currently on the agenda of the

---

* Prepared by Brian J. Arnold, Senior Adviser, Canadian Tax Foundation, Toronto, Canada.

OECD Base Erosion and Profit Shifting project,[1] although the precise scope of the multilateral treaty is not yet clear.

8. Reciprocity is a fundamental underlying principle of tax treaties, although its precise meaning is unclear. The provisions of almost all bilateral tax treaties are reciprocal. For example, if article 10 (Dividends) provides for a maximum rate of source-country withholding tax on dividends paid by a resident company to shareholders resident in the other contracting State, that maximum rate of tax will apply equally to both contracting States. This reciprocal obligation applies to both States, irrespective of the cross-border flows of dividends; in other words, article 10 (and the other distributive provisions of the treaty) applies equally to both States, even where the treaty is between a developed and a developing country, so that significantly more dividends are paid by companies resident in the developing country to shareholders resident in the developed country than vice versa. Similarly, the administrative provisions of tax treaties, such as exchange of information and assistance in the collection of taxes, are intended to apply reciprocally.

III. Types of treaties dealing with tax matters

9. The following deals with income tax treaties. However, there are several other types of treaties that deal with tax issues. For example, countries that impose estate or inheritance taxes may have treaties to eliminate double taxation with respect to them. In addition, many countries have signed the Multilateral Convention on Mutual Administrative Assistance in Tax Matters. This Convention deals with administrative tax issues, such as exchange of information, assistance in the collection of taxes and dispute resolution. In addition, there are many types of treaties that deal primarily with non-tax matters but include tax provisions. These non-tax treaties include air transportation agreements and trade and investment treaties, such as the agreement governing the World Trade Organization. In general, these agreements contain carve-out provisions indicating that any income tax issues will be dealt with exclusively under the income tax treaty between the countries.

10. One important recent development is the proliferation of tax information exchange agreements. Typically, these agreements are entered into by high-tax countries with low-tax or no-tax countries with which they would not otherwise have a tax treaty. In general, these agreements require the low-tax or no-tax countries to exchange information on the same basis as provided in article 26 (Exchange of information) of the United Nations and OECD Model Conventions.

IV. The process of negotiating tax treaties

11. The process of negotiating a tax treaty[2] typically begins with initial contacts between the countries. In deciding whether to enter into tax treaty negotiations with other countries, a country will consider many factors, the most important of which is

[1] Organization for Economic Cooperation and Development, *Action Plan on Base Erosion and Profit Shifting* (Paris, 2013).

[2] For more comprehensive information see “Papers on selected topics in negotiation of tax treaties for developing countries”. Available from http://www.un.org/esa/ffd/documents/Papers_TTN.pdf.

the level of trade and investment between them Once the countries have decided to negotiate, they will exchange their model treaties (or their most recent tax treaties, if they do not have a model treaty) and schedule face-to-face negotiations. Typically, treaties are negotiated in two rounds, one in each country. During the first round of negotiations, the negotiating teams will agree on a particular text — usually the United Nations or OECD Model Conventions — to use as the basis for the negotiations. After presentations by both sides on their domestic tax systems, the negotiations proceed on an article-by-article basis. Aspects of the text that cannot be agreed on are usually placed in square brackets, to be dealt with later. Once the wording of an article is agreed upon, the parties initial it. When the wording of all of the articles has been agreed upon by the treaty negotiators, arrangements will be made for the treaty to be signed by an authorized official (often an ambassador or government official). After signature, each State must ratify the treaty in accordance with its own ratification procedures. The treaty is concluded when the countries exchange instruments of ratification and enters into force in accordance with the specific rules in the treaty (article 29 (Entry into force) of the United Nations Model Convention).

12. Thus, the negotiation of a tax treaty involves several separate steps or stages: signature, ratification, conclusion and entry into force. Each of these steps has a special meaning and particular consequences.

13. Once a treaty has been adopted, it may be modified in minor or major ways by the mutual consent of the contracting States. It is commonplace for them to amend a tax treaty by entering into a protocol to the treaty. Under international law, an agreement designated as a protocol is simply a treaty under a different name. Thus, as described above, it must be ratified under the rules applicable to treaties before it becomes effective.

14. Domestic tax law must be amended and interpreted frequently to respond to new circumstances. Tax treaties are no different from domestic tax law in this regard. In theory, the proper remedy for a defective treaty provision is the bilateral adoption of an appropriate amendment to the treaty. In practice, the amendment process is often exceedingly slow and difficult. It is not uncommon for a protocol to take as long to negotiate as a treaty. Often, once one aspect of a treaty is opened up for renegotiation, other aspects of it become negotiable.

15. To a limited degree, tax treaties may be updated without a formal amendment procedure through the interpretative process. For example, the mutual agreement procedure in most treaties authorizes the competent authorities of the two States to resolve issues of interpretation. The general rules for interpreting treaties are discussed below.

V. The United Nations and Organization for Economic Cooperation and Development Model Tax Conventions

16. There are two influential model tax conventions — the United Nations and OECD Model Conventions. In addition, some countries have their own model tax treaties, which are often not published but are provided to other countries for the purpose of negotiating tax treaties. The United Nations Model Convention draws heavily on the OECD Model Convention.

17. Model tax treaties have a long history, beginning with early diplomatic treaties of the nineteenth century. The limited objective of those treaties was to ensure that diplomats of one country working in another country would not be discriminated against and were extended to cover income taxation once it became significant in the early part of the twentieth century. After the First World War, the League of Nations commenced work on the development of a model treaty dealing exclusively with income tax issues. That work culminated in Model Conventions in 1943 and 1946. They were not unanimously accepted, and the work of creating an acceptable model treaty was taken over by the OECD and the United Nations.

18. Currently, OECD has 34 members, consisting of many of the major industrialized countries. The OECD Model Convention was first published in draft form in 1963. It was revised in 1977 and again in 1992, at which time it was converted to a loose-leaf format in order to facilitate more frequent revisions. Since then, revisions have been made every few years on nine occasions, most recently in 2014. The Committee on Fiscal Affairs. which consists of senior tax officials from the member countries, has responsibility for the Model Convention as well as other aspects of international tax cooperation. The Committee operates through several working parties and its permanent secretariat is contained in the Centre for Tax Policy and Administration. The working parties consist of delegates from the member countries. Working Party No. 1, on Tax Conventions and Related Questions, is responsible for the Model Convention, and it examines issues related to it on an ongoing basis.

19. A detailed commentary, organized on an article-by-article basis, accompanies the OECD Model Convention. The OECD commentaries have become increasingly important with respect to the interpretation and the application of tax treaties, including some treaties between countries that are not members of OECD. To take account of the positions of some non-member States, OECD opened up the commentaries in 1999 to many of them, including Argentina, Brazil, China, India, the Russian Federation and South Africa.

20. The OECD Model Convention favours capital-exporting countries over capital-importing countries. Often it eliminates or mitigates double taxation by requiring the source country to give up some or all of its tax on certain categories of income earned by residents of the other treaty country. This feature of the OECD Model Convention is appropriate if the flow of trade and investment between the two countries is reasonably equal and the residence country taxes any income exempted by the source country. However, the OECD Model Convention may not be appropriate for treaties entered into by net capital-importing countries. As a result, developing countries devised their own model treaty under the auspices of the United Nations.

21. The work of the United Nations on a model treaty commenced in 1968 with the establishment by the Economic and Social Council of the United Nations Ad Hoc Group of Experts on Tax Treaties between Developed and Developing Countries pursuant to its resolution 1273 (XLIII). The Group of Experts produced a Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, which led to the publication of the United Nations Model Double Taxation Convention between Developed and Developing Countries in 1980. The Model Convention was revised in 2001 and again in 2011. In 2004, the Group of Experts became the Committee of Experts on International Cooperation in Tax

Matters, pursuant to Economic and Social Council resolution 2004/69. The Committee maintains detailed commentaries on the United Nations Model Convention; it is also responsible for the publication of several useful manuals on tax issues important for developing countries, such as transfer pricing and the negotiation of tax treaties between developed and developing countries. The members of the Committee are tax officials nominated by their Governments and appointed by the Secretary-General of the United Nations, who serve in their individual capacity. A small majority of the members of the Committee are from developing countries and countries with economies in transition. The United Nations Model Convention follows the pattern set by the OECD Model Convention and many of its provisions are identical, or nearly so, to those in that Model Convention. In general, therefore, it makes sense not to view the United Nations Model Convention as an entirely separate one, but rather as making important, but limited, modifications to the OECD Model Convention.

22. The main difference between the two Model Conventions is that the United Nations Model Convention imposes fewer restrictions on the taxing rights of the source country; source countries, therefore, have greater taxing rights under it compared to the OECD Model Convention. For example, unlike article 12 (Royalties) of the OECD Model Convention, article 12 of the United Nations Model Convention does not prevent the source country from imposing tax on royalties paid by a resident of the source country to a resident of the other country. The United Nations Model Convention also gives the source country increased taxing rights over the business income of non-residents compared to the OECD Model Convention. For example, the time threshold for a construction site permanent establishment under the United Nations Model Convention is only 6 months, compared to 12 months under the OECD Model Convention. In addition, furnishing services in a country for 183 days or more constitutes a permanent establishment under the United Nations Model Convention, whereas under the OECD Model Convention furnishing services is a permanent establishment only if the services are provided through a fixed place of business which, according to the OECD commentary thereon, must generally exist for more than six months.

23. The success of the United Nations and OECD Model Conventions has been astounding. Virtually all existing bilateral tax treaties are based on them. Their wide acceptance, and the resulting standardization of many international tax rules, have been important factors in reducing international double taxation.

24. Changing the United Nations and OECD Model Conventions to correct flaws and respond to new developments is extremely difficult. One source of difficulty is that countries can bring their existing tax treaty networks into line with a revision to the United Nations or OECD Model Conventions only by renegotiating virtually all of their existing treaties. In contrast, the commentaries on the United Nations or OECD Model Conventions are much easier to change than the Model Conventions themselves. Therefore, if a commentary is revised, it is possible for the tax authorities of countries to interpret existing treaties in accordance with it without the need to renegotiate existing treaties.

25. Unlike the United Nations Model Convention, the OECD Model Convention reflects the positions of the OECD member countries. Member countries that disagree with any aspect of the OECD Model Convention can register a reservation on the particular provision. These reservations are found in the commentaries to the

Model Convention and indicate that the country does not intend to adopt the particular provision(s) of the OECD Model Convention in its tax treaties. Most countries have entered reservations on some aspects of it. For example, several countries have entered reservations on article 12, dealing with royalties, by asserting their intention to levy withholding taxes on them.

26. The commentaries on the OECD Model Convention also contain observations by particular countries on specific aspects of them. Countries register observations to indicate that they disagree with the interpretation of the treaty provided in the commentary. A country making an observation does not reject the particular provision of the OECD Model Convention (in other words, it has not registered a reservation on the provision). The purpose of an observation is to indicate that the country may include the provision in its treaties but it will interpret and apply it in a manner different from the interpretation espoused in the commentary.

VI. Contents of a typical tax treaty

27. The following describes briefly the structure and major provisions of a typical bilateral tax treaty which is based on the United Nations or OECD Model Conventions.

28. Chapter I consists of article 1, which identifies the persons whose tax obligations are affected by the treaty, generally residents of the contracting States, and article 2, which describes the taxes covered by the treaty, generally income and capital taxes imposed by the contracting States and their political subdivisions.

29. Chapter II provides definitions of important terms used in the treaty including general definitions in article 3, a definition of the term “resident” in article 4 and “permanent establishment” in article 5.

30. Chapter III contains what are often referred to as the distributive rules of the treaty. Articles 6 to 21 deal with various types of income derived by a resident of one or both of the States. In general, these provisions determine whether only one or both of the contracting States — the State in which the taxpayer is resident (the residence country) and the State in which the income arises or has its source (the source country) — can tax the income and whether the rate of tax imposed is limited. The articles and the types of income are as follows:

Article 6 — Income from immovable property;

Article 7 — Business profits;

Article 8 — Income from the operation of ships or aircraft in international traffic and boats in inland waterways transport;

Article 9 — Profits of associated enterprises and transfer pricing;

Article 10 — Dividends;

Article 11 — Interest;

Article 12 — Royalties;

Article 13 — Capital gains;

Article 14 — Income derived from professional and independent services;

Article 15 — Income from employment;

Article 16 — Directors' fees and remuneration of top-level managerial officials;

Article 17 — Income derived by artistes (entertainers) and athletes;

Article 18 — Pensions and social security payments;

Article 19 — Income derived by government employees;

Article 20 — Income derived by students, business trainees and apprentices;

Article 21 — Other income; in other words, income not dealt with in articles 6 to 20.

31. Chapter IV deals with the taxation of capital (not income from capital).

32. Chapter V provides two alternative methods for eliminating double taxation: article 23A (Exemption method) and article 23B (Credit method). In general, if the contracting State in which income arises is entitled by the rules in articles 6 to 21 to tax the income, the contracting State in which the taxpayer is resident is obligated to provide relief from double taxation. Under the exemption method, the residence country excludes or exempts the income from residence country tax. Under the credit method, the residence country taxes the income but provides a deduction from that tax for the tax paid to the source country on the income.

33. Chapter VI is entitled "Special provisions". Article 24 provides protection against various forms of discriminatory taxation by the source and residence countries. Articles 25, 26 and 27 provide for important types of administrative cooperation between the contracting States for the purpose of carrying out their obligations under the treaty. Article 25 provides a mutual agreement procedure to resolve disputes concerning the application of the treaty; article 26 deals with exchanges of information between the States; and article 27 provides rules for the contracting States to assist in collecting one another's taxes. Article 28 simply provides that nothing in the treaty affects the "fiscal privileges" enjoyed by diplomats and consular officials under international law or other international agreements.

34. Chapter VII provides rules to govern the entry into force and termination of the treaty.

VII. Relationship between tax treaties and domestic law

35. The relationship between tax treaties and domestic tax legislation is a complex one in many countries. The basic principle is that the treaty should prevail in the event of a conflict between the provisions of domestic law and a treaty. In some countries — France is an example — this principle has constitutional status. In many other countries, the Government clearly has the authority under domestic law to override the provisions of a tax treaty. For example, legislative supremacy is a fundamental rule of law in many parliamentary democracies. As a result, it is clear in these countries that domestic tax legislation may override their tax treaties. However, the courts in these countries may require that the legislature explicitly indicate its intention to override a treaty before giving effect to a conflicting

domestic law. Courts may also strain to find some ground for reconciling an apparent conflict between a treaty and domestic legislation.

36. In general, tax treaties apply to all income and capital taxes imposed by the contracting States, including taxes imposed by provincial (state), local and other subnational governments. In some federal States, however, the central government is constrained by constitutional mandate or established tradition from entering into tax treaties that limit the taxing powers of their subnational governments. Accordingly, the tax treaties of such federal States apply only to national taxes. This is the situation for both Canada and the United States of America. In such circumstances, a subnational government may impose taxes in a manner that would not be permitted for its central government.

37. In general, tax treaties do not impose tax. Tax is imposed by domestic law; therefore, tax treaties limit the taxes otherwise imposed by a State. In effect, tax treaties are primarily relieving in nature. Similarly, they do not allocate taxing rights, although it is often claimed that they do. In the light of this fundamental principle, it is usually appropriate before applying the provisions of a tax treaty to determine whether the amount in question is subject to domestic tax. If the amount is not subject to tax under domestic law, it is unnecessary to consider the treaty. For example, assume that under the provisions of a treaty between country A and country B, interest paid by a resident of one State to a resident of the other State is subject to a maximum rate of withholding tax of 15 per cent. If, under the law of country A, interest paid by a corporation resident in that country to an arm's-length lender resident in country B is exempt from tax by country A, the treaty does not give country A the right to impose a 15 per cent withholding tax on the interest.

38. However, whether tax treaties give a right to tax independent of domestic law is a question of domestic law. A few countries — France is an example — take the position that they have the right to tax under domestic law any amount that they are not prevented from taxing under the terms of the treaty.

39. The provisions of tax treaties do not displace the provisions of domestic law entirely. Consider, for example, a situation in which a person is considered to be a resident of country A under its domestic law and is also considered to be a resident of country B under its domestic law. If the person is deemed to be a resident of country A pursuant to the tie-breaker rule in the treaty between country A and country B (article 4 (2) (Resident) of both the United Nations and OECD Model Conventions provides a series of rules to make a person who is resident in both countries a resident of only one country for purposes of the treaty), the person is a resident of country A for purposes of the treaty but remains a resident of country B for purposes of its domestic law for all purposes not affected by the treaty. Thus, for example, if the person makes payments of dividends, interest or royalties to non-residents of country B, the person will be subject to any withholding obligations imposed by country B on such payments because the person remains a resident of country B.

40. Occasionally, some countries have passed legislation to modify or overturn the interpretation of a tax treaty given by a domestic court. Such legislation, adopted in good faith, may not violate a country's obligations under its tax treaties. Often the country overriding its tax treaties in this way will consult with its treaty partners to demonstrate good faith and prevent misunderstandings.

41. Some countries may seek to prevent court challenges to certain domestic tax legislation on the basis of the country's tax treaties by providing that the new legislation prevails over any conflicting provisions of a tax treaty. The most well-known and controversial treaty overrides are probably those adopted by the United States; however, other countries have also done so on occasion. Treaties are solemn obligations that should not be disregarded except in extraordinary circumstances. At the same time, countries must have the ability to amend the provisions of their domestic tax legislation to keep it current and to clarify interpretative difficulties.

42. Many of the provisions of tax treaties do not operate independently of domestic law because they include explicit references to the meaning of terms under domestic law. For example, under article 6 (Income from immovable property) income located in a country is taxable by that country. For this purpose, the term "immovable property" has the meaning that it has under the domestic law of the country in which the property is located. In addition, article 3 (2) (General definitions), which is discussed below, provides that any undefined terms in the treaty should be interpreted to mean what they mean under the law of the country applying the treaty. Conversely, in some countries where domestic law uses terms that are also used in the treaty, the meaning of those terms for purposes of domestic law may be interpreted in accordance with the meaning of the terms for purposes of the treaty.

VIII. Objectives of tax treaties

43. The objective of a tax treaty, broadly stated, is to facilitate cross-border trade and investment by eliminating the tax impediments to these cross-border flows. This broad objective is supplemented by several more specific, operational objectives.

44. Arguably, the most important operational objective of bilateral tax treaties is the elimination of double taxation. If income from cross-border trade and investment is taxed by two or more countries without any relief, such double taxation would obviously discourage such trade and investment. Many of the substantive provisions of the typical bilateral tax treaty are directed at the achievement of this goal. For example, article 4 (2) (Resident) of the United Nations Model Convention contains tie-breaker rules to make a taxpayer who is otherwise considered to be resident in both countries to be a resident in only one of the countries for purposes of the treaty. They also limit or eliminate the source-country tax on certain types of income and require residence countries to provide relief for source-country taxes either by way of a foreign tax credit or an exemption for the foreign-source income.

45. Originally, the focus of tax treaties was almost exclusively on solving the problem of double taxation. Multinational enterprises were facing risks of substantial double taxation, few countries provided unilateral relief for double taxation and treaty networks were just being developed. Treaty solutions to most of the major double-tax problems were worked out in the mid-twentieth century, however, and they are now routinely accepted by States when they enter into tax treaties. The one major exception is the double-tax problem arising from inconsistent applications by countries of the arm's length method for establishing transfer prices in transactions between related persons.

46. The historical emphasis on the elimination of double taxation should not obscure the fact that most tax treaties have another equally important operational objective — the prevention of tax evasion and avoidance or double non-taxation. In other words, the fundamental principle is that treaties should apply to ensure that income is taxed once, and only once. This objective counterbalances the elimination of double taxation. Just as double taxation imposes an inappropriate barrier to international commerce, the tolerance of fiscal evasion and avoidance offers an inappropriate incentive to such commerce. Although the elimination of tax evasion and avoidance is an objective of most tax treaties recognized by both the United Nations and OECD, there are few provisions in typical tax treaties that are designed to achieve it.

47. In addition to the two principal operational objectives of tax treaties, there are several ancillary objectives. One ancillary objective is the elimination of discrimination against foreign nationals and non-residents. Any country entering into a treaty wants to ensure that its residents who carry on business in the other contracting State are treated the same as the residents of that other State who carry on similar activities. A second ancillary objective is to facilitate administrative cooperation between the contracting States. This administrative cooperation has three main dimensions: exchange of information, assistance in the collection of taxes and dispute resolution.

48. The exchange of information in the typical tax treaty can be an important tool in combating tax evasion and avoidance and to ensure that taxpayers receive treaty benefits. The United Nations and OECD Model Conventions both provide that each contracting State will collect tax assessed by the other State as if the tax were its own. Finally, most treaties provide a mechanism in their treaties — the mutual agreement procedure — for resolving disputes concerning the application of the treaty. This procedure is often used to resolve transfer pricing disputes.

49. One of the most important effects of tax treaties is to provide certainty for taxpayers. Certainty concerning the tax consequences of cross-border investment is an important factor in facilitating such investment. Tax treaties have an average life of approximately 15 years. As a result, non-resident investors know that, despite changes in the tax laws of the source country, the basic limitations in the treaty on the source country's right to tax will continue to prevail. For example, if company A, a resident of country A, licenses residents of country B to use intangible property developed by company A, company A will know (for example) that the rate of withholding tax on royalties provided in the treaty between it and country B will continue to apply even if country B increases that rate under its domestic law.

50. Although it may not be an objective of a tax treaty, the allocation of tax revenues from cross-border activity between the two contracting States is certainly an effect of the treaty. As a result, the treaty negotiators should be acutely aware that the provisions of the treaties they are entering into will determine how much tax revenue will be subject to domestic tax. For example, if a country agrees to a 5 per cent rate of tax on interest under article 11 (Interest), its tax on interest paid by residents of the country to lenders resident in the other country will be limited to 5 per cent of the total interest paid and the other country's tax revenues will be whatever its tax rate on its residents is less the 5 per cent tax paid to the source country.

IX. Interpretation of tax treaties

51. The interpretation of tax treaties is a task that must be undertaken by taxpayers, tax authorities and domestic courts. From a simplistic perspective, tax treaties can be interpreted broadly to give effect to their perceived purposes or narrowly adhere strictly to their literal wording.

52. The interpretation of tax treaties bears certain similarities to that of domestic tax legislation. For example, the meaning of the words, the context in which they are used and the purpose of the provision are generally important in interpreting both treaties and domestic tax legislation. There may be a tendency for tax authorities and courts to interpret tax treaties in the same way as domestic tax legislation. There are, however, several important differences between tax treaties and domestic tax legislation, as follows:

(a) Because two contracting States are involved in every treaty, questions of interpretation should be resolved by reference to the mutual intentions and expectations of both of them;

(b) Tax treaties are addressed to a broader audience than domestic legislation, namely, to both the Governments and taxpayers of each country;

(c) Tax treaties are often not drafted using the same terms as domestic legislation. For example, the United Nations Model Convention uses the term "enterprise," which is not used in the domestic legislation of many countries;

(d) Tax treaties are primarily relieving in nature, as discussed above; they do not impose tax;

(e) The United Nations and OECD Model Conventions and commentaries thereon have no counterparts in the context of domestic tax legislation.

53. Given these differences, the question is whether another interpretive approach is appropriate for tax treaties.

54. As tax treaties are treaties, their interpretation is governed by the Vienna Convention on the Law of Treaties (Vienna Convention), which applies to all treaties, not just tax treaties. Many countries have signed it and are bound by its terms. However, even countries that have not done so may be bound by its provisions because they represent a codification of customary international law, which is binding on all nations.

55. The basic rule of interpretation in article 31 (1) of the Vienna Convention provides as follows:

> A treaty shall be interpreted in good faith in accordance with the ordinary meaning to be given to the terms of the treaty in their context and in light of its object and purpose.

56. The context under article 31 (2) includes the text of the treaty and any agreements between the parties made in connection with the conclusion of the treaty and any instrument made by one of the parties and accepted by the other party. For example, the United States produces a technical explanation for each of its tax treaties, and Canada publicly announced its acceptance of the United States

technical explanation of the United States-Canada treaty.[3] In addition, under article 31 (3), subsequent agreements between the parties and subsequent practice with respect to the interpretation of the treaty and any applicable rules of international law must be taken into account together with the context. Therefore, for example, if the competent authorities of the two States enter into an agreement concerning the interpretation of the treaty, the agreement must be taken into account for purposes of interpreting the treaties in the same way as if it were included in the treaty itself.

57. The approach to interpretation in article 31 (1) of the Vienna Convention makes intuitive sense. Obviously, it makes sense as the first step in the interpretive process to consider the ordinary meaning of the words of the treaty, but those words must be read in the context of the treaty as a whole, because the meaning of words is always dependent on the context in which they are used. Finally, it also makes sense to interpret the terms of a treaty in the light of its purpose because, obviously, the contracting States are trying to accomplish something by entering into the treaty and agreeing on its terms.

58. Although article 31 (1) of the Vienna Convention makes sense, it must also be acknowledged that it is vague and does not provide any clear, meaningful guidance on the interpretation of treaties. Most importantly, it does not indicate (and it would be impossible for any interpretive rules to do so in a reasonable manner) how much weight to give to the ordinary meaning of the words, the context and the purpose of the relevant provisions of the treaty in any particular case. For example, if there is a conflict between the ordinary meaning of the words and the purpose of the relevant provision, article 31 (1) does not indicate how the conflict should be resolved.

59. Under article 32 of the Vienna Convention, other elements, referred to as supplementary means of interpretation, which include the preparatory work of the treaty and the circumstances of its conclusion, are only to be considered to confirm the meaning established pursuant to article 31, or to establish the meaning if article 31 produces an ambiguous, obscure, absurd or unreasonable result.

60. Although the United Nations and OECD Model Conventions and Commentaries are important sources for the interpretation of tax treaties, they are clearly not binding. Their legal status under the provisions of the Vienna Convention is unclear. At first glance, they appear to be supplementary means of interpretation under article 32. If so, they might be considered to be of limited relevance or importance because they can be used only to confirm the meaning otherwise established by the application of the principles of interpretation in article 31 or, as mentioned above, to establish the meaning if the meaning under article 31 is ambiguous, obscure, absurd or unreasonable. The United Nations Committee of Experts and OECD do not intend the Model Conventions and commentaries to have such a limited role. The introduction to the United Nations Model Convention states that, while its provisions and the commentaries thereto are not enforceable and should not be considered as formal recommendations, they are "intended to facilitate the negotiation, interpretation and practical application of bilateral tax treaties based upon its provisions." Similarly, in paragraph 29, the introduction to the OECD Model Convention indicates that the commentaries can be of great assistance in the application and interpretation of the conventions and, in particular,

[3] Convention between Canada and the Unites States of America with Respect to Taxes on Income, Washington, D.C., 26 September 1980, as amended.

in the settlement of any disputes. It is difficult, however, to justify including the United Nations or OECD Model Conventions and commentaries as part of the context of a treaty under article 31 of the Vienna Convention, especially if the treaty being interpreted was entered into before the particular aspect of the relevant Commentary was revised.

61. Although the status of the OECD Model Convention and commentaries under the Vienna Convention is a controversial topic among international tax scholars, the issue appears to be primarily theoretical and of little practical significance. In treaty cases from virtually all countries, the courts usually give the Model Conventions and Commentaries substantial weight.

62. It is important that tax treaties be interpreted the same way in both countries (the principle of common interpretation), otherwise income may be taxed twice or not at all. Assume, for example, that S, a resident of country A, performs services in country B for more than 183 days for the benefit of corporation C. The services result in the creation of some work product used by corporation C. S receives a payment from corporation C that is characterized under the laws of country B as compensation for performing services in country B. In contrast, country A characterizes the payment as a royalty for allowing corporation C to use S's work product. Under the tax treaty between the two countries, fees for personal services are taxable in the source State and royalties are taxable exclusively in the residence State (as they are under article 12 (Royalties) of the OECD Model Convention). Under these circumstances, S will be subject to double taxation unless the competent authorities of the two countries can resolve the matter.

63. Some countries have more than one official language. When these countries enter into tax treaties, there may be multiple official versions of the treaty in various languages. Article 33 of the Vienna Convention provides that, for tax treaties concluded in multiple languages, all versions of the treaty are considered to be equally authentic unless the provisions of the treaty specify that one version is to govern in the event of a conflict. Some countries that conclude their tax treaties in multiple languages, such as China, provide that the English language version of the treaty will prevail where the versions conflict.

64. In addition to the provisions of the Vienna Convention, tax treaties based on the United Nations and OECD Model Conventions contain an internal rule of interpretation. Article 3 (2) (General definitions) of the United Nations and OECD Model Conventions provides that any undefined terms used in a treaty should be given the meaning that they have under the domestic law of the country applying the treaty unless the context requires otherwise. Thus, the application of article 3 (2) involves a three-stage process, as follows:

(a) Does the treaty provide a definition of the term?

(b) If the treaty does not provide a definition, what is the domestic meaning (not necessarily the definition under domestic law) of the term?

(c) Does the context of the treaty require a meaning different from the domestic meaning?

65. The first step is not as simple as it appears. For example, some definitions in tax treaties are inclusive. Article 3 (1) (a) defines a person to include an individual, a company and any other body of persons. In contrast, the definition of company in

Article 3 (1) (b) is exclusive ("company means ..."). Generally, an inclusive definition means that the term has its ordinary meaning plus the items that are specifically mentioned. Article 3 (2) should apply to determine the ordinary meaning under domestic law of terms that are defined inclusively, such as "person", although it is not completely clear. Further, definitions in the treaty often contain terms that are undefined. For example, the terms "individual" and "body of persons" in article 3 (1) (a) are not defined. These terms should also take their meaning from domestic law by virtue of article 3 (2), although, once again, this result is not completely clear.

66. The determination of the meaning of a term under domestic law also may be difficult. Domestic tax legislation is generally imposed on the legal consequences of transactions and the legal status of persons under the general law. Article 3 (2) explicitly recognizes that the domestic meaning of a term used in a treaty may be derived from the general domestic law rather than the domestic tax law. Where, however, the domestic tax law provides a meaning for an undefined treaty term, article 3 (2) provides that the meaning of the term under a country's tax law prevails over the meaning under other domestic laws. An undefined term, however, may have more than one meaning for purposes of a country's tax law. In this situation the domestic meaning that is most appropriate should be used in the context of the treaty. It should also be noted that article 3 (2) refers to the "meaning" of an undefined term, not its definition, under domestic law. A term may not be defined for purposes of a country's tax law, but, assuming that it is used in domestic law, it should have an ordinary meaning.

67. The final step in the application of article 3 (2) is to consider whether the context of the treaty requires the use of a different meaning of a term from the meaning under the domestic law. For this reason, it is necessary to consider the alternative meanings of the term for purposes of the treaty and whether one of them is more appropriate in the context of the treaty than the one under the domestic law. Matters that should be considered in this analysis include:

- The ordinary meaning of the term, as compared to the meaning under domestic tax law
- The meaning of the term under the other country's tax law
- The purpose of the relevant provision of the treaty
- Extrinsic material, such as the commentaries to the United Nations and OECD Model Conventions.

68. Some international tax scholars argue that in applying article 3 (2), if at all possible, undefined terms should be given a meaning that is independent of domestic law (a treaty meaning or international fiscal meaning) and that a domestic law meaning should be used only as a last resort. Other scholars argue that article 3 (2) contains a preference for domestic law meanings because they are only displaced by a treaty meaning if "the context requires otherwise." The use of the word "requires," they argue, places a substantial onus on those seeking to justify a treaty meaning.

69. The words of article 3 (2) do not establish any clear preference for domestic law meanings or treaty meanings for undefined terms. Thus, the meaning of

undefined terms in a tax treaty should be determined by reference to all of the relevant information and the entire context.

70. Another important and controversial issue of interpretation in connection with article 3 (2) of the United Nations and OECD Model Conventions is whether the meaning of a term is that existing under domestic law at the time the treaty was entered into (the static approach) or under the domestic law as amended from time to time (the ambulatory approach). Article 3 (2) of the OECD Model Convention was amended in 1995 to make it clear that article 3 (2) should be applied in accordance with the ambulatory approach. A similar conforming amendment was made to the United Nations Model Convention 2001. The ambulatory approach allows treaties to accommodate changes in domestic law without the need to renegotiate the treaty. A drawback of this approach is that it effectively permits a country to amend unilaterally its tax treaty with another country by changing certain parts of its domestic law. For example, an amendment to domestic law that significantly alters the bargain between the two countries and was not contemplated by them, is equivalent to a treaty override and might be rejected as inconsistent with article 26 of the Vienna Convention (*pacta sunt servanda*).