Economic & Social Affairs

United Nations

Manual for the Negotiation of Bilateral Tax Treaties

between Developed and Developing Countries 2019

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United Nations
New York, 2019

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Preface

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

Mobilizing domestic public revenue for investment in sustainable development has featured prominently on the financing for development agenda since the 1990s. The Addis Ababa Action Agenda (Addis Agenda) of the Third International Conference on Financing for Development (Addis Ababa, 13–16 July 2015) provides a global framework for financing sustainable development by aligning all financial flows and policies with economic, social and environmental priorities. The Addis Agenda, with its more than 100 concrete actions and commitments that Member States of the United Nations have pledged to undertake, highlights the need to strengthen tax administration, implement policies to generate additional resources, and combat corruption and illicit financial flows. Recognizing the limits to what individual Governments can accomplish in a globalized economy, it further calls for increased capacity-building and strengthened international tax cooperation.

The Addis Agenda stresses that efforts in international tax cooperation should be universal in approach and scope and should fully take into account the different needs and capacities of all countries. While many countries have made improvements in their tax administrations in recent years, establishing and maintaining a sustainable source of revenues to fund domestic expenditures remain a challenge for many developing countries. Significant gaps persist in the capacities of developed and developing countries to raise public financial resources, including through modernized tax systems, improved tax policy and

efficient tax collection, as well as through combating tax evasion and tax avoidance. While the average tax-to-GDP ratio in OECD countries has remained above 30% over the last 35 years,[1] the tax-to-GDP ratio of many developing countries is still below the 2015 world's average of 15%, which is the target that the IMF typically recommends to countries with low tax-to-GDP levels.[2] It is therefore important to support national domestic resource mobilization efforts of developing countries by providing technical assistance and enhancing international tax cooperation.

Tax treaties play a key role in international cooperation on tax matters. On the one hand, they encourage both investment and the transfer of skills and technology by reducing tax barriers, including double taxation; on the other, they seek to reduce cross-border tax avoidance and evasion through exchange of tax information and mutual assistance in the collection of taxes. Tax treaties can benefit both developed and developing countries. However, developing countries, especially the least developed among them, often lack the adequate skills and experience to effectively negotiate and administer tax treaties that encourage international investments while protecting their tax base.

The present publication, entitled *United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* (the Manual), aims at strengthening the technical expertise of developing countries' tax officials as regards the negotiation of tax treaties. It provides practical guidance to treaty negotiators in developing countries, in particular those who use the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (the UN Model).[3] This Manual constitutes an introductory guide to tax treaty negotiations and, as such, provides general explanations

1 OECD, *Revenue Statistics 2017—Tax revenue trends in the OECD*, Paris, 2018, p. 2.

2 Vitor Gaspar, Laura Jaramillo and Philippe Wingender, T*ax Capacity and Growth: Is there a Tipping Point?,* IMF Working Paper WP/16/234, November 2016, p. 30.

3 United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries 2017,* (New York: United Nations, 2018), available at https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

on the way treaty negotiations are conducted and on the issues that are typically addressed during these negotiations. While it seeks to identify important issues that treaty negotiators should be aware of, it does not attempt to provide an exhaustive analysis of these issues. When preparing for treaty negotiations, the user of this Manual will therefore often need to go beyond the explanations provided in these pages and to further research the issues that are identified therein. keeping in mind that the detailed Commentaries on the provisions of the *United Nations Model Double Taxation Convention between Developed and Developing Countries* and of the *OECD Model Tax Convention on Income and on Capital* constitute the most authoritative source of information on the interpretation of these provisions.

We see this Manual as an important contribution to the implementation of the Addis Agenda and hope that it will serve as a useful and relevant tool in assisting developing countries to foster their sustainable development efforts.

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Introduction

Historical background

1. The *Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries* (the Manual) was initially published in 1978[4] and first revised in 2003.[5] In its resolution 2004/69 of 11 November 2004, the Economic and Social Council mandated the Committee of Experts on International Cooperation in Tax Matters (the Committee) to "keep under review and update as necessary" both the Manual and the *United Nations Model Double Taxation Convention between Developed and Developing Countries* (the UN Model).[6]

2. From 2005 to 2011, work on updating the Manual was undertaken by the first Subcommittee on a Manual for the Negotiation of Tax Treaties.[7] In 2012, the Committee requested the Secretariat "to seek additional resources to advance the work" in this area. In response to that request, an expert group meeting on "Tax Treaty Negotiation and Capacity Development" was organized at the end of December 2013. One of the proposals resulting from that meeting was to draft a series of practical papers, from the perspective of developing countries, on issues related to tax treaty negotiation.

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4 Department of International Economic and Social Affairs, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, United Nations Publications, New York, 1979, document ST/ESA/94.

5 Department of Economic and Social Affairs, Division for Public Administration and Development Management, *Manual for the Negotiation of Bilateral Tax Treaties Between Developed and Developing Countries*, United Nations, New York, 1979, document ST/ESA/PAD/SER.E/37.

6 United Nations, Department of Economic and Social Affairs, *United Nations Model Double Taxation Convention between Developed and Developing Countries 2017,* (New York: United Nations, 2018), available at https://www.un.org/esa/ffd/wp-content/uploads/2018/05/MDT_2017.pdf.

7 The mandate and composition of that former Subcommittee is available at http://www.un.org/esa/ffd/tax-committee/tc-psubcommittee-tax-treaties.html.

3. These draft papers were finalized in 2013 and published under the title *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries*[8] (the Papers). They were presented at the ninth session of the Committee (Geneva, 21–25 October 2013),[9] when the Committee decided to establish a Subcommittee on Negotiation of Tax Treaties — Practical Issues.[10] That Subcommittee was mandated to develop a practical manual on the negotiation of bilateral tax treaties based on the following principles:

— That it be a compact practical training tool for beginners or tax officials with limited experience and reflect the realities for developing countries at their relevant stages of capacity development;

— That it reflect the current version of the UN Model and the relevant Commentaries thereon, as well as ongoing decisions of the Committee leading to changes therein; and

— That it draw upon the previous work done by the Committee and any other relevant inputs, as well as work being done in other fora.

4. As a first step, the Subcommittee prepared an outline for a substantial revision of the Manual. A first draft, prepared with the assistance of former treaty negotiators, was discussed at a meeting of the Subcommittee held in September 2014 and at the tenth session of the Committee (Geneva, 27–31 October 2014).[11] A totally revised version of the *Manual* was subsequently finalized, edited and adopted by the Committee at its eleventh session (Geneva, 19–23 October 2015).[12]

5. At its fifteenth session (Geneva, 17 -20 October 2017), the Committee decided that the Manual should be revised to take account of

8 Available at http://www.un.org/esa/ffd/publications/papers-ntt.html.

9 The report of the ninth session is available at http://www.un.org/esa/ffd/events/ninth-session-tax.html.

10 The mandate of that Subcommittee is available at http://www.un.org/esa/ffd/uncategorized/tc-subcommittee-tax-treaties.html.

11 The report of the tenth session is available at http://www.un.org/esa/ffd/events/event/tenth-session-tax.html.

12 The report of the eleventh session is available at http://www.un.org/esa/ffd/events/event/eleventh-session-tax.html.

the substantial changes included in the new version of the UN Model that was adopted at its fourteenth session (New York, May 2017). A Subcommittee on Tax Treaty Negotiation was set up for that purpose with the following membership: Ms. Patricia Mongkhonvanit, coordinator (Thailand); Mr. Carlos E. Protto (Argentina); Ms. Stephanie Lynn Smith (Canada); Ms. Titia Stolte-Detring (Germany); Ms. Marlene Patricia Nembhard-Parker (Jamaica) and Ms. Chinyama Margaret Moonga Chikuba (Zambia). That Subcommittee was given the following mandate:[13]

> The Subcommittee is mandated to propose updates to the United Nations Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries, based on the following principles:
>
> - That it reflects the current version of the UN Model Double Taxation Convention between Developed and Developing Countries and the relevant UN Commentaries as well as ongoing decisions of the Committee leading to changes in them;
> - That it pays special attention to the experience of developing countries and reflects their realities and needs at their relevant stages of capacity development;
> - That it draws upon and feeds into, as appropriate, the relevant work done in other fora, especially the work on the toolkit on tax treaty negotiation by the Platform for Collaboration on Tax.
>
> The aim of the Subcommittee shall be to present to the Committee an update of the Manual for consideration with a view to adoption to in 2019. Updates on the progress of the work shall be provided to the Committee at each preceding session. The Subcommittee may request the secretariat to develop necessary inputs and provide necessary support within its resources.

6. In accordance with this mandate, a first draft of a revised Manual was prepared by the Subcommittee and was presented for discussion at the seventeenth session of the Committee (Geneva, 16 – 19 October

13 The report of the fifteenth session is available at http://www.un.org/ga/search/view_doc.asp?symbol=E/2018/45.

2018). Based on the discussion at the meeting, the Subcommittee revised the draft and this version of the Manual was finalized and adopted at the eighteenth session (New York, 23 – 26 April 2019).

Overview and structure

7. While every country should develop its own policy and define its objectives in relation to tax treaties, the Manual seeks to provide practical guidance on all aspects of tax treaty negotiation, including on how to prepare for and conduct negotiations. Treaty negotiators in developing countries, especially those with limited experience, are therefore encouraged to use this Manual in preparing for tax treaty negotiations in the light of their country's policy framework and the intended outcomes they wish to achieve.

8. Although the Manual provides a description of the Articles of the UN Model and, where there are differences, of those of the OECD *Model Tax Convention on Income and on Capital*[14] (OECD Model), it is not intended to replace the detailed Commentaries on these two models; these constitute the most authoritative sources on issues of interpretation of the UN and OECD models and should be consulted in parallel with the Manual.

9. Section I of the Manual introduces the main principles which underlie double tax treaties, including the concepts of residence and source. Tax treaties aim to address issues related to double taxation, as well as other tax barriers which can act as a deterrent to cross-border trade and investments. Section I deals with methods for the elimination of double taxation, as well as the risks associated with the failure by the residence country to provide relief of double taxation, excessive source taxation, tax discrimination and uncertainty and complexity in the tax environment. In addition, it discusses how tax treaties may help in addressing tax avoidance and evasion and in preventing tax base erosion, including situations of double non-taxation.

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14 OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, OECD Publishing, Paris, https://doi.org/10.1787/mtc_cond-2017-en, available at https://read.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2017_mtc_cond-2017-en#page1.

10. Section II of the Manual first addresses the fundamental question of why a country should negotiate tax treaties. It then elaborates on the importance of developing a tax treaty policy framework and a country model before entering into negotiations. It finally provides a comprehensive overview of the practical steps to be taken before, during and after the negotiation of each tax treaty.

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

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

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

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

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

— Chapter V (Methods for the elimination of double taxation) illustrates the operation of Article 23, which requires the country of residence of the taxpayer to provide relief from double taxa-

tion. This may be done by either the exemption method or the credit method.

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

— Chapter VII (Final provisions) covers the procedures for the entry into force and termination of treaties, as included in Articles 30 and 31.

12. Section IV of the Manual deals with the improper use of tax treaties, which may occur, for instance, when taxpayers enter into certain transactions or arrangements for the purpose of obtaining treaty benefits which would not otherwise be available to them. Section IV reviews the different tools that are available to prevent the granting of treaty benefits in these situations while taking into account the need to provide certainty and stability in the application of tax treaties.

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The electronic version of this Manual is available, free of charge, at https://www.un.org/esa/ffd/publications/manual-bilateral-tax-treaties-update-2019.html.

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

Contents

Section I

General introduction

A. Introduction

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

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

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

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

15. International income and capital taxation revolve around two main concepts — the concept of source and the concept of residence. Under their domestic tax law, countries will assert the right to tax income arising (or sourced) in their jurisdiction, and most countries will seek to tax residents on their income wherever arising. Similarly, countries that levy capital taxes (e.g. wealth taxes) will typically assert the right to tax property situated in their country and tax their residents on property wherever situated.

16. If more than one country asserts the right to tax the same income or capital, for example, where income having its source in one country is derived by a resident of another country or where property situated in one country is owned by a resident of another country, international double taxation of income or capital may arise.

17. It is in the interests of both taxpayers and governments that tax barriers to cross-border trade and investment such as double taxation be removed while ensuring that domestic tax systems can be properly applied and administered. Tax treaties contribute to the elimination of double taxation and other tax barriers. They also contribute to the prevention of cross-border tax evasion and avoidance.

B. Concepts and issues

1. Concept of residence

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

19. Domestic law rules for determining residence for tax purposes differ from country to country. With respect to individuals, residence is typically based on factors such as the economic and family ties that the individual has with the country, the existence of a place of abode in that country and the duration of physical presence in that country. Citizenship is different from residence but it is important to remember that the United States requires its citizens to pay tax on their worldwide income even if they do not reside in that country. This raises a number of issues when negotiating and applying tax treaties with the United States but a detailed discussion of these issues would go beyond the scope of this Manual.

20. In the case of legal entities such as companies, residence may be based on the place of incorporation or constitution of the entity, the location of its head office, the place where it is managed and controlled,

the place of its effective management or other similar criteria that indicate a strong connection with a country.

21. Differences in the domestic tax law criteria used to determine residence for tax purposes mean that individuals and legal entities that have links to more than one country may be regarded as tax residents of more than one country, and hence liable to tax on their worldwide income or capital in more than one country. Tax treaties typically address the potential double taxation that would result from such situations by providing rules (often referred to as "tie-breaker rules") that allocate tax residence to only one country for the purposes of the application of the provisions of a tax treaty.

2. Concept of source

22. Income tax is also imposed under the domestic law of most countries if the income is considered to have its source therein ("source principle") regardless of whether that income is derived by a resident or a non-resident. Similarly, capital taxes are typically levied with respect to property situated in a country regardless of the residence of the owner of the property.

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

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

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

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

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

C. International double taxation

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

1. Residence/residence juridical double taxation

29. As noted above, double taxation may occur where a person is taxed on worldwide income in more than one country on the basis that

the person is regarded as a resident for tax purposes in each of them. Such double taxation, which is referred to as "residence/residence juridical double taxation", is dealt with under tax treaties by the inclusion of tie-breaker rules, such as those contained in Article 4 (Resident), paragraphs 2 and 3, of the UN Model. These rules deem the person to be a resident of only one of the countries for the purposes of the treaty.

30. This ensures that, for the purposes of the application of the treaty by the two treaty countries, one country taxes the person on a source basis only with relief from double taxation being provided by the other country (i.e. the single country of residence for the purposes of the treaty).

2. Source/residence juridical double taxation

31. Source/residence juridical double taxation arises where the same income is taxed in both the country where it arises and in the country of which the person deriving the income is a resident. This form of double taxation is addressed in different ways under treaties depending on the type of income: in the case of some types of income, exclusive taxing rights over the income is allocated to one of the treaty partner countries while in the case of other types of income, taxation is permitted in both countries and source/residence double taxation is eliminated by requiring the country of residence to provide relief for the tax imposed by the source country.

32. The allocation of taxing rights over income and capital is found in the distributive rules of treaties, that is to say, Articles 6 to 22 of the UN Model. These are discussed further in section III.D.

3. Source/source juridical double taxation

33. Double taxation may arise where more than one country regards the same income as having a source in its territory under domestic law. For example, one country may regard income from certain services as being sourced in its territory if the activities are performed there, while another country may treat the same income as sourced in its territory if the services are paid for by a resident of that country.

34. For most categories of income, such as dividends, interest and, in treaties that follow the UN Model, royalties and fees for technical services, a tax treaty will provide explicit rules for determining the

source of the income for treaty purposes. Through these rules and by limiting the circumstances in which source taxation may be imposed, the UN and OECD models will often provide solutions to problems of double taxation based on source in the case of income derived by a resident of one of the treaty partner countries.

4. Economic double taxation

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

36. A common form of economic double taxation arises where associated enterprises (a foreign parent and a domestic subsidiary company, for example) are treated in different countries as having derived the same profits following transfer pricing adjustments. Through the "arm's length" standard and the corresponding adjustment rules applicable to transactions between associated enterprises, treaties help to ensure that profits are not subject to that form of double taxation.

37. Another form of economic double taxation arises where certain types of entities or arrangements, such as partnerships and trusts, are treated differently under the domestic tax laws of two or more countries with the result, for example, that one country taxes a partnership on the income that it derives while the other country does not tax the partnership but taxes each partner on its respective share of the same income. A new provision, the so-called "transparent entity provision" was added to both the UN and OECD models in 2017 in order to address expressly such cases of economic double taxation.

38. Economic double taxation may also be dealt with under a treaty to the extent that Article 25 (Mutual agreement procedure) allows the competent authorities of the treaty partner countries to "consult together for the elimination of double taxation in cases not provided for in the Convention".[15]

39. Economic double taxation can also arise where corporate profits are taxed when derived by the company and then again when distrib-

15 Paragraph 9 of the Commentary on Article 25 of the UN Model, quoting paragraphs 10–12 of the Commentary on Article 25 of the 2014 OECD Model.

uted as dividends to shareholders. Some countries address such double taxation under their domestic law, for example, by exempting the dividends (typically where a substantial shareholder is a resident of the same country as the paying company) or by providing imputation credits for taxes paid at the company level. Some treaties extend such treatment to cross-border situations although this is less common.

5. Elimination of double taxation

40. When international juridical double taxation arises, most countries provide at least some relief under their domestic law. Where such unilateral relief is granted, it usually applies in the same way in respect of income from all countries and may include limitations on the amount of relief that will be provided.

41. Two main methods are commonly used for this purpose: the exemption and the credit methods. Under the exemption method, a country will exempt certain items of income derived by its residents from other countries. Under the credit method, a country will give a credit, in computing the tax payable by its residents, for the tax paid in other countries by those residents with respect to income derived from these countries.[16]

42. Treaties will assist in eliminating juridical double taxation by ensuring that, where the treaty permits both countries to tax the income, the country of residence of the taxpayer is required to provide relief for that double taxation under one of these methods.

D. Other tax barriers to cross-border transactions

1. Excessive source taxation

43. Very high levels of source taxation can be a deterrent to international trade and, in particular, to investment. These can occur not only when the headline tax rate is high, but also where the effective rate is excessive, for example, where tax is imposed on a gross basis without allowance for deductions for costs incurred in deriving the income. In such cases, notwithstanding that the taxpayer's country of residence may provide double tax relief by exemption or by credit, the overall

16 These methods are discussed in section III.F.

tax burden on the taxpayer may discourage foreign investment in the country of source.

44. Tax treaties can facilitate cross-border trade and investment by limiting source taxation that might otherwise act as a deterrent. This is typically found with respect to categories of income that are subject to withholding tax on a gross basis, such as dividends, interest, royalties and fees for technical services.

2. Tax discrimination

45. Discriminatory tax rules can be a significant deterrent to foreign investment. This is the case where, for example, foreign investors are subject to higher taxation than local investors.

46. Tax treaties aim to address this issue by prohibiting some common forms of tax discrimination. While many countries seek to ensure that their domestic tax laws are non-discriminatory, the inclusion of non-discrimination provisions in tax treaties provide some certainty to potential investors that they will not be subject to tax discrimination in the event of changes to domestic tax law.

3. Uncertainty and complexity

47. One way in which a developing country can help attracting foreign investment is by ensuring that the tax environment is clear, transparent and certain.

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

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

50. As tax treaties are usually in effect for an extended period (on average more than 15 years), they also provide a level of comfort to

taxpayers that the tax treatment afforded to the income from their activities or investments in the other country will be reasonably stable.

51. Importantly, tax treaties also provide a mechanism for tax administrations to resolve disputes and to agree on how to interpret or apply treaty provisions,[17] thereby contributing to a more consistent application of the treaty by both countries.

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

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

53. One reason why a country may wish to enter into a tax treaty with another country is to improve coordination and cooperation between tax administrations in order to address tax avoidance or evasion. Tax treaties provide for the exchange of tax information, which may help ensure that a country that taxes its residents on worldwide income is aware of (and can therefore effectively tax) income arising in a treaty partner country. Many tax treaties also include provisions for assistance in the collection of unpaid taxes. Through these provisions, which are found in the UN Model and the OECD Model as well as in the *Convention on Mutual Administrative Assistance in Tax Matters* developed jointly by the OECD and the Council of Europe,[18] tax administrations are able to assist each other in ensuring the proper application of tax treaties, as well as enforcement of domestic laws.

54. Tax treaties should also address gaps in the interaction of domestic tax systems or in tax treaties that may lead to income not being taxed in any country (double non-taxation), or being subject to less-than-single taxation. As a result of work on tax treaties carried on between 2013 and 2015 in the context of the OECD/G20 Action Plan

17 See the discussion in section III.G.2.

18 See https://www.oecd.org/ctp/exchange-of-tax-information/convention-on-mutual-administrative-assistance-in-tax-matters.htm.

on Base Erosion and Profit Shifting (BEPS),[19] many changes, including the addition of a number of anti-abuse provisions, were made in 2017 to both the UN Model and the OECD Model. These changes are discussed in Sections III and IV below.

19 See, in particular, OECD (2015), *Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241695-en, available from http://www.oecd.org/tax/preventing-the-granting-of-treaty-benefits-in-inappropriate-circumstances-action-6-2015-final-report-9789264241695-en.htm, as well as OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241220-en., available from https://read.oecd-ilibrary.org/taxation/preventing-the-artificial-avoidance-of-permanent-establishment-status-action-7-2015-final-report_9789264241220-en#page1.

Section II

Treaty policy, domestic model, negotiations

A. Why negotiate tax treaties?

55. Countries enter into tax treaties for a variety of reasons. The reasons are likely to be different for each country, and even for each treaty entered into by a country, and will depend on the tax system as well as the political and economic situation of the country (e.g. whether it is a net capital exporter — typically a developed country — or a net capital importer — typically a developing country) and its relations with the potential treaty partner country. Considerations that are important in one case may be less important in another case depending on the circumstances prevailing in each country and having regard to the relationship between the two countries. In some countries, the desire to attract foreign investment will be paramount, whereas in other countries revenue or political considerations may be more important. Some common reasons why a country may decide to negotiate a tax treaty with another country may include some or all of the following:[20]

(a) To facilitate outbound investment by its residents;

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

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

(d) To pursue political or diplomatic objectives.

56. Since there is usually little outbound investment by the residents of a developing country, the main reason why such a country would enter into treaty negotiations is often to attract foreign direct investment and inbound transfers of technology or skills. Less desirably, however, tax treaties are sometimes negotiated by developing countries simply to respond to political or diplomatic pressure from other countries.

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20 Obviously, even if one country concludes that it would serve its interests to enter into a tax treaty with another country, that other country may not be willing or able to commence negotiations.

57. The main benefit of tax treaties is that they remove or reduce double taxation, tax discrimination, complexity and uncertainty which, as explained in Section I, constitute barriers to cross-border investment and the transfer of knowledge and skills. For developing countries, however, there may be other benefits to be gained from tax treaties. For example, negotiation of treaties by a developing country may be seen by other countries as an expression of its willingness to conform to the international tax norms (e.g. the arm's length principle and the international standard on exchange of information). It may also signal a close political and/or economic relationship between two countries, or form part of a network of relationships, for example, within a region. Sometimes, a tax treaty may be negotiated as part of a suite of bilateral treaties aimed at closer ties between the countries.

58. Developing countries, however, may be legitimately concerned about entering into tax treaties, either generally or with particular countries, because of a fear of losing revenues as a result of the limitations on source taxation that such treaties impose and the risks of treaty abuse, including treaty-shopping, that they present. They may also be concerned about the challenges and administrative burden (especially for countries with limited resources) associated with the negotiation of tax treaties and the application of the provisions of these treaties and their interaction with domestic tax law.

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

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

determine to what extent they can depart from their original positions during the negotiations.

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

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

— *What are the actual risks of double taxation between the two countries?* This should be the primary tax policy concern. Since most of the provisions of tax treaties are aimed at avoiding double taxation, it is logical to consider that a country that accepts treaty provisions that restrict its right to tax income and capital does so on the understanding that these will be taxable in the other country. For instance, the risk of double taxation of income is unlikely to be important with countries that levy no or low income taxes.

— *To what extent are such risks of double taxation already eliminated through domestic provisions for the relief of double taxation?* It should be acknowledged, however, that such domestic provisions will not cover all cases of double taxation, especially if there are significant differences in the source rules of the two states or if the domestic law of these states does not allow for unilateral relief of economic double taxation.

— *Are there elements of the other country's tax system that could increase the risk of non-taxation (e.g. special tax regimes that are ring-fenced from the domestic economy)*?

— *What are the risks of excessive taxation that may result from high withholding taxes in the other country?*

— *Will it be helpful to have the treaty rules that prevent the discriminatory tax treatment of foreign investment?*
— *Will it be helpful for taxpayers to have the greater certainty of tax treatment provided by the treaty and the dispute resolution mechanisms provided by the mutual agreement procedure?*
— *Will the tax administration of the other country be willing and able to implement effectively the provisions of tax treaties concerning administrative assistance, such as the ability to exchange tax information and provide assistance in the collection of taxes?* As already noted, however, these administrative provisions do not, by themselves, justify a tax treaty because such administrative assistance may be obtained through specific tax information exchange agreements or the participation in the multilateral *Convention on Mutual Administrative Assistance in Tax Matters.*[21]

B. Tax treaty policy framework and country's model tax treaty

63. All countries would find it beneficial to develop a tax treaty policy framework and a model treaty before entering into tax treaty negotiations. A country has to "know what it wants".

64. The tax treaty policy framework should establish and explain the main policy outcomes that a country wishes to achieve when negotiating tax treaties. It should identify:

(a) The treaty negotiation outcomes that would be the most beneficial to the country;
(b) The outcomes that must be achieved in any negotiation; and
(c) How much flexibility negotiators have on other issues, including whether there is a "bottom line" is (that is to say, a minimum outcome that must be achieved in order to reach agreement).

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

21 Note 18.

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

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

68. Both the policy framework and the country model should be reviewed regularly to ensure that future tax treaties continue to provide beneficial and appropriate outcomes for the country and remain up to date with international developments.

1. Designing a tax treaty policy framework

69. A number of factors should be taken into account when developing a country's tax treaty policy framework. These include:

- International treaty norms reflected in the UN Model and the OECD Model.
- Commitments related to tax treaty provisions that have been made as participants in regional groupings and international organizations.
- Key aspects of the country's economy, including its main sources of revenue and areas of current or potential foreign investment.
- The domestic tax law of the country and the way tax treaties will interact with that domestic tax law.
- The ability of the country's tax administration to comply with treaty obligations.

70. The international treaty norms that are incorporated in the UN and OECD models provide the list of policy issues that are usually addressed in a tax treaty and which the country should therefore expect to have to address during treaty negotiations. As these models show, a country should expect that its tax treaties will address the

allocation of taxing rights on different categories of income (the distributive rules), the relief of double taxation by the state of residence, non-discrimination, mutual agreement procedure and exchange of tax information. It would be rare for a tax treaty not to address these issues even though the contents of the provisions dealing with these issues as well the inclusion of other aspects of the UN and OECD models, such as the coverage of capital taxes, may be open to negotiation.

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

(a) Its preferred position;

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

(c) The degree of flexibility available to negotiators and any fixed "bottom line".

Distributive rules

72. The distributive rules of a treaty, which are set out in Articles 6 to 22 of the UN Model, determine how the taxing rights will be allocated with respect to different categories of income. This allocation of taxing rights between the source and residence countries is generally the most controversial part of tax treaty negotiations. The distributive rules will often result in a limitation of the right to tax of the country of source but will also impose a reciprocal obligation on the country of residence to eliminate any double taxation where the treaty grants taxing rights to the country of source. In developing its tax treaty policy framework, it is important for each country to decide on its preferred position on the balance between source and residence taxation, the priority it gives to maintaining that preferred position and, where flexibility is appropriate, the bottom line for negotiators. It is also important to bear in mind that while a treaty will allocate taxing rights to one or both countries, that right may be exercised only if domestic tax law provides for the taxation of the relevant income.

73. With respect to each category of income, developing countries may find it helpful to develop their treaty policy framework on the basis of an analysis of the distributive rules of the UN and OECD models in the context of their own circumstances. In particular, they may wish to consider:

(a) *Category of income*: Does the treaty classification of income give rise to difficulties in applying the treaty, or to unacceptable policy outcomes?

(b) *Tax treatment*: Can taxing rights allocated under a tax treaty be exercised in the country? Such rights can be exercised only if tax is imposed under domestic law. If not, consideration should be given to whether this is an outcome that the country wishes to provide for under a treaty.

(c) *Ease of administration*: Does the proposed treatment present any particular difficulties for the tax administration of the country? Such difficulties may include issues relating to administrative burden, especially where tax liability is determined by assessment by tax authorities (rather than self-assessment or withholding), or relating to the interpretation or application of treaty provisions.

(d) *Ease of compliance*: Does the proposed treatment place an onerous compliance burden on taxpayers? This can be a particular problem where taxpayers are required to keep detailed records that they would not ordinarily keep, or meet strict information disclosure requirements in order to obtain treaty benefits.

74. For the reasons already mentioned, countries would be well advised to follow as closely as possible the treaty policy options reflected in the UN and OECD models. Having regard to their particular circumstances, however, countries may determine that these options do not fully meet their needs or may create unacceptable difficulties for them. By developing a policy framework, these countries will be able to decide in advance what rules will best serve their country's interests, and how important those rules are to that country. In deciding to move away from the policy choices endorsed in the UN and OECD models, countries should, in relation to each policy issue, consider the matters mentioned above. In addition, they should consider:

(a) *Reason*: Is there a compelling reason for the departure from the policy options reflected in the UN and OECD models? Such reasons may include the protection of a significant source of revenue in the country, the desire to attract investment in an area of the country's economy that the Government is seeking to develop, significant difficulties for the tax administration or taxpayers in administering the usual treaty approach in the context of the domestic law, or the particular circumstances of the bilateral relationship, especially having regard to the other country's tax system.

(b) *Priority*: How much of a priority is it for the country that this outcome be achieved vis-à-vis other issues? Is this an outcome that must be achieved or something that is highly desirable but not essential?

(c) *Achievability*: Is this treatment likely to be readily accepted by treaty partners? Is it consistent with regional norms? Have other countries sought or accepted this approach in their treaties?

(d) *Flexibility*: Is the Government prepared to allow negotiators any flexibility on this issue? Is this a deal-breaker? Is there scope for compromise, for example, a different time-threshold, a different rate limit, the exclusion/inclusion of certain provisions?

(e) *Fall-back positions*: If there is scope for compromise, what fall-back positions would be acceptable to the Government? What is the bottom line?

75. In designing its tax treaty policy framework, a country should also be mindful of the commitments related to tax treaty provisions that it has made as a participant in regional groupings and international organizations. For instance, countries that are members of regional groupings may have agreed to follow a common approach when negotiating tax treaties. Also, countries that have joined the *Inclusive Framework on BEPS*[22] have committed to follow certain minimum standards when negotiating treaties. Similarly, the large number of countries that are members of the *Global Forum on Transparency and*

22 See http://www.oecd.org/tax/beps/beps-about.htm.

Exchange of Information for Tax Purposes[23] have committed to an international standard of transparency and exchange of information that limit the extent to which they can depart from the provisions of the UN and OECD models dealing with exchange of information.

76. By developing a tax treaty policy framework, countries will be in a much better position to "know what they want" out of treaty negotiations and to achieve outcomes that are in the best interests of the country. Such a framework will also assist countries in designing their country model, which should reflect the policy outcomes sought.

2. Designing a country's tax treaty model

77. In developing their own model tax treaties, countries should, as far as possible and to the extent that this is consistent with their policy objectives, adopt the structure of the UN Model and the OECD Model and use the wording of provisions found in these models or in the other instruments referred to in the previous paragraph. There are two simple but compelling reasons for doing so:

— The use of a familiar structure and wording is likely to simplify considerably the negotiation of tax treaties.

— Provisions that appear in the UN Model, the OECD Model and multilateral instruments have typically been thoroughly discussed and analyzed in international fora and have often been used for decades, thereby reducing the risks of technical mistakes and unforeseen consequences.

78. Section III provides a summary of the various provisions of the UN and OECD models and discusses possible alternatives.

79. A number of bilateral treaties have a protocol that was negotiated at the same time as the treaty (as opposed to a subsequent protocol, which constitutes another treaty amending the initial one). Provisions of a protocol attached to a treaty are part of that treaty and have the same legal status as if they had been incorporated in the treaty itself. Such protocols often include unusual provisions, interpretative rules or provisions that apply to only one of the treaty states. They are usually the result of the bilateral negotiation process and it would therefore be unusual for a country's tax treaty model to include such

23 See http://www.oecd.org/tax/transparency/about-the-global-forum/.

a protocol, especially since there is always a risk that the reader of the treaty might overlook the provisions of a protocol when reading the provisions found in the main part of the treaty.

C. Preparing for tax treaty negotiation[24]

80. Once a country has developed its tax treaty policy framework and its country model as discussed above and has determined an order of priority of the countries with which it intends to have tax treaties, it will be in a position to start preparations for actual negotiations with another country.

81. Treaty negotiators may be approached by officials of another country for the purposes of having "exploratory" discussions related to a possible tax treaty. In order to avoid any misunderstanding, it should be made clear, before such discussions take place, whether this will involve an article-by-article discussion and whether there is any expectation that the discussions will be followed by the negotiation of a tax treaty.

82. Preparations are an extremely important part of the negotiation process. Without adequate preparations, the negotiating team will be at a disadvantage during the negotiations and will most probably not achieve an optimal result for the country it is representing.

83. The following observations outline some of the important steps that should be taken by developing countries prior to the commencement of tax treaty negotiations.

1. Obtaining authority to negotiate

84. In most countries, treaty negotiators require authorization from appropriate authorities to negotiate with another country. Sometimes a new authorization is required for each round of negotiations. Practice, however, varies among countries. Regardless of the process for authorization, the ministry in charge of foreign affairs should be consulted before any decision is made to undertake negotiations with another country.

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24 More guidance on how to prepare for treaty negotiations may be found in Odd Hengsle, "Preparation for tax treaty negotiations", in *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014), p. 69.

2. Logistics

85. Where two countries have agreed to undertake tax treaty negotiations, they need to agree on:

— The dates on which the negotiations will take place.

— Where the negotiations are to take place. In most cases, each country will alternatively host the negotiations.

— The language in which the negotiations will be conducted, which will typically also be the language in which the draft treaty prepared by each country will be presented to the other country. While in some cases it may be impossible to avoid using interpreters, that should be avoided as far as possible as it will slow down progress and may create drafting problems.

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

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

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

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

similar to those that are applicable to the government officials who will participate in the negotiations.

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

91. The host country should provide:

- A draft agenda showing, as far as possible, the starting and finishing times for each negotiation session, refreshment and meal breaks as well as official meals.
- The venue for the negotiations: a suitably sized meeting room equipped, if possible, with electronic equipment to edit, save and project a draft treaty text as well as a flip chart or white board that could be used, for example, to illustrate complex examples with diagrams.
- Directions on how to find and access the venue as well as any information that would be useful for the visiting delegation.
- Any security passes or escorts necessary to allow the other team access to the venue.

92. The visiting treaty negotiators will need to arrange for:

- Travel authorizations and, if necessary, visas.
- Travel arrangements such as flights, trains and so forth.
- Accommodation and local transportation.
- In many countries, notification to its embassy in the country of the visit.

3. Defining the roles of each member of the team

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

a) The leader of the team:

- The leader of the team (head of delegation) should be a senior official with the authority to make important decisions during the negotiations.
- The leader will typically have comprehensive knowledge of do-

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

b) Other team member(s):

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

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

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

— They usually have primary responsibility for preparing the comparison of the two countries' treaty models and developing the team's negotiating positions.

c) Note taker:

— At least one of the members of each team should be responsible for taking detailed notes of the arguments presented during the discussions and of any agreements reached during the meeting. These notes are for internal purposes only and are not intended to be exchanged with the other team or publicly disclosed.

— Responsibility for taking notes is typically given to an experienced team member. A team member who has limited tax treaty experience would not be the ideal note taker because such person may have difficulties understanding and summarizing complex arguments or proposals that need to be recorded in the notes and deciding what should be noted.

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

— Notes taken during the negotiations may also be very useful when preparing the treaty for signature and explaining provisions agreed upon to the governmental or parliamentary bodies responsible for its adoption. They may also be extremely important when issues of interpretation arise after the treaty has entered into force, e.g. when the competent authority of a country seeks, in the context of the mutual agreement procedure, to understand the purpose of a treaty provision negotiated many years before.

4. Consulting business and relevant ministries and agencies

94. When preparing for negotiations with another country it is prudent to consult with business and relevant ministries and agencies:

— A request for the negotiation of a tax treaty may be initiated by business representatives in one or both countries, for example, to address problems they have met or are anticipating when engaging in cross-border activities.

— Consultation with business will, in most cases, provide the team with important information on economic sectors or issues that should be taken into account during the negotiations.

— Relevant ministries and agencies, such as the ministries in charge of foreign affairs and trade, may also have relevant information that should be taken into account during the negotiations. For example, they may have information on sectors in which they would like to encourage outbound investment or sectors in which they would like to attract foreign investment.

— It may also be advisable to consult with the embassy in the other country. It may have important information on economic as well as non-economic areas that could be relevant to the negotiations.

5. Preparing the draft text that the team will use for a particular negotiation

95. The team must prepare a draft text which they will use as the basis for the negotiation:

— Many countries will use their standard model treaty (see section II.B) when negotiating with other countries. Some countries, however, will adapt their model to each country with which

they are negotiating in order to take into consideration particular inputs they have received, such as previous negotiations or business submissions. Some developed countries may also use a different draft model treaty when the proposed treaty partner is a developing country.

— It is important to understand all the articles of the draft text and how they interact. The model may have been changed in some areas following previous negotiations. The team should be aware of where and why such changes have been made, and of their effects.

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

6. Preparing alternative provisions

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

— These may be provisions that have been accepted in negotiations with other countries, provisions that the other country has previously accepted in treaties with other countries or may be unique provisions intended to specifically address concerns expressed by the other country.

— It is easier to discuss alternative provisions when they are presented in writing rather than orally.

— Such alternatives can also indicate a willingness to reach a compromise where necessary.

7. Non-negotiable provisions

97. In the preparation of the negotiations, it is also important to clarify internally which provisions are non-negotiable, that is to say, provisions that reflect strongly held policy or technical positions and that must be included in any treaty concluded by the country (for example, as noted in paragraph 75 above, the large number of countries that are members of the *Global Forum on Transparency and Exchange*

of Information for Tax Purposes have committed to an international standard of transparency and exchange of information that constrains their ability to depart from the provisions of Article 26 of the UN and OECD models dealing with exchange of information):

- Since a negotiating team would logically be unable to agree to a treaty that would not take account of provisions that are genuinely non-negotiable, it would be advisable to communicate such provisions to the other negotiating team in advance of the negotiations so as to avoid spending time on negotiations that cannot reach a conclusion because of irreconcilable differences of views concerning such provisions.
- A distinction should be made between provisions that are genuinely non-negotiable (such as provisions on exchange of information that comply with the international standard of transparency and exchange of information) and provisions which merely reflect a strong preference but which, under certain circumstances, can be flexible. Provisions that merely reflect a strong preference should not be presented as completely non-negotiable.
- To be prepared for the positions of the other country, it is helpful to check the various country reservations, observations and positions set out in the Commentaries to the OECD Model. While these do not necessarily reflect a non-negotiable position, they are a very valuable indicator of strongly held positions.

8. Understanding the interaction between domestic legislation and treaty provisions

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

- During the negotiations, a team will often be asked to explain features of its domestic tax legislation and how proposed provisions of the draft treaty would interact with that legislation.
- Understanding how a treaty provision would affect the application of a country's tax legislation will also be necessary to determine the costs and benefits of that provision and whether it would be favorable for that country.
- It is strongly advisable for each team to research and understand the key features of the domestic tax legislation of the other

country. This will help it to identify issues, such as the existence of preferential tax regimes, that may need to be specifically addressed during the treaty negotiations and to better anticipate and understand the position of the other country concerning certain proposed treaty provisions.

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

99. Many countries prepare a short explanation of their domestic tax system, especially if there is something in the legislation that is likely to require clarification during the negotiations:

— A short explanation of the main points in the legislation will make it easier to understand why some articles need special drafting and will also identify issues that need to be considered.

— To facilitate the negotiations, a short explanation of the domestic legislation and a draft text should be sent to the treaty partner well in advance of the meeting. At the same time, a similar explanation and a draft text may be requested from the treaty partner.

— A short explanation of its domestic tax legislation provided by another country is not a substitute for researching and understanding the tax legislation of that country. Such short explanations are often too basic and incomplete to be useful when assessing the exact impact of specific treaty provisions.

10. Preparing a comparison of the drafts

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

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

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

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

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

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

— A team should be aware of the treaties that its country has concluded with third countries because where the provisions of such treaties are seen as being more beneficial than those proposed in its model, the negotiating team for the other country is likely to request that such provisions be included in the treaty under negotiation.

— A team should therefore be prepared to accept similar provisions or to explain why these provisions are unacceptable in the context if the ongoing negotiations.

— Treaties entered into by the other country with countries which are economically or regionally comparable should be carefully analyzed, as these treaties will give an indication of what the other team may be willing to accept and how strongly that other team is likely to argue in favor of its own position. For that purpose, recent treaties would be more relevant than older ones and, if that other country is a developed country, treaties concluded with developing countries will be more relevant than treaties with other developed countries.

11. Studying the economy, culture and customs of the other country

102. It is advisable to have some general information about the other country with which a tax treaty will be negotiated. For instance, a negotiating team should have a general idea of that other country's economic situation, e.g. its population, gross national product (GNP), important industries and its relations with other countries. It should also be aware of local customs and sensitive issues, for example, regarding food, alcohol, religious beliefs and behaviors that may be considered offensive. Consultation with one's embassy in the other country may help to avoid incidents and embarrassing situations.

D. Conduct of negotiations[25]

103. The way in which treaty negotiations are conducted is vital in achieving a treaty that is beneficial to both countries and meets the interests of each side as far as possible. In particular, it is important that the negotiations be conducted in a cooperative atmosphere that is conducive to reaching agreement on balanced outcomes that are expressed in well-drafted, effective provisions that will stand the test of time.

1. Opening of the meeting and working draft

104. At the beginning of the negotiation meeting, both leaders should introduce themselves and their team so that both delegations know who is present and what the role of each team member is. The leader from the host country will usually open discussions and there should be agreement on the agenda for the meeting.

105. The two teams will need to decide the practical issue of how to discuss and amend the two draft texts in order to produce the working document that will constitute the draft treaty:

— Ideally, a common working draft in which all the differences between the two models would appear in square brackets, and in different colors for the text proposed by each country, would be prepared in advance of the negotiation meeting and would be displayed and amended during that meeting.

— If that cannot be done, one approach would be for the two teams to decide to use one of the two draft texts as the working draft. The host state may propose that its own draft be used at the working draft. From a mere logistical perspective, however, if one country's draft is significantly more detailed or developed than the draft of the other country, it would be easier to work from that document as it is easier to delete or amend provisions that are already in the working draft than to add new ones (especially if changes are made by hand rather than electronically

25 For more information on how to conduct tax treaty negotiations see Odd Hengsle, "How to conduct tax treaty negotiations", *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014), p. 93.

during the meeting). It could, however, give a certain advantage to one country to have its own draft accepted as the working draft even though both drafts will be on the table and should be taken into consideration during the discussions.

— If that approach cannot be agreed upon, each team would be forced to use its own draft as a working draft and to make all the required changes to that draft as the negotiations progress. That approach, however, should be a last-resort solution since it risks creating confusion as to which provision is being referred to during the meeting and may generate inconsistencies. In order to avoid such inconsistencies, it would then be important for the negotiators to periodically confirm the wording that they have agreed to (for example, after negotiating each Article of the treaty) and, at the end of the meeting, to carefully compare each country's working draft in order to confirm the wording of the provisions that have been agreed to and those that need further discussion.

2. Negotiation style

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

— A "soft" negotiator seeks to reach agreement on all articles as soon as possible. This may lead to the negotiator making unnecessary concessions.

— An "aggressive" negotiator insists on his/her proposals and demands concessions. This style may result in the other side pushing back or even refusing to continue the negotiations.

— A negotiation style somewhere between these two extremes is obviously desirable. A negotiator should be consistent in the approach adopted, but always polite. He/she should be prepared for the negotiation, knowing what is important for his/her country and proposing and explaining the preferred solutions without being aggressive.

107. Whatever approach is adopted, a negotiator must remember that his/her style should consider the goal of the negotiations, which is to achieve a mutually beneficial treaty.

3. Trust

108. To achieve a productive atmosphere during the negotiation process, it is necessary to gain the trust of the other team. The explanations given by a team must be truthful, complete and correct:

— If a team is in doubt about an item such as a feature of its domestic tax law, it should say so to the other team and provide clarification as soon as possible.

— Members of a team should be truthful and never lie.

— Incomplete explanations or disclosure of facts can be damaging to the credibility of a team.

— It is easier to lose than to gain credibility.

4. Building a relationship

109. Formality is appropriate during a negotiation meeting even if one already knows the members of the other team. All interactions, however, play a part in the negotiations: informal discussions or contacts taking place during a break, or at lunches or dinners, may contribute to building a good relationship.

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

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

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

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

— A team should be polite in explaining to the other team why one has a different opinion or prefers a different solution.

5. Discussions

113. The nature of the discussions will vary depending on the stage of the negotiations. For the first round of negotiations, it is usually desirable to work quickly through all articles one by one without lengthy discussions of difficult issues in order to resolve minor issues and identify difficult or important ones for further discussion

114. When all the articles have been worked through, it is time to concentrate on solving the remaining difficult issues:

— This may be done during the first round of negotiation but will very often be postponed to a second round.

— Even if one team has no serious objections to a proposal by the other team, for example, because the item is not particularly important to them, it may defer acceptance of the proposal in the hope of achieving something in return at a later stage in the negotiations. Understanding the value of the issues to the other side is therefore essential when trying to reach a compromise or a trade-off.

— If a provision relates specifically to one of the countries, or is merely a clarification of the meaning of a provision, it is sometimes better to include that provision in a protocol than to try to include in the treaty itself.

— Even if the issues are important, it is not necessarily difficult to find solutions, for example, if the two teams seek similar outcomes. If, however, both teams regard an issue as important, but disagree on the solution, a compromise may be difficult (but not impossible) to find.

115. For an effective discussion to take place, a team should introduce the difference between the two models and present its position clearly. A country that seeks to include a provision that is not found in either the UN Model or the OECD Model should expect to have to introduce and explain that provision.

116. The response of the other team should be noted carefully. It may sometimes be found that the other team's own proposal or counter-proposal is actually more advantageous for the first team than the provision initially proposed. To avoid unnecessary misunderstandings, it is important that both teams send correct signals on their

attitude to the proposals put forward. The reaction of the members of the other team to arguments put forward in the discussion should also be observed and noted.

117. A team should be prepared to make counter-proposals. If it seems difficult to get acceptance for the proposal that is being discussed, alternatives should be sought. These may have been prepared before the negotiations, or may have been developed during the process. Alternatives may also be found in the Commentaries to the UN and OECD models. They may also be found in one of the countries' other treaties or in treaties between third countries.

118. There are different approaches that, in the right circumstances, may be used to solve difficult issues.

119. One such approach is to propose a "most favored nation" (MFN) clause that will apply in the event that a country that objects to a certain provision (for example, a tax sparing provision, a provision providing for a maximum rate of tax on royalties that is lower than the rate agreed to in the treaty or provisions on assistance in collection of taxes) would subsequently accept such a provision in a treaty with any third state or a comparable third state (for example, another country member of the OECD). The wording of these clauses, which are typically included in a protocol to the proposed treaty, varies in important ways. Some of these clauses provide that in such a case, the two countries will undertake negotiations with a view to modify the treaty so that the treaty partner is eventually granted the same benefit as that granted to the third country. In other cases, the effect of the clause is merely to require the two countries "to discuss" the granting of a similar benefit. Other clauses have a more direct and immediate impact and provide that a provision corresponding to the provision agreed to with the third country will automatically become applicable between the two countries as soon as the treaty with the third country enters into force. In addition, some of these clauses require the competent authority of the country that concludes a treaty with a third country that triggers the application of the clause to notify this fact to the competent authority of its treaty partner.

120. Some countries consider that these clauses constitute an unacceptable restriction on their ability to negotiate subsequent treaties that reflect a different overall balance of benefits for the two coun-

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

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

122. A different approach that could be used to deal with cases where a country is not prepared to accept a provision at the time of the negotiations but may do so in the future is to agree to include the provision in the treaty but to provide that it shall only become effective when both competent authorities so agree.

123. Another approach is to propose a "sunset clause" that limits the period of time during which a controversial provision will apply. For instance, sunset clauses are sometimes found in "tax sparing" provisions with the result that a country will agree to provide relief for tax

that the other country does not levy pursuant to certain tax incentives but will stop doing so after a certain number of years.

124. A possible way of dealing with difficulties that may arise when a country wants to replace an existing treaty provision that the other country wants to preserve is the use of a "grandfathering clause". Under such a clause, the provision to be replaced would continue to apply to persons already benefiting from that provision at the time of its repeal, thereby ensuring that the repeal does not affect taxpayers that benefit from it at the time the countries agree to repeal it.

125. One country may be prepared to accept a proposal from the other country but, at the time of negotiations does not have the legislative instruments in place to give effect to the relevant provisions. If it is relatively certain that the necessary legislative changes will be adopted within a reasonable period of time, a solution might be to include the provisions in the treaty but deferred its entry into effect to a specified future date.

126. During the discussions, a new provision will sometimes be suggested as a way to address an issue. Unless that provision represents an alternative found in the Commentary of the UN or OECD models or has been used in other treaties, countries should be very careful when drafting or accepting such new provisions. As already mentioned, the provisions found in the UN and OECD models have typically been thoroughly discussed and analyzed in international fora and have often been used for decades, thereby reducing the risks of technical mistakes and unforeseen consequences. Even if a proposed new provision seems to solve a problem, it may have unforeseen interactions with other parts of the treaty or with the domestic law of one or both countries. The best approach to such new provisions is to put them in brackets for further consideration.

127. If one team believes that the other team has misunderstood the meaning or effect of a proposal, the issue should be raised again. If the misunderstanding is not recognized during the negotiations, but before signature, a delicate situation may arise if the country concerned refuses to sign the treaty or insists on renegotiation.

128. If a team at any time during the negotiation wishes to clarify issues or discuss arguments between its own members, it should ask for a pause in order to do so.

129. If the official language of one of the teams is different, then it is important for that team to indicate any words or phrases which, when translated, could lead to difficulties in interpretation or result in a different interpretation from that of the other team.

130. If the wording of a provision is agreed upon, both teams should accept it explicitly and move forward after confirmation that the provision has been agreed to. Normally, the host country team should record all the additions and changes made to the draft treaty during the meeting. The resulting draft treaty should be added to the agreed minutes after every round of negotiations and provided to both teams in paper and electronic form.

6. Arguments

131. Teams should be prepared to present relevant arguments to explain the provisions that they propose in the different articles of the working draft. This is true of all provisions, but is essential where the wording of a provision deviates from what is found in the UN and OECD models.

132. There are different kinds of arguments commonly used:

- Policy arguments are based on logic and sound tax policy. They are often based on economic arguments and is closely linked to a revenue argument.
- A reason often used in support of a proposal is the precedent argument, where a team shows that other countries have accepted the wording of an article. For a developing country negotiating with a developed country, such an argument will be of greater value if the developing country can show that other developed countries have accepted the wording. It may also be the other way around. One team may ask for wording that the other country has accepted in treaties with third countries. It may point to those treaties and ask the other team why such wording is no longer acceptable.
- Another argument along the same lines is that if a country does not want to agree to a certain provision that it has included in treaties with other comparable countries, this will be disadvantageous to the enterprises from the other country.

— Where a provision is presented as an anti-abuse provision, a specific example should be used to illustrate the potential abuse that the provision is intended to address.
— As already mentioned, only genuinely non-negotiable provisions should be presented as such.
— Arguments such as "We need this wording because we are a developing country" and "We need this wording because we have such a provision in our domestic legislation" are unlikely to convince the other team and should be supported by additional explanations addressing the substance and effect of the relevant provisions.

7. Keeping an accurate record of what has been agreed to

133. It is important to keep a full and accurate record of what has been agreed to and of the provisions that remain to be discussed:

— As already mentioned, the working draft should ideally be amended to reflect the discussions and projected on a screen during the negotiation meeting; this will typically be arranged by the host team. If it is not possible to do so, the text of each article should be read when the discussion of that article has been completed in order to ensure that both teams agree on what has been agreed to and what remains to be discussed.
— When going through the working draft article by article, all wording that is not agreed upon should be put in brackets. These brackets should be confirmed when reading the text of an article that has just been completed and should only be removed when both teams have expressly agreed to do so.
— At the end of the meeting, the working draft should be reviewed to ensure that there is agreement on which issues have been resolved and which are postponed for a second or subsequent round of negotiations. Both teams should have a printed version of the working draft as it stands at the end of discussion.

134. Countries are encouraged to follow the practice of producing agreed minutes at the end of each negotiation meeting. The contents of these minutes, which are signed by the leader of each negotiating team at the end of the negotiation meeting, vary. In some cases, the agreed

minutes constitute a short document that simply acknowledges that a meeting took place and that an agreed draft, which is attached to it, has been initialed. In other cases, the agreed minutes refer to the meeting that took place and indicate that a subsequent meeting will take place on specific dates and location in order to continue the negotiation of the working draft attached to these minutes. Some countries, however, prefer to produce agreed minutes that record all outstanding issues and any agreed interpretations. Ideally, the agreed minutes should record any remaining issues that are not identified in the working draft as well as any interpretation of negotiated provisions that were agreed to during the meeting and have not otherwise been recorded in writing. It may also be useful to confirm in the agreed minutes the understanding of both countries as to when the initialed text of the treaty can be made public (see paragraph 141 below).

E. Post-negotiation activities[26]

135. After agreement has been reached on all the provisions of the working draft, which may happen at the end of the first or a subsequent negotiation meeting, it is usual for the head of each delegation to initial each page the draft treaty. This simply means that the draft reflects the results of the negotiations.

136. There are a number of subsequent steps required before that draft becomes a binding treaty. The first steps are related to the signature of the treaty and include the preparation for signature (including translation if necessary), obtaining the authority to sign and completing the formalities for the signature. Each country should know in advance whether the ministry in charge of the negotiation of tax treaties or the ministry in charge of foreign affairs will be responsible for the signing procedure for that country. Steps that take place after the signature relate to the approval, ratification and entry into force of the signed treaty and entry-into-effect of its provisions.

137. The following is a summary of the different steps leading to the signature and entry into force of the treaty.

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26 For more information on the post-negotiation process, see Odd Hengsle, "Post-negotiation activities", *Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries* (New York: United Nations, 2014), p. 121.

1. Preparing for signature

138. After the two heads of delegation have initialed the draft treaty, the next step is to prepare the proposed treaty for signature:

— The draft treaty should be thoroughly proofread prior to the preparation of the texts for signature. If it will be signed in more than one language, translations and the verification of these translations will also be necessary (see below).

— The time gap between initialing and signing should be as short as possible in order to allow the treaty to enter into force without any undue delay.

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

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

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

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

2. Translation and official texts

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

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

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

145. A thorough proofreading of the text should be done prior to translation. Editorial or substantive mistakes are often found at that stage or in the translation process; the correction of these mistakes can be done informally but should be agreed to in writing by the two countries (typically by members of the teams that negotiated the proposed treaty).

146. The selection of the translator varies from one state to another. In some states, the translation is done by members of the team that negotiated the proposed treaty; in others, another governmental office does the translation or a professional translator is hired for that purpose. In the latter cases, it is recommended that the translation be thoroughly reviewed by members of the team that negotiated the treaty before being communicated to the other country. It is important that the translation is done correctly and that all official versions of the treaty have consistent wording, even if the languages are different. In particular, the translation should be checked to ensure that, as far as possible, it uses the same terminology as the official versions of the UN and OECD models and of previously-concluded treaties that have used similar wording. For example, the term "permanent establishment" is

used in almost all treaties and it would therefore be rare not to have a previous treaty concluded in the same language that would already include a translation of that term.

147. When the proposed treaty has been translated into another official language in which it will be signed, that translation must be transmitted to the other country for approval. Both countries must agree that the translated versions completely and accurately reflect the initialed draft text.

148. In the signed version of the treaty that will be given to each country, that country's official language will typically be mentioned first, the language of the other country being mentioned after and any third language being mentioned last.

3. Signing of the treaty

149. When the required translations have been completed and accepted by the two countries, the next step is to seek the approval of each government for the signature of the treaty. The procedure for obtaining that approval varies from country to country; it is fairly common, however, to submit the proposed treaty and a general explanation of its contents to the approval of the Cabinet or Council of ministers which then authorizes its signature. This governmental approval of the signature of the treaty should not be confused with the state's consent to be bound by the treaty, which intervenes at a later stage.

150. Although any person could theoretically be given the role of representing a country for the purposes of signing a treaty, tax treaties are typically signed by heads of state, heads of government, ministers or ambassadors. As indicated in the *Vienna Convention on the law of Treaties*,[27] the Head of state, Head of Government and Minister for Foreign Affairs have, by virtue of their functions, full powers to sign a treaty. Where the treaty is to be signed by the Minister of Finance, another minister, an ambassador or any other person, that person will generally be required to produce a written confirmation that they have been given full powers to sign.

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27 *Vienna Convention on the law of Treaties*, available at https://treaties.un.org/doc/publication/unts/volume%201155/volume-1155-i-18232-english.pdf, subparagraph 2 (*a*) of Article 7.

151. Once approval for signature has been granted, the proposed treaty will frequently be transmitted to the ministry in charge of foreign affairs, which is usually the government agency responsible for arranging the signing ceremony. If the tax authority is in charge of the signing procedure — as may be the case in some countries — and there is any doubt about the authority of the person of the other country who is going to sign the treaty, the ministry in charge of foreign affairs should be consulted in advance.

152. There are no set rules about where and when the signing ceremony should take place. It should be signed where and when it is most convenient for the two countries.

153. As already explained, at least two original versions of the treaty will be signed, one for each state. Where the treaty is signed in more than one language, two versions of the treaty will be signed in each official language. Each country will receive a signed version of the treaty in each official language.

154. Once a treaty has been signed, its provisions should no longer be considered to be confidential. It is a good practice to publish the text of a treaty as soon as it has been signed and to post it on the website of the tax administration or of the ministry in charge of finance so that all interested parties are aware of its contents.

4. From signature to entry into force

155. In almost all countries, the signed treaty has to be approved by the parliament or legislative assembly before it can be considered that the state has given its consent to be bound by the treaty. The procedure for doing so differs between countries and it is generally advisable to clarify the procedure to be followed and the timetable for doing so through consultations with the relevant officials in charge of legislative or parliamentary matters.

156. In many cases, the ministry in charge of finance or the tax administration will need to prepare a technical explanation of the treaty for purposes of its parliamentary or legislative approval.

157. In the rare case where the parliament or legislative assembly does not approve a proposed tax treaty, the other country's negotiating team should be informed of the reason(s) why the treaty was not

approved. If these reasons are related to the contents of the treaty, the teams may then agree to meet again to explore possible changes that would make it possible to get approval of the treaty. There may also be significant changes of circumstances (such as major changes to domestic tax law or tax policy) that may lead a country to inform the other country that it wants to re-open previously concluded negotiations. While the countries may certainly agree to do so, this may present difficulties when the treaty has already been signed and may prove even more complicated when the treaty has already been ratified in one of the countries.

158. The entry-into-force article of a tax treaty indicates the process through which each country will inform the other that consent to be bound by the treaty has been obtained as well as when the treaty will enter into force.

159. A large number of treaties provide that consent to be bound by the treaty will be expressed through the ratification of the treaty by each country and that the treaty will enter into force when the instruments of ratification produced by each country are exchanged. The ratification of the treaty is the act through which a country, usually through its Head of state, officially expresses its consent to be bound by the signed treaty; the instrument of ratification is typically a short document expressing that consent.

160. The entry-into-force article of many other treaties provide that each country agrees to notify the other, through diplomatic channels, when the country's internal requirements or procedures for the entry into force of the treaty have been satisfied, which is when the country may be considered to have agreed to be bound by the treaty. The same article will also typically provide that the treaty will enter into force when the last of these notifications has been provided.

161. The exchange of instruments of ratification or the notification to another country that a country's internal requirements or procedures for the entry into force of the treaty have been satisfied are usually dealt with by the ministry in charge of foreign affairs. Lengthy delays between the approval by the parliament or legislative assembly and the entry into force of a treaty should be avoided as far as possible.

162. The signatory countries may wish to discuss which country and which ministry (typically the ministry in charge of foreign affairs)

should address the requirement imposed by paragraph 1 of Article 102 of the *Charter of the United Nations*, according to which

> Every treaty and every international agreement entered into by any Member of the United Nations after the present Charter comes into force shall as soon as possible be registered with the Secretariat and published by it.

5. After the entry into force

163. The date on which the provisions of a tax treaty start to have effect for the taxpayers and the tax administration of each country, which is the most important date as regards the practical application of the treaty, should not be confused with the date of signature or the date of entry into force of a tax treaty. The vast majority of tax treaties provide that their provisions shall have effect from a date that differs from the date of entry into force of the treaty. For instance, it is frequent for a tax treaty to provide that its provisions shall have effect, as regards withholding taxes, with respect to amounts that are paid or credited on or after a certain period (e.g. two months) following the date of entry into force and, as regards other taxes, with respect to the first taxable year that begins after the date of entry into force (which, in the case of taxes that are determined on the basis of taxable years, avoids the treaty having effect for only part of a taxable year). There are, however, many variations and it is not unusual to provide that some provisions will have effect at a different time, sometimes even before the entry into force of the treaty.

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

165. The service in charge of the negotiation of tax treaties should ensure that the different parts of the tax administration that may be involved in the application of the provisions of tax treaties are aware of the contents of a treaty that has entered into force and should be available to assist officials of these parts of the tax administration with

respect to any issues related to the interpretation and application of the treaty. A good filing system that will allow quick access to notes taken during the negotiations even decades after the negotiations took place will be very important for that purpose.

Section III

Treaty provisions

A. Title and Preamble

166. The Title and Preamble of the treaty will typically follow the wording used in both the UN and OECD models as modified in 2017. The main reason for this is that countries that are members of the Inclusive Framework on BEPS[28] have agreed, as part of their commitment to implement the minimum standard on treaty-shopping included in the report on Action 6 of the OECD/G20 BEPS project,[29] to include in their treaties the part of the Preamble of the OECD and UN models that refers to the signatories' intention to eliminate double taxation "without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including treaty-shopping arrangements aimed at obtaining reliefs provided in this Convention for the indirect benefit of residents of third States)". These countries are also likely to want to include in the Title the reference to the prevention of both tax evasion and avoidance that appears in the UN and OECD Models.

167. Taking this into account, countries may of course agree to change the Title and Preamble. One issue that they will need to address is whether the Title and Preamble will include the reference to taxes on capital that is found in both models. The inclusion or omission of that reference will often be decided after the discussion of Article 2, which, as explained below, indicates which taxes are covered by the treaty.

B. Chapter I—Scope of the Convention

168. Articles 1 and 2 deals with the scope of application of the treaty to persons and the taxes that it covers.

1. Article 1—Persons covered

169. Article 1 is basically the same in both the UN and OECD models and contains the general rule governing the application of the tax

28 Note 22.

29 Note 19, page 19.

treaty to natural and juridical persons. It also includes two additional rules clarifying the application of the tax treaty as regards income derived through entities or arrangements, such as some partnerships and trusts, that are not treated as taxable entities under the tax law of one or both countries and clarifying that, subject to a few exceptions, the treaty is not intended to affect the taxation, by a country, of its own residents.

Paragraph 1

170. Paragraph 1 of Article 1 states that the treaty "applies to persons who are residents of one or both Contracting States". The term "Contracting States" is used throughout the treaty to refer to the countries that will enter into that treaty). The term "person" is defined in Article 3 (General definitions) to include "an individual, a company and any other body of persons". "Any other body of persons" has a wide meaning and would include entities other than companies such as partnerships, in some countries the trustees of a trust and unincorporated associations, such as some sport clubs, education clubs and charities. The term "resident of a Contracting State" is defined in Article 4.

171. Since a tax treaty that follows the UN and OECD models generally applies to persons who are residents of the countries that sign that treaty, a person who is not a resident of either Contracting State will generally not be entitled to the benefits of the tax treaty between the two countries. Thus, the mere fact that a person has the nationality of one of the Contracting State is in principle not relevant for the application of the provisions of such treaties except as regards certain provisions such as the tie-breaker rule in paragraph 2 of Article 4 (Resident) as well as the rules of Article 19 (Government service) and Article 24 (Non-discrimination).[30]

172. It is important to note, however, that even if a person qualifies as a resident of a Contracting State, that person will not necessarily be entitled to all the benefits of that treaty. Apart from the fact that many provisions of the treaty include additional requirements that need to be satisfied in order to obtain the benefit of these provisions (e.g. the reduction of source taxation applicable to a dividend payment under

30 Treaties with the United States constitute an important exception to that principle: see paragraph 19 above.

Article 10 of the UN Model only applies to a resident who is the beneficial owner of the dividends), the granting of the benefits of the Convention is subject to the rules of Article 29 (Entitlement to benefits) of the UN and OECD models (see Section IV).

173. In addition, the Commentary on Article 1 includes a number of alternative provisions that treaty negotiators may want to consider including in their treaties in order to further restrict the entitlement to treaty benefits because of certain features of the tax system of treaty countries. As indicated in the Commentary "[a] State may conclude that certain features of the tax system of another State are not sufficient to prevent the conclusion of a tax treaty but may want to prevent the application of that treaty to income that is subject to no or low tax because of these features."[31] Such features may exist at the time the treaty is negotiated or may be introduced afterwards. The alternative provisions included in the Commentary deal with

— "special tax regimes" that may exist in the domestic tax law of a country at the time of the conclusion of the treaty or be introduced subsequently;[32]
— "subsequent changes in domestic law", which are changes of a general nature that are made to the domestic law of a country after a treaty has been concluded and which might have prevented the conclusion of the treaty if they had existed at that time;[33]
— "notional deductions for equity";[34] and
— "remittance based taxation".[35]

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31 Paragraph 118 of the Commentary on Article 1 of the UN Model, quoting paragraph 83 of the Commentary on Article 1 of the OECD Model.

32 Paragraph 118 of the Commentary on Article 1 of the UN Model, quoting paragraphs 85 to 100 of the Commentary on Article 1 of the OECD Model.

33 Paragraph 118 of the Commentary on Article 1 of the UN Model, quoting paragraphs 101 to 106 of the Commentary on Article 1 of the OECD Model.

34 Paragraph 118 of the Commentary on Article 1 of the UN Model, quoting paragraph 107 of the Commentary on Article 1 of the OECD Model.

35 Paragraph 118 of the Commentary on Article 1 of the UN Model, quoting paragraph 108 of the Commentary on Article 1 of the OECD Model.

Paragraph 2

174. Paragraph 2 of Article 1 deals with the application of the tax treaty to entities or arrangements, such as some partnerships and trusts, that are not treated as taxable entities under the tax law of one or both countries, the income derived through such entities being instead taxed in the hands of the partners, members or other persons. One example would be a partnership established in country A all the members of which are residents of that country. Under the domestic law of country A, partnerships are not taxable entities and the partners are directly taxable on their respective shares of the income derived by the partnership. The partnership derives income from country B, which treats partnerships as taxpayers taxable in the same way as companies.

175. Absent paragraph 2, issues may arise as to how the tax treaty between countries A and B would apply to that income. On the one hand, country B might consider that since the income is received by the partnership and the partnership does not qualify as a resident of country A because it is not liable to tax in country A (where it was established), the treaty is simply not applicable. On the other hand, country A might consider that since the partners who are residents of country A do not pay any tax in country B on the income derived from that country because it is the partnership itself that is taxed on that income by country B, it does not have to provide relief of double taxation to the partners. Both results would be unsatisfactory because the income derived from country B by taxpayers in country A is taxed by both countries and the main purpose of the treaty between countries A and B is to eliminate double taxation.

176. These issues were dealt with in a 1999 OECD report[36] that included a number of recommendations as to how countries should apply their tax treaties in various examples involving partnerships that one or both countries do not treat as a taxable entity. That report, however, did not deal with other entities or arrangements, such as trusts, that raised similar issues; also, some countries found it difficult to ap-

36 OECD (1999), *The Application of the OECD Model Tax Convention to Partnerships*, Issues in International Taxation, No. 6, OECD Publishing, Paris, https://doi.org/10.1787/9789264173316-en.

ply the recommendations of that report without specific treaty provisions to that effect. For that reason, paragraph 2 was included in the UN and OECD models in 2017 in order to clarify how the tax treaty should apply in the case of an entity or arrangement that at least one of the Contracting States does not consider to be a taxable entity. The Commentary of both models provides useful clarification as to how the paragraph is intended to be interpreted and applied;[37] it also indicates that the 1999 OECD Report "provides guidance and examples on how the provision should be interpreted and applied in various situations".[38]

177. In addition to the situations dealt with by paragraph 2, there are a number of issues that may arise as regards the application of tax treaties to different types of entities and arrangements, in particular where such entities or arrangements do not pay tax. Such issues may arise, for instance, in relation to pension funds, sovereign wealth funds and collective investment vehicles. Since these constitute some of most important cross-border investors in developing countries, it is important for these countries to have a clear understanding of how tax treaties will apply to income derived through such entities and, where necessary, to make the necessary adaptations. For instance, even though in some cases paragraph 2 of Article 1 might theoretically apply to income derived through a widely-held collective investment vehicle, the practical application of that paragraph might be extremely difficult because that collective investment vehicle may have thousands of members resident of different countries and that membership may change on a daily basis. The Commentary of the OECD Model addresses some of the treaty issues raised by pension funds,[39] sovereign wealth funds[40] and collective investment vehicles.[41]

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37 Paragraphs 4 to 7.1 of the Commentary on Article 1 of the UN Model.

38 Paragraph 2 of the Commentary on Article 1 of the OECD Model as quoted in paragraph 7 of the Commentary on the UN Model.

39 Definition of "recognized pension funds" in paragraph 1 *i*) of Article 3 of the OECD Model as well as paragraphs 10.3 to 10.18 of the Commentary on that article. See also paragraph 209 below.

40 Paragraphs 49 to 53 of the Commentary on Article 1 of the OECD Model.

41 Paragraphs 22 to 48 of the Commentary on Article 1 of the OECD Model.

Paragraph 3

178. Paragraph 3 of Article 1 corresponds to what is generally referred to as the "saving clause". This provision was added to the UN and OECD models in 2017 as a result of the report on Action 6 of the OECD/G20 BEPS project,[42] which endorsed the long-standing practice of treaties concluded by the United States. The provision states expressly that the provisions of the treaty, except a certain number of provisions specifically listed, do not affect a Contracting State's right to tax its own residents.

179. This provision is particularly relevant where the two countries tax different taxpayers on the same income, which may happen, for example, when one country taxes a resident shareholder under controlled foreign company rules or where it taxes a resident partner on the profits of a foreign partnership.

180. The provisions that should be listed as exceptions in paragraph 3 of Article 1 are all the provisions of the treaty which provide some relief that is intended to be granted by a country to its own residents. This is obviously the case of Article 23 (Elimination of double taxation), which requires a country to give to its residents relief from double taxation as regards income taxed by the other state, but is also the case of provisions such as those of Articles 20 (Students) and 24 (Non-discrimination) that are intended, at least in some cases, to apply to both residents and non-residents.

2. Article 2—Taxes covered

181. Article 2 (Taxes covered) of the UN Model identifies the taxes to which the treaty applies. These are taxes levied on income or on capital; other taxes, such as taxes on estates and inheritances and on gifts, are excluded.[43]

182. Clearly, the treaty is not intended to apply to certain charges such as, for example, mandatory contributions to social security schemes, consumption taxes and user charges such as those levied by local authorities. Certain provisions of the treaty, however, such as Articles 24 (Non-discrimination) and 26 (Exchange of information),

42 Note 19.

43 Paragraph 1 of the Commentary on Article 22 (Capital) of the UN Model.

apply to all taxes, regardless of whether they are included as covered taxes in Article 2.

Paragraph 1

183. Paragraph 1 describes the taxes to which the treaty will apply, that is to say, taxes on income and on capital imposed in the Contracting States by any level of government (for example, national Government, state or provincial government or local government), irrespective of the method by which these taxes are imposed, for instance, by withholding or by assessment. The terminology relating to the taxes covered by a treaty must be clear, precise and as comprehensive as possible.[44]

184. Some countries, however, prefer not to cover capital taxes, and some prefer to limit the application of the treaty to national-level taxes.

Capital taxes

185. While both the UN and OECD models cover capital taxes, in practice many treaties do not. The decision whether to include capital taxes in a tax treaty depends on whether they are imposed in both treaty partner countries. If both countries do so, then double taxation can arise where elements of capital belonging to a resident of one country is taxed by the other country. In these circumstances, provisions to eliminate such double taxation should be included in a treaty between the two countries following the text of Article 22 of the UN Model.

186. Not all countries, however, impose capital taxes under their domestic law. Double taxation of capital will not arise if one of the treaty partner countries does not impose capital taxes, or if neither does. In either case, it is a policy decision whether a country that does not impose capital taxes would want to include an article dealing with them in its treaties. That decision would be part of the development of a policy framework and country model mentioned in section II.

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

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44 Paragraph 2 of the United Nations Commentary on Article 2 of the UN Model.

188. If a country that does not currently impose capital taxes decides to cover such taxes, and is concerned about how the treaty may limit their imposition, one option may be to address the issue in negotiation of the provisions of Article 22 (Capital).[45]

Subnational taxes

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

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

Paragraph 2

191. Paragraph 2 describes the taxes that are to be treated as taxes on income and on capital for purposes of the treaty. While the definition includes "taxes on the total amounts of wages or salaries paid by enterprises", the Commentary notes that practices regarding the coverage of such taxes vary.[46] Whether or not such taxes should be covered is a matter for discussion during negotiations. In this regard, negotiators should take account of paragraph 3 of the Commentary on Article 2 of the OECD Model,[47] where the scope of such taxes is considered.

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45 Paragraph 4 of Article 22 of the UN Model and the Commentary thereon.

46 Paragraph 4 of the Commentary on Article 2 of the UN Model.

47 Referred to in paragraph 4 of the Commentary on Article 2 of the UN Model.

Paragraph 3

192. Paragraph 3 identifies the existing taxes in each country to which the treaty will apply. Although the list is "not exhaustive",[48] negotiators should be careful to ensure that the list is as clear, precise and comprehensive as possible.

193. Some countries do not include paragraphs 1 and 2 of Article 2. They simply provide an exhaustive list of existing taxes and clarify that similar taxes imposed subsequently will also be covered.[49] It should be noted, however, that this may limit the range of future taxes that could come within the scope of the treaty in accordance with paragraph 4. Without the general descriptions provided in paragraphs 1 and 2, it might be more difficult to conclude that a new tax is identical or substantially similar to the listed taxes. For example, a newly introduced capital gains tax may not be regarded as substantially the same as existing income taxes.

Paragraph 4

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

195. A tax treaty will normally apply to new taxes introduced after the entry into force of that treaty if those taxes are taxes on income or on a capital. Paragraph 4 clarifies that taxes that are "identical or substantially similar" to the taxes that existed at the time of the signature of the treaty and were expressly listed in paragraph 3 will be covered.[50] It is sometimes unclear whether a new tax is a tax on

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48 Paragraph 5 of the Commentary on Article 2 of the UN Model.

49 Paragraph 6.1 of the Commentary on Article 2 of the OECD Model for drafting of suitable provisions to achieve this outcome.

50 UN Model, Article 2(4). As noted above, however, some treaties do not include paragraphs 1 and 2 of Article 2 and therefore only apply to listed taxes and to "identical or substantially similar" taxes imposed after the signature of the treaty.

income or capital or if it "identical or substantially similar" to a tax expressly listed in the treaty. In case of doubt, a country could ask its treaty partners if they agree that a new tax is of an identical or substantially similar nature.

196. When, after the entry into force of a treaty, a country makes significant changes in its domestic tax legislation, paragraph 4 also requires it to inform its treaty partners of such changes.[51] The competent authority should inform its counterpart in the other country of important new legislation; some countries might inform its treaty partners also about significant judicial decisions, administrative rulings, and so forth. Negotiators should discuss when and how notification will take place. Some countries provide annual updates to their treaty partners, while others prefer to notify only important changes when they occur.

C. Chapter II—Definitions

197. Articles 3 to 5 include definitions of certain key terms used in the treaty. Other definitions of terms used in treaties are found in the articles to which they are relevant. For example, "immovable property" is defined in Article 6, which deals with income from such property, while dividends, interest and royalties are defined in their relevant Articles (10 to 12, respectively). These other definitions have a direct impact on the taxing rights granted by the respective Articles and care should be taken when deciding on their scope.

1. Article 3—General definitions

198. Article 3 provides a definition for a number of terms used in the treaty. The meaning given to the term in this Article applies for all purposes of the treaty, except where the context requires that another meaning be applied.

Paragraph 1

199. Paragraph 1 sets out a number of defined terms that are used in the treaty. Unlike the OECD Model, the terms "enterprise" and "business" are not defined in the UN Model. The OECD Model introduced

51 Ibid.

the definitions of the terms "enterprise" and "business" to clarify the scope of Article 7 (Business profits) after Article 14 (Independent personal services) was deleted from the OECD Model. In treaties that follow the UN Model, where Article 14 has not been deleted, these definitions should not be added.

200. The meaning of specific terms defined in Article 3 is discussed throughout this section in the context of the provisions in which they appear.

201. Many treaties include additional definitions in Article 3. For example, definitions of each Contracting State and their respective territory are frequently drafted in a way that clarifies that the geographic reference to a state includes any area beyond the territorial waters over which that state has jurisdiction under its domestic law and in accordance with international law. This is primarily intended to cover the continental shelf and the exclusive economic zone, as defined under the *United Nations Convention on the Law of the Sea*, which are areas over which a state may exercise certain rights, including taxing rights, with respect to natural resources even though these areas are not otherwise part of the territory of the state. Absent such a clarification, a tax treaty reference to activities taking place in a state could be interpreted as covering only activities taking place on the territory of that state, thereby excluding activities taking place on the continental shelf or in the exclusive economic zone. Whenever such territorial definitions are included, they should refer to international law, particularly in respect of any areas or boundaries that may be contentious or areas over which a state's jurisdictional rights are restricted by international law. For that reason, it is usually necessary to coordinate with the ministry in charge of foreign affairs in order to draft or approve the territorial definition of a state that will be included in a tax treaty. It is important for treaty negotiators to agree on the exact scope of the territory where the taxation rules agreed in the treaty should apply.

202. The meaning given to a term by Article 3 prevails over any domestic law meaning of the same term. For example, the term "company" is defined to include, for treaty purposes, taxable entities that are treated as companies for tax purposes, notwithstanding that a domestic law definition of company does not include such entities.

Paragraph 2

203. Paragraph 2 provides that a term that is not defined in the treaty is to take the meaning that the term has, at the time of the application of the treaty, under the domestic law of the country that applies the treaty, unless the context of the treaty requires that another meaning be given to the term. Paragraph 14 of the Commentary on Article 3 of the UN Model, quoting paragraph 12 of the Commentary on Article 3 of the OECD Model, notes that the "context is determined in particular by the intention of the Contracting States when signing the Convention as well as the meaning given to the term in question in the legislation of the other Contracting State". Also, paragraph 3 of Article 25 (Mutual agreement procedure) authorizes the competent authorities to resolve by mutual agreement any doubts arising as to the interpretation of the Convention and the competent authorities may use that power to agree on the interpretation of certain treaty terms. In that case, the treaty negotiators could consider providing expressly in paragraph 2 of Article 3 that any meaning agreed to in this manner would prevail over the domestic law meaning of a treaty term. That approach has been followed in paragraph 2 of Article 3 of the 2017 OECD Model.

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

2. Article 4—Resident

205. Article 4 defines the term "resident of a Contracting State" for purposes of the treaty, including in cases where a person is a resident under the domestic law of both countries. This definition is of course vital in interpreting the treaty as it determines who will be treated as residents of the treaty partner country in accordance with Article 1.

Paragraph 1

206. The definition in paragraph 1 refers to the concept of residence under domestic law. Thus, the starting point for determining whether a person is a treaty resident is to ascertain whether that person is a resident for tax purposes under the domestic law of either country. The

definition focuses on certain specified criteria, however; that is to say, domicile, residence, place of management, place of incorporation[52] or any other criterion of a similar nature. For countries where a person is treated as a resident on the basis of other criteria that may not be regarded as "of a similar nature" to the listed criteria (for example, where a company is treated as resident if its head office is located in the country, or where the majority of the voting power in a company is held by residents of that country), these criteria should also be discussed in negotiations and listed where appropriate. In general, any criteria that result in a person being fully liable to tax as a resident in a country would be acceptable.[53]

207. The treaty definition in paragraph 1 requires that the person be "liable to tax" in that state by reason of domicile, residence, place of incorporation, place of management or any other criterion of a similar nature. This generally means that the person is liable to the most comprehensive taxation imposed by that country, such as taxation on worldwide income or, in the case of countries operating territorial taxation systems, to full taxation under that tax law.

208. The definition in paragraph 1 specifically includes the phrase "that State and any political subdivision or local authority thereof". This ensures that Governments of a Contracting State are treated as residents of that state for treaty purposes, irrespective of whether those Governments are taxed under domestic law.

209. As pension funds now represent one of the largest categories of cross-border investors, the application of the provisions of tax treaties to the income derived by pension funds (for instance, the provisions of Article 10 that limit the amount of tax imposed on dividends beneficially owned by pension funds) is an important question. Depending on how a pension fund is structured and on how it is treated for tax purposes, there may be doubts as to whether a particular pension fund is a person "liable to tax" in a state as required by paragraph 1. Most countries are of the view that it is appropriate policy to consider pension funds as residents for treaty purposes and wish to

52 While "place of incorporation" is not included in the specified criteria in Article 4 of the OECD Model, it is frequently found in treaties negotiated by OECD member countries.

53 Paragraph 4 of the Commentary on Article 4 of the OECD Model.

clarify that issue in Article 4. If it is decided to provide expressly in a treaty that pension funds are entitled to treaty benefits, it is important to include in that treaty a definition of pension funds that would ensure that the application of the relevant provisions is restricted to funds that do in fact provide retirement benefits. Paragraph 1 of Article 4 of the OECD Model as well as the accompanying definition of "recognized pension fund" in paragraph 1 *f*) of Article may be used for that purpose.[54]

210. Doubts may also arise as to whether other entities or arrangements that do not pay tax, such as charitable organizations and sovereign wealth funds, qualify as persons "liable to tax" in a state and therefore as residents of that state. Where doubt exists, countries may wish to clarify the position of these entities or arrangements, either in Article 4 of the treaty or through the mutual agreement procedure.

Paragraph 2

211. Paragraph 2 deals with the situation where the domestic law of both countries treats the same individual as its own resident, for example, where a person is considered for tax purposes to be a resident of one country because he or she is domiciled there and is also treated as a resident of the other country because he or she is present in that country for an extended period. Similar situations can arise with companies and other entities.

212. The proper application of the provisions of tax treaties make it necessary to assign residence, for treaty purposes, to only one of the Contracting States. This is done by paragraph 2, which sets out a number of rules (known as "tie-breaker rules") for determining a single state of residence for an individual who is a resident of both Contracting States under these states' domestic law. It should be noted that these tie-breaker rules apply only for the purposes of the treaty and do not, by themselves, affect the person's residential status under domestic tax law.

213. Treaty negotiators may wish to discuss the tie-breaker rules (and in particular the "permanent home available" and "habitual abode"

54 See the explanations in paragraphs 10.3 to 10.18 of the Commentary on Article 3 and in paragraphs 8.6 to 8.10 of the Commentary on Article 4 of the OECD Model.

tests) during negotiations to ensure that both sides share the same understanding of their operation. The Commentaries on Article 4 of the UN and OECD models will assist negotiators in reaching a shared understanding.[55]

Paragraph 3

214. Paragraph 3 addresses the situation of dual residence of persons other than individuals. Tax entities such as companies or other bodies of persons can also be treated as residents of both treaty states, for example where an entity is incorporated or established in one country and is managed in the other country. Before 2017, both the UN and OECD models resolved such cases by assigning the residence of such persons to the state where the person's place of effective management was situated.

215. There was uncertainty, however, concerning the meaning of "place of effective management". Some countries considered that this referred to a place, such as the headquarters of a company, where an entity was managed on a day-to-day basis while other countries considered that this referred to the place where the most senior person or groups of persons (such as the board of directors of a company) reached their decisions. As part of the work on BEPS Action 6,[56] it was recognized that cases of dual residence of companies and other legal entities were rare and often involved tax avoidance strategies. As a result, both the UN and OECD models were amended in 2017 to provide that such cases of dual residence should be dealt with on a case-by-case basis by mandating the competent authorities to endeavor to determine a single state of residence by mutual agreement. As long as the competent authorities do not reach such an agreement, the entity shall not be entitled to any of the benefits provided by the treaty (unless the competent authorities nevertheless agree to extend certain limited benefits) and both states will continue to tax the entity in accordance with their domestic law.

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55 While paragraph 7 of the Commentary on Article 4 of the UN Model quotes paragraphs 9–20 of the Commentary on Article 4 of the 2014 OECD Model, the Commentary of the 2017 OECD Model includes additional explanations on the concept of "permanent home available" and "habitual abode".

56 Note 19.

216. Some countries, however, prefer to keep the rule based on the "place of effective management" and consider that they can apply it in a way that prevents abuses. Paragraph 10 of the Commentary to Article 4 of the 2017 UN Model provides wording that can be used for that purpose.

3. Article 5—Permanent establishment

217. Article 5 defines the term "permanent establishment", which is a key concept in tax treaties. This concept determines when a country may tax business profits of an enterprise of another country. Moreover, it is relevant to determining taxing rights over dividends, interest, royalties, fees for technical services, capital gains and other income, as well as to determining the source of certain income (Articles 11, 12 and 12A) and entitlement to non-discriminatory treatment (paragraph 3 of Article 24).

218. The definitions of permanent establishment found in the UN and OECD models differ in a number of important respects.[57] The UN Model provides a broader definition of permanent establishment, resulting in greater taxing rights for the source country than is provided under the OECD Model. The negotiation of Article 5 is therefore often controversial, particularly in negotiations between developing and developed countries.

219. The interpretation and application of the definition can also give rise to difficult issues. For example, some countries do not agree with the Commentary with respect to certain interpretations relating to the application of the definition in the context of the digitalization of the economy.[58] It will often be useful for negotiators to discuss their understanding of the definition during negotiations in order to avoid subsequent disputes.

Paragraph 1

220. Paragraph 1, like paragraph 1 of the OECD Model, provides a basic definition of permanent establishment. Under that definition,

57 These differences are outlined in paragraph 1 of the Commentary on Article 5 of the UN Model.

58 Paragraphs 36 and 37 of the Commentary on Article 5 of the UN Model, quoting paragraphs 42.1 – 42.10 of the Commentary on Article 5 of the OECD Model.

"permanent establishment" means "a fixed place of business through which the business of an enterprise is wholly or partly carried on".

221. The term "enterprise" itself is not defined in the UN Model and the non-exhaustive definition of "enterprise" found in the OECD Model[59] is merely intended to clarify that Article 7 applies to the carrying on of professional and other independent activities (which are covered by Article 14 in the UN Model). Paragraph 42 of the Commentary on Article 5 of the OECD Model, which was added in 2017, clarifies, however, that the term "enterprise" as used in Article 5 "refer[s] to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form".

222. For a permanent establishment to exist under the definition of paragraph 1, the following three conditions must be met:

— There must be a "place of business"
— That place of business must be "fixed" with regard to duration and location, and
— The business of the enterprise must be carried on wholly or partly through that place.

223. Since the definition in paragraph 1 is the same in the UN and OECD models, paragraph 3 of the Commentary of the UN Model quotes, with a few adaptations, the guidance on the interpretation and application of paragraph 1 that was found in the Commentary of the 2014 OECD Model.[60] In 2017, however, a number of additional clarifications were added to the Commentary on paragraph 1 of the OECD Model and these changes have not yet been considered for inclusion in the UN Model.

Paragraph 2

224. Paragraph 2 lists a number of examples of what typically constitutes a permanent establishment. These places will constitute a permanent establishment, however, only if they fall within the definition

59 Paragraph 1 (*c*) of Article 3 of the OECD Model.

60 Paragraphs 2–11 of the Commentary on Article 5 of the 2014 OECD Model.

of paragraph 1, that is to say, where there is a fixed place of business through which the business of the enterprise is wholly or partly carried on. The paragraph is identical to paragraph 2 of Article 5 of the OECD Model.

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

Paragraph 3

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

227. Unlike paragraph 3 of the OECD Model, paragraph 3 of the UN Model, which starts with the words, "[t]he term 'permanent establishment' also encompasses", operates as an extension of the definition found in paragraph 1 and therefore applies regardless of the requirements of that definition. While some countries prefer to clarify this point by replacing the words "also encompasses" by words such as "is deemed to include", the effect of paragraph 3 is clear as regards paragraph 3 (*b*), which applies regardless of whether or not services are provided at a single fixed place of business. The wording is less relevant for paragraph 3 (*a*), which seems to refer to a building site or construction, installation or assembly project at a single location (which would therefore constitute a "fixed place of business" under paragraph 1).

228. A number of countries, including developed and developing countries, seek to include special provisions in their treaties that, like paragraph 3, deem a permanent establishment to exist as regards activities related to the exploration for or exploitation of their natural resources, especially hydrocarbons. This preference may be reflected in additional provisions in Article 5[61] or, in the case of offshore activities, in an additional article dealing specifically with those activities. Under these provisions, a permanent establishment will often be deemed to exist in respect of these activities after only a short period of time, for example, 30 days.[62]

229. The Commentary[63] refers to the potential abuse of the time thresholds of paragraph 3 by giving the example of enterprises (mainly contractors or subcontractors working on the continental shelf or engaged in activities connected with the exploration and exploitation of the continental shelf) dividing their contracts into several parts, each covering a period of less than six months and being attributed to a different company of the same group. It adds that such abuses may, depending on the circumstances, fall under the application of legislative or judicial anti-avoidance rules but may also be addressed through the general anti-abuse rule of paragraph 9 of Article 29 (Entitlement to treaty benefits).[64] The Commentary also includes a specific "anti-contract-splitting rule"[65] that countries that wish to deal expressly with the issue or that do not adopt paragraph 9 of Article 29 could include in their treaties. That rule originated from the G20/OECD work on BEPS Action 7, which dealt with strategies for avoiding the permanent establishment definition, and was included in the final report on that topic.[66]

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61 See, for example, paragraph 4 (*a*) of Article 5 of the treaty between New Zealand and South Africa dated 6 February 2002.

62 See Article 21 of the treaty between Norway and South Africa dated 12 February 1996.

63 Paragraph 11 of the Commentary on Article 5 of the UN Model, quoting and supplementing paragraphs 52 and 53 of the Commentary on Article 5 of the OECD Model.

64 See examples J and N in paragraph 182 of the Commentary on Article 29 of the UN Model.

65 Paragraph 11 of the Commentary on Article 5 of the UN Model, quoting paragraph 52 of the Commentary on Article 5 of the OECD Model.

66 OECD (2015), *Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*, OECD/G20 Base

Construction activities

230. Paragraph 3 (*a*) covers building sites, construction, assembly and installation projects as well as connected supervisory activities, where those sites, projects or activities last more than six months.

231. Paragraph 3 (*a*) appears to be broader than paragraph 3 of Article 5 of the OECD Model, which does not refer to assembly projects or supervisory activities. The Commentary on Article 5 of the OECD Model suggests, however, that these differences are not significant, as it states that on-site planning and supervision of a construction site are covered by paragraph 3[67] and the examples of construction or installation activities that it includes would probably include most assembly projects. Nevertheless, developing countries may wish to clarify the position by following the UN Model in this regard.

232. Paragraph 3 of the OECD Model also has a 12-month threshold instead of the 6-month threshold found in the UN Model. In practice, the majority of treaties between developing countries, or between a developed and a developing country, provide a time threshold of less than 12 months and most provide for six months.[68] While some developing countries seek a shorter period for this paragraph, the six-month test provides approximate symmetry with the permanency test for a fixed place of business under paragraph 1 of this Article, which will generally not constitute a permanent establishment if it lasts for less than six months; [69] it also provides symmetry with the 183-day rules of paragraph 1 (*b*) of Article 14 (Independent personal services) and paragraph 2 (*a*) of Article 15 (Dependent personal services), thereby preventing difficulties that could arise from taxpayers attempting to change the treaty characterization of activities that they perform in order to benefit from more beneficial time thresholds.

Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241220-en, page 43.

67 Paragraph 50 of the Commentary on Article 5 of the OECD Model.

68 See Wim Wijnen and Jan de Goede, "The UN Model in Practice 1997–2013", *Bulletin for International Taxation,* No. 3 (2014), section 2.1.3.1.

69 Paragraph 3 of the Commentary on Article 5 of the UN Model, quoting paragraph 6 of the Commentary on Article 5 of the 2014 OECD Model (paragraph 28 in the current OECD Model).

233. Negotiators should also ensure that the chosen time threshold should not be less than any domestic time threshold for the taxation of such activities, as this could lead to double non-taxation of income of non-resident construction or assembly enterprises in treaties with countries that apply an exemption system (that is to say, where income that may be taxed in the host state under the treaty is exempted from tax in the other state). This is because, while the treaty assigns to the source state the right to tax the income, that state would not be able to exercise that right if the construction site lasts less than the required time threshold under its domestic law.

234. The Commentary includes some explanations as to what constitutes a building site or a construction or installation project for the purposes of paragraph 3 (*a*).[70]

Furnishing of services

235. Paragraph 3 (*b*) provides that certain service activities constitute a permanent establishment where these activities continue within a country for a period or periods totaling more than 183 days in any 12-month period.

236. There is no equivalent provision in Article 5 of the OECD Model although the OECD Commentary on that Article includes a similar alternative provision.[71]

237. While both provisions are intended to achieve a similar outcome (a permanent establishment where services are provided in a country for more than 183 days in any 12-month period), there are substantive differences between the two drafts.

238. In the first place, the OECD alternative provision explicitly deems activities that meet the conditions of the provision to be carried on through a permanent establishment notwithstanding that there may be no fixed place of business. As previously explained, while para-

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70 Paragraphs 11 and 15 of the Commentary on Article 5 of the UN Model, quoting the relevant parts of the Commentary on Article 5 of the OECD Model.

71 Paragraphs 132 to 169 of the Commentary on Article 5 of the OECD Model. The draft alternative provision is found in paragraph 144 of that Commentary.

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

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

240. While Article 14 has been retained in the UN Model, the Commentary includes alternative provisions that should be inserted in Article 5 by countries that wish to delete Article 14, as well as a list of consequential changes that should be made to other articles.[72] In particular, a new paragraph 3 (*c*) should be added to deem a permanent establishment to exist where an individual meets a 183-day length of stay test.[73] Developing countries that do not include Article 14 in their treaties, but that wish to provide for source-country taxing rights over independent personal services income when those services are provided over an extended period in their country, should ensure that these services are covered by the inclusion of both paragraphs 3 (*b*) and (*c*) when negotiating Article 5.

241. It should be noted that the OECD alternative provision covers two different situations. The first situation, dealt with under subparagraph (*a*), is that of an enterprise that derives its income primarily from services performed by one individual. Subparagraph (*a*) includes both a "length of stay" test (similar to that in paragraph 1 (*b*) of Article 14 or in the alternative paragraph 3 (*c*) of Article 5 of the UN Model

72 See the discussion in paragraphs 15.1–15.26 of the Commentary on Article 5 of the UN Model.

73 See the wording proposed in paragraph 15.7 of the Commentary on Article 5 of the UN Model.

referred to above) and an additional requirement that more than 50 per cent of the gross revenues of the enterprise attributable to active business activities of the enterprise during the period of presence of the individual be derived from the services performed by that individual during the period. This second condition is intended to ensure that an enterprise, such as a one-person company, that derives most of its income from the activities performed in one country by a single individual who is present in that country for more than 183 days, will be considered to have a permanent establishment in that country and will be taxed as if the services provided were covered by Article 14. There is no equivalent to the second condition in either Article 14 or in alternative paragraph 3 (*c*) of Article 5 of the UN Model referred to above.

242. The second situation dealt with under the OECD alternative provision is where an enterprise provides services in a country through one or more individuals (generally employees, but it may also refer to partners or agents). Unlike paragraph (*b*) of Article 5 of the UN Model, the services must be provided for "the same or connected projects" during at least 183 days in any 12-month period, though they may be provided by different employees or other personnel on behalf of the enterprise.

243. A similar condition under which the services had to be provided "for the same or a connected project" was originally included in paragraph 3 (*b*) of the UN Model but was deleted in 2017. As explained in the Commentary,[74] it was then considered that this condition "was easy to manipulate and created difficult interpretive issues and factual determinations for tax authorities". It was also considered that where a non-resident enterprise provides services within a country for more than 183 days, the extent of the activities justifies source taxation regardless of whether the services are provided for one project or for multiple projects. On the other hand, it was argued that enterprises can more easily monitor the location of the activities of their employees and independent contractors on a project-by-project basis. Taking this into account, the Commentary provides that countries that are concerned about the uncertainty involved in adding together unrelated projects may add the phrase "(for the same or a connected project)" in paragraph 3 (*b*).

74 Paragraphs 12 and 12.1 of the Commentary on Article 5 of the UN Model.

Paragraph 4

244. Paragraph 4 deems a permanent establishment not to exist in certain circumstances. It applies where a fixed place of business that would otherwise constitute a permanent establishment under the definition of paragraph 1 is used solely for the purpose of activities that have a preparatory or auxiliary character. While paragraphs 4 (*a*) to (*d*) include a list of specific activities that could be considered as such, the reference to "any other activity" in paragraph 4 (*e*) ensures that any activity of a preparatory or auxiliary character, or, under paragraph 4 (*f*), any combination of such activities as long as the overall activity of the fixed place of business does not exceed the preparatory or auxiliary character, could satisfy the requirements of paragraph 4. The policy underlying paragraph 4 is that such a fixed place of business would generate profits that would either be minimal or difficult to ascertain.

245. Paragraph 4 of the UN Model mirrors paragraph 4 of Article 5 of the OECD Model with the exception of the reference to "delivery" in paragraphs 4 (*a*) and (*b*).[75] Both paragraphs were amended in 2017 as a result of the G20/OECD work on BEPS Action 7, which dealt with strategies for avoiding the permanent establishment definition. The final report on Action 7[76] provided that the paragraph should be amended by expressly providing that its application was restricted to cases where activities listed in the paragraph were of a preparatory or auxiliary character. As a result of that change, and because paragraph 4 (*e*) covers any activity not listed in paragraphs 4 (*a*) and (*b*), the inclusion or omission of the word "delivery" in paragraphs 4 (*a*) and (*b*) has lost much of its practical importance.

246. The Commentary provides detailed explanations on the meaning of the phrase "preparatory or auxiliary character" as well as on the scope of each type of activities specifically listed in paragraphs 4 (*a*) to (*f*).[77] It also discusses the position of countries that prefer alternative versions of the paragraph (including a version corresponding to

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75 The omission of the world "delivery" is discussed in paragraphs 20 – 21 of the Commentary on Article 5 of the UN Model.

76 Note 66.

77 Paragraph 18 of the Commentary on Article 5 of the UN Model, quoting paragraphs 58 to 77 of the Commentary on Article 5 of the OECD Model.

the way in which it was drafted before the 2017 changes) or even its complete omission.[78]

Paragraph 4.1

247. Paragraph 4.1 is an anti-avoidance rule that was added to Article 5 of both the UN and OECD models as a result of the final report on BEPS Action 7.[79] That report observed that because it was easy for a company to establish any number of subsidiaries, the preparatory or auxiliary requirement of paragraph 4 should not be applied exclusively with respect to activities taking place at one location or within one company but should be extended to cover all the locations in a state where closely related companies carry on business activities that belong to a cohesive business operation. This new rule was therefore seen as the logical consequence of the decision to restrict the scope of paragraph 4 of Article 5 to activities that have a "preparatory and auxiliary" character because, without paragraph 4.1, a company could carry on in a state one or more activities which, taken in isolation, would have a preparatory or auxiliary character while other related companies would carry on substantial business activities which, when taken together with the activities of the first company, would show that the group of companies taken as a whole was carrying business operations that went beyond what is purely preparatory or auxiliary.

248. Paragraph 9 of Article 5, which is discussed below, includes the definition of the concept of "closely related enterprises" which is referred to in paragraph 4.1.

249. The Commentary[80] explains the conditions of paragraph 4.1 and illustrates its application through examples.

Paragraph 5

250. Paragraph 5 deems an enterprise of one state to have a permanent establishment in the other state where a person acting in the other state on behalf of that enterprise (commonly referred to as a "depend-

78 Paragraph 19 and 19.1 of the Commentary on Article 5 of the UN Model.

79 Note 66, page 39.

80 Paragraph 21.1 of the Commentary on Article 5 of the UN Model, quoting paragraphs 79 to 81 of the Commentary on Article 5 of the OECD Model.

ent agent") involves that enterprise in substantial economic activity in that other state.[81] Where the conditions of paragraph 5 are met, a permanent establishment for the enterprise will exist, even if neither the enterprise nor the dependent agent has a fixed place of business in that country. This paragraph does not apply, however, if the person is an independent agent to whom paragraph 7 of the Article applies.

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

252. Paragraph 5 of both models and the related exception applicable to independent agents were substantially amended in 2017 as a result of the G20/OECD work on BEPS Action 7, which dealt with strategies for avoiding the permanent establishment definition. The final report on Action 7[82] explains that the changes were made because "in many cases *commissionnaire* arrangements and similar strategies were put in place primarily in order to erode the taxable base of the State where sales took place" and to reflect the policy that "where the activities that an intermediary exercises in a country are intended to result in the regular conclusion of contracts to be performed by a foreign enterprise, that enterprise should be considered to have a sufficient taxable nexus in that country unless the intermediary is performing these activities in the course of an independent business."

253. Paragraph 5 (*a*) reflects this intention. It applies where a person that is acting in a state on behalf of an enterprise of the other state habitually concludes contracts, or habitually plays the principal role leading to the conclusion of contracts that are routinely concluded by the enterprise without material modification, and these contracts fall into one of the following categories:

— they are concluded in the name of the enterprise;
— they are for the transfer of the ownership or for the right to use the enterprise's property;
— they are for the provision of services by that enterprise.

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81 Paragraph 22.1 of the Commentary on Article 5 of the UN Model.

82 Note 66, page 15.

254. Where these conditions are met, paragraph 5 deems the enterprise to have a permanent establishment in the state where the person is acting unless the independent agent exception of paragraph 7 applies or unless the activities of the person would fall within the exception of paragraph 4 (which deals with preparatory or auxiliary activities) if they were exercised through a fixed place of business.

255. Paragraph 5 (*b*), which has no equivalent in the OECD Model, similarly deems an enterprise of one state to have a permanent establishment in the other state where a person acting in the other state on behalf of that enterprise habitually maintains a stock of goods or merchandise from which they regularly deliver on behalf of the enterprise. This is consistent with the view that a warehouse or stock of goods that the enterprise itself would maintain in the other state for purposes of making deliveries would give rise to a permanent establishment under paragraph 1.

256. The Commentary provides extensive explanations concerning the interpretation and application for paragraph 5 (*a*).[83] It also explains that some countries prefer to broaden the scope of paragraph 5 (*a*) by omitting the phrase "that are routinely concluded without material modification by the enterprise".[84]

257. As regards paragraph 5 (*b*), the Commentary suggests that if all sales-related activities take place outside the source state and only delivery by an agent takes place there, this would not lead to a permanent establishment; however, a permanent establishment could exist if sales-related activities (for example, advertising or promotion) are also conducted in the source state on behalf of the resident and have contributed to the sale of the goods or merchandise that are delivered.[85]

258. Treaty practice shows that a few countries have extended the scope of paragraph 5 to cover other situations where a permanent establishment would be deemed to exist, for example, where a dependent agent habitually secures orders for sales of goods in the state wholly or

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83 Paragraph 23 of the Commentary on Article 5 of the UN Model, quoting paragraphs 84 to 98 of the Commentary on Article 5 of the OECD Model.

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

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

almost wholly on behalf of a foreign enterprise or related enterprises[86] or where a dependent agent manufactures or processes goods belonging to the enterprise.[87]

Paragraph 6

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

260. The Commentary[88] explains the reason for paragraph 6. It also indicates[89] that some countries prefer to delete the exception that relates to activities performed by an independent agent. Some countries take a broader approach and simply excludes the profits of insurance enterprise from the application of the treaty, leaving these profits to be taxed in accordance with domestic law.[90]

261. Although this paragraph has no equivalent in the OECD Model, the Commentary on Article 5 of that Convention[91] recognizes that foreign insurance enterprises can make substantial profits in a country without establishing a fixed place of business there and without using agents that would trigger a permanent establishment under paragraph 5. It notes that "[t]he decision as to whether or not a provision along these lines should be included in a convention will depend on the factual and legal situation prevailing in the Contracting States concerned", although it also remarks that the changes made to para-

86 See for instance, paragraph 5 (*c)* of Article 5 of the Cambodia-Thailand treaty signed on 7 September 2017.

87 See for instance, paragraph 6 (*b)* of Article 5 of the Australia-France treaty signed on 20 June 2006.

88 Paragraph 28 of the Commentary on Article 5 of the UN Model.

89 Paragraph 29 of the Commentary on Article 5 of the UN Model.

90 See paragraph 7 of Article 7 of the treaty between Mexico and New Zealand signed on 16 November 2006.

91 Paragraph 114 of the Commentary on Article 5 of the OECD Model.

graphs 5 and 6 in 2017 have addressed some of the concerns that such a provision would address.[92]

262. When discussing whether or not to include paragraph 6 in a treaty, negotiators should analyze the conditions under which foreign insurance enterprises are allowed to carry on insurance activities in each state as well as the other taxes or levies that may apply to insurance premiums or activities.

Paragraph 7

263. Paragraph 7 constitutes an exception to the deemed permanent establishment rules of paragraphs 5 and 6[93] and provides that these rules do not apply where the person who is acting on behalf of a foreign enterprise does so in the course of its business as an independent agent. The second sentence of paragraph 7 restricts the scope of that exception, however, by providing that a person cannot be considered to be acting as an independent agent where that person acts exclusively or almost exclusively on behalf of one or more enterprises to which it is closely related. The definition of a person "closely related" to an enterprise is provided in paragraph 9.

264. Like paragraph 5, paragraph 7 was substantially amended in 2017 as a result of the G20/OECD work on BEPS Action 7, which dealt with strategies for avoiding the permanent establishment definition. As explained in the final report on Action 7,[94] the changes made to the paragraph were aimed at preventing strategies where an enterprise sought to avoid the application of paragraph 5 by arguing that a person, usually a related company, constituted an "independent agent" to which the exception of paragraph 7 applied even though it was acting exclusively on behalf of other companies of the same group.

265. The changes made to paragraph 7 also corrected a few difficulties that arose from the previous version of the paragraph. For instance,

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92 Ibid.

93 The paragraph is similar to paragraph 6 of the OECD Model, which, however, only applies with respect to the deemed permanent establishment rule of paragraph 5 since the OECD does not include a provision similar to paragraph 6 of the UN Model.

94 Note 66, page 15.

while the previous version of paragraph 7 of the UN Model had an exclusion corresponding to what is now found in the second sentence of the new version, that exclusion was limited to cases where an agent acted wholly or almost wholly on behalf of the enterprise and its dealings with the enterprise did not reflect arm's length conditions. As explained in the Commentary,[95] the requirement that the dealings did not reflect arm's length conditions was deleted because "the lack of an arm's length relationship should not be a deciding factor in determining that an agent does not qualify as an agent of independent status."

266. The Commentary[96] also provides additional explanations concerning the interpretation and application of the paragraph, including the criteria to apply in order to determine whether a person acts as an independent agent.

Paragraph 8

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

268. As indicated in the Commentary, however, a permanent establishment may arise under paragraph 1 if one of the two companies has at its disposal and uses for its own business part of a building belonging to the other company. Also, the provisions of paragraph 5 may apply to deem the activities of one company to constitute a permanent establishment of the other, for example, if one company acts on behalf of the other in a way that meets the conditions for the application of paragraph 5.[97]

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95 Paragraph 32 of the Commentary on Article 5 of the UN Model.

96 Paragraph 30 of the Commentary on Article 5 of the UN Model, quoting paragraphs 102 to 113 of the Commentary on Article 5 of the OECD Model.

97 Paragraphs 33 and 34 of the Commentary on Article 5 of the UN Model, quoting paragraphs 115 to 118 of the Commentary on Article 5 of the OECD Model.

Paragraph 9

269. Paragraph 9 provides rules for determining whether a person or an enterprise is closely related to an enterprise. This rule is relevant for the purposes of paragraph 4.1, which refers to a "closely related enterprise", as well as for the purposes of paragraph 7, which refers "a person [who] acts … on behalf of one or more enterprises to which it is closely related". The definition may also be relevant for other treaty purposes, which could justify including it in Article 3 (General definitions) rather than in Article 5.[98]

270. The first part of paragraph 9 provides a general rule according to which a person or enterprise is closely related to an enterprise if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same persons or enterprises.

271. The second part of paragraph 9 indicates that a person or enterprise will automatically be considered to be closely related to an enterprise in certain circumstances. These circumstances relate to situations where there is direct or indirect ownership of more than 50 per cent of the beneficial interests in a person or enterprise.

272. As indicated in the Commentary,[99] the concept of a person or enterprise closely related to an enterprise must be distinguished from the concept of "associated enterprises" which is used for the purposes of Article 9; although the two concepts overlap to a certain extent, they are not intended to be equivalent.

D. Chapter III—Taxation of income

273. One of the main effects of a tax treaty is to allocate taxing rights over income derived by a resident of one treaty partner from sources in the other treaty partner country. Treaties provide for different methods for allocating tax rights and for certain minimum thresholds for taxa-

98 See, for example, the alternative provision on "special tax regimes" in paragraph 85 of the Commentary on Article 1 of the UN Model as well as the alternative provision on "contract splitting" in paragraph 11 of the Commentary on Article 5 of the UN Model.

99 Paragraph 35 of the Commentary on Article 5 of the UN Model, quoting paragraph 119 of the Commentary on Article 5 of the OECD Model.

tion of income derived by non-residents. The treaty may allocate exclusive taxing rights to one country (that is to say, the other country is not permitted to tax the income), unlimited primary source taxing rights (where the source country's right to tax is not limited by the treaty, and the residence country is required to relieve any resulting double taxation), limited primary source taxing rights (where the source country must limit its taxation, and the residence country must relieve double taxation) or, in a few treaties, shared taxing rights (where both countries are allocated exclusive taxing rights over an agreed portion of the income). The method and threshold depend on the category of income derived. [100]

274. Generally, the phrase "shall be taxable only" in a state signifies that that state has been allocated exclusive taxing rights, while the phrase "may be taxed" in a state is used where that state is allocated a non-exclusive taxing right. The fact that income "may be taxed" in one state under a provision of the treaty does not affect the other country's right to tax that income (except as regards to the application of Article 23, under which the state of residence of obliged to eliminate double taxation of income which "may be taxed" in the other state in accordance with the treaty). [101]

1. Article 6—Income from immovable property

275. Income such as rents, agricultural or forestry profits, or other income derived from the use of immovable property, is seen as having a very strong economic link with the country in which the immovable property is situated. Accordingly, Article 6 allocates unlimited taxing rights over this income to the source country and this position should always be maintained.

276. Unlike the OECD Model, the UN Model includes in Article 6 "income from immovable property used for the performance of independent personal services". [102] This reflects the fact that Article 14 (Independent personal services) has been deleted from the OECD Model but not the UN Model.

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100 See distributive rules, section III.D of the present Manual.

101 As explained in paragraph 25.1 of the Introduction of the OECD Model.

102 Paragraph 4 of the Article.

Paragraph 1

277. Paragraph 1 gives the country where the immovable property is located the first taxing right over income derived by a resident of the other Contracting State from that property. This does not mean that the source country has exclusive rights to tax income from immovable property; the country of residence of the person deriving the income may also tax such income. The source country's right to tax is the prior right, however, and is not subject to any limits under the treaty (other than where the taxation would be in breach of Article 24 (Non-discrimination)). The country of residence must provide double taxation relief.

278. Article 6 does not dictate the method by which such income is to be taxed in the source state. Accordingly, although the Commentary notes that "the object should be taxation of profits rather than of gross income",[103] taxation on a gross basis, or on the basis of estimated or deemed profits, is not precluded. Provision for taxation on a net profits basis is particularly important in the case of income from agriculture and forestry, which activities are likely to incur significant expenses. While such income is specifically included within the scope of Article 6, countries are free to agree in their treaties that income from agricultural or forestry activities is to be dealt with under Article 7 (Business profits),[104] to ensure that the income is taxed on a net (profits) basis.

279. Income derived from immovable property situated in the country of which the recipient is a resident, or in a third state, is not covered by paragraph 1. Such income is dealt with under paragraph 1 of Article 21 (Other income).[105]

Paragraph 2

280. The meaning of the term "immovable property" is defined in paragraph 2 by reference to its meaning under the domestic law of the country in which the property is situated. Typically, this will include land, commercial and residential buildings and things attached to the land such as crops and minerals. In countries where immovable prop-

103 Paragraph 2 of the Commentary on Article 6 of the OECD Model.

104 Paragraph 6 of the Commentary on Article 6 of the UN Model.

105 Ibid.

erty is referred to as "real property" (many common law countries), immovable property may be defined for treaty purposes by reference to the meaning of "real property" in the law of that country.

281. A number of assets and rights are specifically included in the treaty definition of "immovable property". These are items that are widely regarded as immovable property, such as property accessory to immovable property, mining rights or other rights relating to the exploitation of natural resources. Income from such assets and rights is covered by Article 6, even if the assets or rights are not encompassed by the domestic law definition of immovable property in the country in which the property is situated. The reference to rights relating to the exploitation of natural resources is particularly important because the holder of such rights may be a non-resident. For example, a company from one state may acquire a mining license from the other state and may receive substantial royalties from allowing another company (either domestic or foreign) to operate the relevant mine. In that case, these royalties would fall under Article 6 as income from immovable property even if the sublicense does not constitute immovable property under the domestic law of the state which granted the mining license.

282. Some countries specifically include in the definition of "immovable property" rights to the use or enjoyment of immovable property situated in their jurisdiction, where those rights derive from the holding of shares or other corporate rights in the company that owns the property.[106] This covers the holding of apartments in what are typically referred to as housing cooperatives or housing companies.[107]

283. Ships and aircraft are excluded from the treaty definition of "immovable property" in paragraph 2, regardless of whether they are covered by any domestic law definition. Interest from a debt secured by immovable property is not covered by Article 6.[108]

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106 Paragraph 4 of the Commentary on Article 6 of the UN Model.

107 Paragraph 4 of the Commentary on Article 6 of the UN Model.

108 Paragraph 7 of the Commentary on Article 6 of the UN Model. Interest, including interest secured by immovable property, is dealt with under Article 11 of the UN Model.

Paragraph 3

284. Paragraph 3 makes it clear that paragraph 1 applies to income from the direct use of immovable property (such as the income from an owner-occupied house or apartment that some countries tax), rental income or income from any other use of the immovable property, such as income from the granting of rights to others to use the property, e.g. by exploiting their natural resources.

Paragraph 4

285. Paragraph 4 ensures that the provisions of paragraphs 1 and 3 apply to profits derived from the use or exploitation of immovable property of an enterprise and to immovable property used for the performance of independent personal services. Accordingly, the country in which the immovable property is situated may impose tax on the income derived from the use of that property by a resident of the other country irrespective of whether or not that property is effectively connected with a permanent establishment or fixed base situated in the country in which the immovable property is situated.

286. If the treaty does not include Article 14 (Independent personal services), the words "and to income from immovable property used for the performance of independent personal services" should be deleted from paragraph 4 as in done in Article 6 of the OECD Model.

2. Article 7—Business profits

287. Article 7 is a key provision of the treaty because it allocates taxing rights over business profits derived by an enterprise of a Contracting State. Under this Article, profits of an enterprise of one state may not be taxed in the other state unless the enterprise carries on business through a permanent establishment situated in that other state. Where the business is carried on through a permanent establishment in a country, the Article specifies the profits that may be taxed in that country.

288. The term "enterprise of a Contracting State" is defined in Article 3 (General definitions) as an enterprise carried on by a resident of that state. The term "enterprise" itself is not defined in the UN Model[109] and the non-exhaustive definition of "enterprise" found in the OECD

109 Paragraph 6 of the Commentary on Article 3 of the UN Model.

Model[110] is merely intended to clarify that Article 7 applies to the carrying on of professional and other independent activities (which are covered by Article 14 in the UN Model). Paragraph 42 of the Commentary on Article 5 the OECD Model, which was added in 2017, clarifies the meaning of "enterprise of a Contracting State" by indicating that it "refer[s] to any form of enterprise carried on by a resident of a Contracting State, whether this enterprise is legally set up as a company, partnership, sole proprietorship or other legal form".

289. Article 7 of the UN Model broadly follows the version of Article 7 that was found in the 2008 OECD Model ("former OECD Article 7"). The new version of Article 7 that was included in the 2010 OECD Model ("new OECD Article 7") has not been adopted in the UN Model.[111] The new OECD Article 7 takes into account dealings between different parts of an enterprise to a greater extent than is recognized by the UN Model. In practice, treaties of developing countries (and of many developed countries) do not include the new OECD Article 7 and generally follow Article 7 as it appears in the UN Model.

Paragraph 1

290. Paragraph 1 sets out the main rule for taxation of business profits. Exclusive taxing rights over such profits are allocated to the country of residence (that is to say, the country of residence of the person carrying on the enterprise). If the enterprise carries on business in the other treaty partner country through a permanent establishment ("PE country"), however, then that country may also tax certain profits. Paragraph 1 of Article 7 of the UN Model specifies three categories of profits that may be taxed in the PE country, that is to say, profits attributable to:

(a) The permanent establishment;

(b) Sales in the PE country by the enterprise of goods or merchandise that are of the same or a similar kind as those sold through the permanent establishment; or

(c) Other business activities carried on in the PE country that are the same or of a similar kind as those carried on through the permanent establishment.

110 Paragraph 1 (*c*) of Article 3 of the OECD Model.

111 Paragraph 1 of the Commentary on Article 7 of the UN Model.

291. The equivalent paragraph in both the former OECD Article 7 and the new OECD Article 7 provide only for the taxation in the PE country of profits attributable to the permanent establishment. Many developed countries oppose the "limited force of attraction" provisions of the UN Model, that is to say, the extension of taxing rights to profits from sales and other business activities covered by paragraphs 1 (*b*) and (*c*) of Article 7, on the basis that profits from activities that are not part of those carried on through the permanent establishment, and which do not themselves give rise to a permanent establishment, should not be subjected to tax in the PE country. On the other hand, some developing countries consider that, where an enterprise sells goods or services in their country both directly and through a permanent establishment, the same tax treatment should apply, both to discourage abusive arrangements and to simplify administration.[112]

292. In some treaties, taxing rights in the PE country extend to the profits covered by paragraphs 1 (*b*) or (*c*) only in cases of abuse.[113] Also, since these provisions only apply to goods or services provided by the enterprise that has the permanent establishment and not to those provided by associated enterprises, these provisions have a fairly narrow application.

Paragraph 2

293. Paragraph 2, which mirrors paragraph 2 of the former OECD Article 7, determines the meaning of "profits attributable to a permanent establishment". In effect it requires that the profits be determined in both states in accordance with the separate entity and arm's length principles, that is to say, for purposes of the Article, profits attributable to the permanent establishment are the profits that it "would have made if, instead of dealing with the rest of the enterprise, it had been

112 Paragraphs 6 and 7 of the Commentary on Article 7 of the UN Model.

113 An example of relevant wording is as follows: "However, the profits derived from the sales or activities described in subparagraphs (b) and (c) shall not be taxable in the other Contracting State if the enterprise demonstrates that such sales or activities have been carried out for reasons other than obtaining a benefit under this Agreement".

dealing with an entirely separate enterprise under conditions and at prices prevailing in the ordinary market".[114]

294. The separate entity and arm's length principles apply to all dealings of the permanent establishment, whether the dealing is with the head office of the enterprise or another part of the enterprise. These principles will therefore apply to transfers of goods and services between a permanent establishment and its head office and between a permanent establishment and other permanent establishments of the same enterprise. Also, transactions between the enterprise and associated enterprises, which are subject to the arm's length principle under Article 9, may be attributable to a permanent establishment.

295. Paragraph 2 of the new OECD Article 7 also embodies the separate entity and arm's length principles. In addition, it clarifies that the attribution of profits also applies for purposes of Article 23 (Methods for the elimination of double taxation). While this is how most countries would interpret paragraph 2 of Article 7 of the UN Model,[115] the new OECD Article 7 is more specific in this regard.

296. More importantly, paragraph 2 of the new OECD Article 7 also makes specific reference to the method by which profits attributable to the permanent establishment are to be determined, that is to say, by reference to the functions performed, assets used and risks assumed through the permanent establishment and the rest of the enterprise. This wording was added to the OECD Model for the purpose of allowing the application of the so-called "Authorized OECD Approach" (AOA), a comprehensive approach for determining the profits of a permanent establishment that was developed by the OECD between 1998 and 2008.[116] As explained in paragraph 1 of the Commentary on Article 7 of the UN Model, the approach developed by the OECD was expressly rejected for the purposes of the UN Model.

297. The general rule of paragraph 2 concerning the determination of the profits attributable to a permanent establishment leaves much

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114 Paragraph 14 of the Commentary on Article 7 of the UN Model, quoting paragraph 14 of the Commentary on Article 7 of the 2008 OECD Model.

115 Paragraph 8 of the Commentary on Article 7 of the UN Model, quoting paragraph 12 of the Commentary on Article 7 of the 2008 OECD Model.

116 Paragraph 19 of the Commentary on Article 7 of the OECD Model.

room for interpretation. The practical application of the separate entity and arm's length principles underlying that general rule gives rise to a number of difficulties which are addressed in the Commentary on Article 7.[117]

Paragraph 3

298. Paragraph 3 clarifies, in relation to expenses of the permanent establishment, how the profits are to be determined.

299. The first sentence of paragraph 3, like paragraph 3 of the former OECD Article 7, provides that deductions are to be allowed for expenses incurred for the permanent establishment, irrespective of where such expenses are incurred.

300. The Commentary notes that the expenses do not need to be wholly, exclusively and necessarily incurred for purposes of the business carried on through the permanent establishment, but the expenditure must be "relevant, referable and necessary for carrying out the business operations".[118]

301. The Commentary also states that paragraph 3 only determines which expenses should be attributed to the permanent establishment for the purposes of the application of the provisions of the Convention. Whether or not those expenses are deductible for purposes of computing taxable income under domestic law will depend on domestic law; for example, in some countries, entertainment expenses are not allowed as deductions and paragraph 3 does not have the effect of obliging a state to grant a deduction for such expenses. Some countries prefer to clarify this principle explicitly in their treaties.[119]

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117 Paragraph 15 of the Commentary on Article 7 of the UN Model, quoting paragraphs 12–15.4 of the Commentary on Article 7 of the 2005 OECD Model. Some of these difficulties are also addressed in the Commentary on paragraph 3 of Article 7 and in the abundant literature on the issue of the attribution of profits to permanent establishments, including Jinyan Li, "Taxation of non-residents on business profits", *United Nations Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries* (United Nations, Sales publication No. 13.XVI.2).

118 Paragraph 17 of the Commentary on Article 7 of the UN Model.

119 Paragraph 18 of the Commentary on Article 7 of the UN Model, quoting

302. The second and third sentences of paragraph 3 in Article 7 of the UN Model provide that deductions are not allowed in respect of any charge between the permanent establishment and any other part of the enterprise by way of intra-enterprise royalties, commissions, management or other services or interest (except in the case of banks), unless the charge were made as reimbursement to the other part of the enterprise for actual expenses incurred. Thus, for example, where an enterprise owns a patent or copyright, no deduction will be allowed, in calculating the profits attributable to the permanent establishment for purposes of Article 7, in respect of any "royalties" charged by the head office or another part of the enterprise to a permanent establishment of the same enterprise. These sentences in paragraph 3 have no equivalent in the former OECD Article 7, although the UN Model provision largely reflects the interpretation found in the Commentary on paragraph 3 of the former OECD Article 7.[120] The new OECD Article 7, which has no provision equivalent to paragraph 3, does not limit deductions to actual expenses, and requires the recognition and arm's length pricing of all dealings where one part of the enterprise performs functions for the benefit of the permanent establishment.[121]

303. Paragraph 3 of the new OECD Article 7 performs a completely different function. It provides for corresponding adjustments to profits where one state adjusts the profits of the permanent establishment. It is intended to ensure that all double taxation is relieved[122] and operates in a way similar to paragraph 2 of Article 9.

Paragraph 4

304. Paragraph 4 allows countries that customarily determine the profits of a permanent establishment by apportioning the total profits of the enterprise according to a formula (for example, on the basis of

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paragraphs 30 of the Commentary on Article 7 of the 2008 OECD Model.

120 Paragraph 18 of the Commentary on Article 7 of the UN Model, quoting paragraphs 34 – 44 of the Commentary on Article 7 of the 2008 OECD Model.

121 Paragraphs 38 – 40 of the Commentary on Article 7 of the 2010 OECD Model.

122 Paragraphs 44 – 70 of the Commentary on Article 7 of the 2010 OECD Model.

receipts, expenses or capital) to continue to do so provided that the method of apportionment provides for a result that is in accordance with the arm's length principle.

305. The Commentary notes that the paragraph may be deleted where neither state uses such methods.[123] In practice, few countries use formulary apportionment methods to determine the profits of a permanent establishment. Even where such methods are used, it is difficult to ensure that the method produces arm's length results. For these reasons, paragraph 4, which was also found in the former OECD Article 7, was not included in the new OECD Article 7.[124]

Paragraph 5

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

307. This paragraph was omitted from the new OECD Article 7 because such different methods of attribution of profits are not available under that Article.[125]

Paragraph 6

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

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123 Paragraph 19 of the Commentary on Article 7 of the UN Model, quoting paragraphs 52 and 54 of the Commentary on Article 7 of the 2008 OECD Model.

124 Paragraph 41 of the Commentary on Article 7 of the 2010 OECD Model.

125 Paragraph 42 of the Commentary on Article 7 of the 2010 OECD Model.

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

310. The Commentary notes that while the term "profits" is not defined in the treaty, it is open to countries to agree bilaterally upon special explanations or definitions concerning this term, for example, where, under domestic law, the term includes special classes of receipts, such as income from the alienation of a business.[126]

311. Article 7 of the UN Model includes a note indicating that the question of whether profits should be attributed to a permanent establishment by reason of the mere purchase, by that permanent establishment, of goods and merchandise for the enterprise has not been resolved and should be settled in bilateral negotiations. This note reflects the fact that the drafters of the UN Model could not reach agreement on the inclusion of a provision (paragraph 5) that was included in the former OECD Article 7 and according to which no profits should be attributed to the permanent establishment in these circumstances. That paragraph, however, was not included in the new OECD Article 7. Since the paragraph was deleted from the OECD Model because there was broad consensus that is was not consistent with the arm's length principle and was not justified,[127] treaty negotiators from developing countries may prefer to avoid the inclusion of that paragraph in their treaties.

3. Article 8—International shipping and air transport

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

313. The term "international traffic" is defined in paragraph 1 (*d*) of Article 3 (paragraph 1 (*e*) of Article 3 of the OECD Model) to mean es-

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126 Paragraph 21 of the Commentary on Article 7 of the UN Model, quoting paragraphs 59 and 63 of the Commentary on the Article 7 of the 2008 OECD Model.

127 Paragraph 299 of the OECD *Report on the Attribution of Profits to Permanent Establishments,* available at http://www.oecd.org/ctp/transfer-pricing/41031455.pdf.

sentially any transport by a ship or aircraft except where the ship or aircraft is operated by a foreign enterprise within the territory of a state. It therefore covers transport activities conducted by an enterprise of one state between places within the same state, the qualification of such transportation as international traffic being relevant for the purposes of taxation by the other state. It may also cover transportation by an enterprise of a third state, this being relevant for the purposes of paragraph 3 of Article 15 dealing with the taxation of employees working aboard a ship or aircraft operated by such an enterprise.

314. The profits from transportation that does not constitute international traffic and from any form of transportation other than by ship or aircraft (such as rail or road) are not covered by Article 8 and will instead fall under the general rules of Article 7 (Business profits). Accordingly, profits from such transport by an enterprise of one state may only be taxed in the other state if the enterprise has a permanent establishment in that other state and the profits are either attributable to that permanent establishment or, in treaties that include paragraph 1 (*c*) of Article 7, to business activities performed in that other state that are of the same or similar kind as those carried on through the permanent establishment.

315. Some countries, however, prefer to extend the scope of Article 8 to international transport by road and rail. In such a case, the definition of "international traffic" in Article 3, as well as paragraph 1 of Article 8, paragraph 3 of Article 13, paragraph 3 of Article 15 and paragraph 3 of Article 22 should be modified so as to include references to road and rail transport.

316. The UN Model has two versions of Article 8. Alternative A mirrors Article 8 of the OECD Model in allocating exclusive taxing rights over the profits to the state of residence. Alternative B permits limited source taxation over shipping profits. Alternative B, however, is rarely found in practice, even in treaties negotiated by developing countries.[128]

317. Article 8 of both the UN and OECD models was modified extensively in 2017. The changes made were primarily aimed at reflecting the preferred treaty practice of the majority of countries in the following areas:

128 Wim Wijnen and Jan de Goede, "The UN Model in Practice 1997–2013", *Bulletin for International Taxation* No. 3 (2014), section 2.10.

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

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

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

319. The Commentary on Article 8 indicates, however, that some countries prefer to use the previous wording of Article and it includes alternative wording to that effect.[129]

Paragraph 1(alternative A), paragraphs 1 and 2 (alternative B)

320. Paragraph 1 of alternative A, like paragraph 1 of Article 8 of the OECD Model, indicates that the profits from ships or aircraft operated in international traffic by an enterprise of a state shall be taxable only in that state, i.e. the state of the residence of the person doing business through that enterprise.

321. The business of a modern shipping or air transport enterprise involves many different activities that are directly or indirectly related to the operation of ships or aircraft or are ancillary to such operation. The application of Article 8 to the profits from these activities raise a number of issues which are discussed in the Commentary.[130] For in-

129 Paragraphs 10 – 10.1 and 15 to 16 of the Commentary on Article 8 of the UN Model (paragraphs 2 – 3 and 15 to 17 of the Commentary on Article 8 of the OECD Model are to the same effect).

130 Paragraphs 10.2 to 11.1 of the Commentary on Article 8 of the UN Model, quoting paragraphs 4 to 14.1 of the Commentary on Article 8 of the OECD Model.

stance, the application of the article to profits from bareboat charters or from container leasing can be controversial and should be discussed during negotiations. If necessary, the application of the article to such profits should be clarified, as is done in some treaties.

322. Under alternative B, the words "ships or" are deleted from paragraph 1, with the result that this paragraph applies only to profits from the operation of aircraft in international traffic. Paragraph 2 of alternative B provides for source-country taxation of profits from the operation of ships in international traffic if the operations in that country are "more than casual".[131] If the operations are more than casual, an "appropriate allocation of the overall net profits" may be taxed in the source country. The UN Model provides for a reduction in the source tax, but does not specify a percentage. A reduction of 50 or 60 per cent is typically provided for in the very small number of treaties that include this provision.[132]

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

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

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

4. Article 9—Associated enterprises

325. The following excerpt from the *United Nations Practical Manual on Transfer Pricing for Developing Countries* provides the background for Article 9:[133]

131 The meaning of "more than casual" is discussed in paragraph 13 of the Commentary on Article 8 of the UN Model.

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

133 Paragraphs B.1.1.5 and B.1.1.6, United Nations, Department of Economic

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

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

327. Article 9 of the UN and OECD models incorporate the arm's length principle that forms the basis for allocating profits resulting from transactions between associated enterprises. The *United Nations Practical Manual on Transfer Pricing for Developing Countries* and the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*[134] explain in detail the application of Article 9.

Paragraph 1

328. Paragraph 1 of Article 9 applies to associated enterprises of different treaty countries. Enterprises are "associated" if:

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

134 OECD (2017), *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations 2017*, OECD Publishing, Paris, https://doi.org/10.1787/tpg-2017-en.

— The enterprise of one state participates directly or indirectly in the management, control, or capital of the enterprise of the other state, or
— The same persons participate directly or indirectly in the management, control, or capital of both enterprises.

329. In cases of associated enterprises, the tax authorities of one of the treaty states may, for tax purposes, increase the profits of one of the enterprises where, as a result of non-arm's length conditions in the commercial and financial relations between that enterprise and the associated enterprise, the profits of the enterprise do not correspond to the profits that an independent enterprise would have realized.

Paragraph 2

330. Paragraph 2 deals with the consequences of a transfer pricing adjustment made by one state (the initial adjustment). In that case, the other state is required to make a corresponding adjustment in order to avoid economic double taxation. The requirement to make a corresponding adjustment is not automatic, however; it is only required where the initial adjustment reflects the arm's length amount of profits that would have been realized if the conditions between the two enterprises would have been those prevailing between independent enterprises.

331. Some states are concerned that an open-ended obligation to make a corresponding adjustment may create administrative difficulties where an initial adjustment is made many years after the taxation year in which the relevant transactions took place. Negotiators who share that view may wish to consider the inclusion of the alternative provision found in paragraph 10 of the Commentary on Article 9 of the 2017 OECD Model. Under that alternative provision, the period during which a state can make an initial adjustment is limited to a certain number of years (to be negotiated bilaterally) after the taxable year to which the adjusted profits relate. Thus, the alternative provision indirectly limits the period of time during which the other state has an obligation to provide a corresponding adjustment. Negotiators pursuing this alternative formulation should determine the period of time during which an initial adjustment will be possible based on the number of years during which the domestic law of each state allow adjustments to be made to the tax payable for a given taxation year.

Paragraph 3

332. Paragraph 3 (which has no equivalent in the OECD Model) constitutes an exception to the requirement, in paragraph 2, that a corresponding adjustment be provided. No such corresponding adjustment is required where, in the context of judicial, administrative or other legal proceedings, there is a final ruling that one of the associated enterprises is liable to penalty for fraud, gross negligence or willful default with respect to the actions that triggered the initial adjustment of profits.

333. As noted in the Commentary, some countries consider that denying the corresponding adjustment in addition to imposing penalties may be too harsh, although cases when the provision will apply are likely to be exceptional.[135] Treaty practice shows that this paragraph is not widely adopted; it also shows that a few countries include a variation of this provision that excludes the application of paragraph 2 in cases of fraud, willful default or negligence regardless of whether penalties are imposed as a result of legal proceedings.

5. Article 10—Dividends

334. Article 10 deals with distributions of corporate profits in the form of dividends from a company in one country to its shareholders in a treaty partner country. The dividends may be taxed in both the country of residence of the shareholder (residence state) and the country of which the paying company is a resident (source state). Taxation in the source state, however, is limited if the beneficial owner of the dividends is a resident of the other state.

335. The Article is similar to Article 10 of the OECD Model except that while the OECD Model suggests specific limits for the taxation at source of dividends, the UN Model leaves these limits to be determined through bilateral negotiations.

Paragraph 1

336. Paragraph 1 provides that dividends paid from the source state to a resident of the other state may be taxed in that other state, that is to say, in the country of residence of the shareholder. There are no lim-

135 Commentary on paragraph 8 of Article 9 of the UN Model.

its imposed under the treaty on the residence state's taxing rights (although the residence state is required to relieve double taxation where the source state is also permitted under the treaty to tax the income).

Paragraph 2

337. Paragraph 2 provides that the source state may also tax the dividends, but the tax payable to the source state is limited if the dividends are beneficially owned by a resident of the other Contracting State.

338. Two different limits are provided: one for direct investment dividends (that is, where one company holds a substantial interest in the other company) and another for portfolio investment dividends (that is, where a company holds a small interest in the other company, or where the shareholder is an individual). In both cases, the limit is calculated as a percentage of the gross amount of the dividends. This reflects the fact that most countries tax dividends paid to non-residents by means of a withholding mechanism where the company paying the dividend must withhold a tax expressed as a fixed percentage of the amount of the gross dividend payment.

339. The limit for direct investment is generally lower than that applicable to portfolio investment for a number of reasons. In the first place, the risk of multiple layers of taxation is higher for intercorporate dividends (dividends paid by one company to another). This can lead to excessive taxation of corporate profit and/or unrelieved double or multiple taxation. Second, many developing countries seek to encourage direct investment in preference to more mobile portfolio investment.

340. As previously mentioned, the UN Model does not propose specific limits for dividend withholding taxes. Limits of 5 per cent of the gross amount of direct investment dividends and 15 per cent for all other dividends are provided in the OECD Model. In practice, the limits that are found in treaties with developing countries vary primarily for direct investment dividends whereas a 15 per cent limit for portfolio investment dividends is fairly common. It is important for the negotiators to be aware of the limits agreed to in the previous treaties concluded by both countries.

341. Paragraphs 7 to 12 of the Commentary on Article 10 of the UN Model discuss some of the policy and technical factors that should be

considered by negotiators in setting rate limits on dividend withholding taxes. In particular, developing countries should take into account the total tax that will be imposed on corporate profits, including tax at the company level and tax imposed on successive levels of shareholders. While a high rate of dividend withholding tax may serve to discourage the repatriation of profits from local subsidiaries, it is also likely to discourage foreign investors from investing in local companies in the first place. Also, while most treaties provide lower rates of withholding on direct investment dividends to reduce the incidence of recurrent taxation, some countries find it difficult to administer the dual rates under their domestic law and prefer to include in their treaties a single rate applicable to all dividends. This approach can of course affect direct investment particularly if the single rate provided in the treaty is high.

342. Paragraph 2 (*a*), which deals with direct investment dividends, specifies a minimum holding of 10 per cent of capital in the paying company as the threshold for that holding to be regarded as direct investment. The Commentary notes, however, that this level is illustrative only.[136] In the OECD Model, the minimum holding is 25 per cent of capital. In some treaties, the threshold for determining direct investment dividends is expressed as a percentage of the voting stock or voting power, as opposed to capital, in order to reflect the degree of influence the shareholder may have over the company rather than the amount of capital owned.

343. Other issues that may arise in the application of the lower limit applicable to direct investment dividends are addressed in the Commentary on Article 10 of the UN Model.[137] In addition, the Commentary on Article 10 of the OECD Model was amended in 2017 to address the issue of the application of that lower limit where shares are held through an entity or arrangement (such as a partnership in many countries) that is not treated as a taxpayer under domestic law.[138]

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136 Paragraph 6 of the Commentary on Article 10 of the UN Model and paragraph 13 of the Commentary on Article 10 of the UN Model, quoting paragraph 14 of the Commentary on Article 10 of the OECD Model.

137 Paragraph 12 of the Commentary on Article 10 of the UN Model, quoting the Commentary on Article 10 of the 2010 OECD Model.

138 Paragraph 11 and 11.1 of the Commentary on Article 10 of the 2017 OECD Model.

344. A change made in 2017 to paragraph 2 (*a*) of both the UN and OECD models requires that the minimum shareholding be maintained for a period of at least 365 days which includes the day the dividend is paid. This change, which was made as a result of the report on Action 6 of the OECD/G20 BEPS project,[139] was intended to prevent abusive transactions in which the holder of shares that did not meet the required threshold for the lower limit applicable to direct investment dividends would, shortly before the payment of dividends, temporarily transfer his shares to a shareholder that met the threshold. The 365-day minimum holding period does not need to be met before the dividend is paid; it can also be met after that payment. Changes of ownership that result from corporate reorganizations should be disregarded for the purposes of the computation of that minimum holding period.

345. Some countries seek an exemption from source-country taxation in respect of certain categories of dividends, in particular where the dividend recipient is exempt from tax on such income in the recipient's country of residence. The Commentary discusses the cases of dividends paid to pension funds and to a state or state-owned entities (including sovereign wealth funds).[140] On the one hand, a withholding tax imposed by the source state on dividends received by such entities may have the effect of making it more advantageous for these entities to invest in other countries that grant them an exemption similar to the one to which they are entitled in the state in which they are established. On the other hand, the source state may be concerned that granting an exemption to such entities will give then an unfair advantage over other taxpayers deriving similar income and it may also be concerned that if no equivalent exempt entities of a similar size exists under its own law, the exemption would primarily benefit entities of the other state. The application of paragraph 2 in these circumstances could be discussed during the negotiations.

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139 Note 19.

140 Paragraph 13 of the Commentary on Article 10 of the UN Model, quoting paragraphs 13.1 and 13.2 of the Commentary on Article 10 of the OECD Model. The addition of the definition of "recognized pension fund" in the 2017 OECD Model would be relevant to the drafting of an exemption for dividends paid to pension funds.

346. A few (mainly developed) countries may wish to include special rules to deal with the particular case of dividends paid by companies that qualify as real estate investment trusts. The issues that these raise and possible solutions are discussed in the Commentary on Article 10 of the OECD Model.[141]

347. Dividends to which Article 10 applies are mostly paid by companies resident of developing countries since there is substantially more investment in equity capital from developed to developing countries than in the opposite direction. Accordingly, the immediate impact of revenue reductions as a consequence of treaty limits on source taxation will fall on the developing country (although there may be long-term revenue gains as a result of increased capital flows). Developing countries will need to decide what limits they can accept in their treaties bearing in mind that high rates of withholding taxes may deter investment.[142]

348. All developing countries should aim to have a reasonably consistent treaty practice with respect to limits of source taxation applicable to dividends. If, for example, a developing country agrees to a limit in one of its treaties that is significantly lower than the limits found in its other treaties, the negotiators from other countries will typically insist in getting an equivalent lower limit in order to avoid the competitive disadvantage that the higher source taxation of dividends would create for their resident investors. Negotiators of developed countries that are concerned that a developing country may agree, in future treaties, to a lower limit of source taxation of dividends will often seek the inclusion in the treaty of a most favored nation (MFN) provision that will require the developing country, in the event that it agrees on a lower rate with a third country, to provide similar treatment to its existing treaty partner. The pros and cons of such provisions are discussed in paragraphs 119 to 121 above.

349. The limits provided for in paragraph 2 apply only where the beneficial owner of the dividends is a resident of the treaty partner country. If the dividends are paid to a resident of the other country who acts as an agent or nominee for a resident of another country who is the

141 Paragraphs 67.1 – 67.7.

142 See section II.B dealing with the development of a country's tax treaty policy framework and model treaty.

beneficial owner of the dividends, the source country is not obliged to reduce its tax in accordance with the treaty with the state of residence of the direct recipient of the dividend.[143]

350. As explained in the Commentary of the UN Model,[144] the concept of "beneficial owner" was introduced in paragraph 2 to clarify that the words "paid … to a resident" used in paragraph 1 do not require a state to apply the limits of paragraph 2 where the dividends are directly "paid to" a person that merely acts and an agent or nominee for another person who is the real beneficiary of the dividends. The Commentary adds that the same logic applies where a company, being the formal owner of dividends, has, as a practical matter, very narrow powers which render it, in relation to these dividends, a mere fiduciary or administrator acting on account of the other parties.

351. The Commentary on the OECD model was amended in 2014 to provide additional explanations on the meaning of "beneficial owner".[145] As noted in that Commentary, the fact that a person may qualify as the beneficial owner of dividends does not mean that it is automatically entitled to the limits provided for in paragraph 2:[146] under the rules of Article 29 (Entitlement to treaty benefits), the source state is not required to limit its source taxation of dividends in abusive cases, including treaty-shopping arrangements.[147]

352. The treaty does not prescribe how the limit is to be applied. Paragraph 2 authorizes the competent authorities to settle by mutual agree-

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143 In that case, however, the source state should apply the limits provided in its treaty with the state of which the beneficial owner is resident; see paragraph 13 of the Commentary on Article 10, quoting paragraph 12.2 of the Commentary on Article 10 of the 2010 OECD Model. The wording of paragraph 2 of Article 10 of the OECD Model was modified in 2014 to provide expressly for that result: that paragraph indicates that the limits apply to any dividend paid by a company resident of one state that is beneficially owned by a resident of the other state.

144 Paragraph 13 of the Commentary on Article 10, quoting paragraph 12 and 12.1 of the Commentary on Article 10 of the 2010 OECD Model.

145 Paragraphs 12 to 12.6 of the Commentary on Article 10 of the OECD Model.

146 Paragraph 12.5

147 See section IV on the Improper use of treaties.

ment the mode of application of the limitation. Each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment.[148] Most countries collect tax on dividends paid to non-residents through the imposition of a withholding tax which is deducted by the payer of the dividends and remitted to the tax authority of the source state. The source state may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.[149] Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

353. Finally, paragraph 2 clarifies that the limits on source taxation do not affect taxation of the company profits out of which the dividends are paid. The paragraph is concerned only with taxation of the distributions to the shareholder, not with taxation of the underlying company profits.

Paragraph 3

354. Paragraph 3 specifies the meaning of the term "dividends" for purposes of the treaty. The definitions in the UN and OECD models are identical and cover income from all kinds of shares or other rights that participate in profits, as well as income from other corporate rights that are taxed in the same way as dividends in the source state.

355. In some countries, excessive interest payments between related enterprises may be treated under domestic law as dividend distributions under domestic thin capitalization rules. While the Commentary provides guidance on when the payments may be considered to be dividends for purposes of the treaty, it may be desirable to clarify that the provisions of Article 10 (Dividends) have priority over Article 11 (Interest) in these cases. This may be achieved by extending the definition of "interest" in paragraph 3 of Article 11 by adding wording such as: "The

148 Paragraph 13 of the Commentary on Article 10 of the UN Model, quoting paragraph 18 of the Commentary on Article 10 of the OECD Model.

149 Paragraph 26.2 of the Commentary on Article 1 of the OECD Model expresses a strong preference for application of treaty limits at source, rather than subsequent refund.

term 'interest' shall not include any item of income which is considered as a dividend under the provisions of paragraph 3 of Article 10."

Paragraph 4

356. Under paragraph 4, the rules of paragraphs 1 and 2 for the allocation of taxing rights over dividends do not apply where the dividends form part of the profits of a permanent establishment or fixed base situated in the country of which the paying company is a resident (the source state). In that case, the source state is not required to limit its tax on those dividends and may instead tax the income as business profits attributable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business profits) or Article 14 (Independent personal services), as the case may be. The references to a fixed base and to Article 14 should be deleted from treaties that do not include Article 14.

357. Paragraph 4 requires that the holding in respect of which the dividends are paid be "effectively connected" with the permanent establishment or fixed base. Broadly speaking, paragraph 4 applies only where the holding in respect of which the dividends are paid is a business asset of the permanent establishment or fixed base. Paragraph 4 does not operate as a "force of attraction" rule, that is, the paragraph does not apply where, for example, the shareholder has a permanent establishment or fixed base in the source state but the holding is not a business asset of that permanent establishment or fixed base.[150] An example of an effective connection is the case of a company which is engaged in business operations in the source state through a branch and whose branch manager would invest temporary excesses of the cash flow needed for the operation of the branch in shares of publicly-listed companies of the source state. In that case, the shares would be effectively connected to the permanent establishment as they represent a business asset of the branch rather than the head office. As a result, the dividends are taxable in the source state under Article 7 rather than under Article 10.

Paragraph 5

358. In accordance with paragraph 5, a country may generally tax only its own residents, or permanent establishments or fixed bases

150 Paragraph 15 of the Commentary on Article 10.

situated in its jurisdiction, on dividends paid by a company that is a resident of a treaty partner. It may not tax other dividends paid by that non-resident company nor impose an undistributed profits tax on any such profits of the non-resident company. The reference to a fixed base should be deleted from treaties that do not include Article 14 (Independent personal services).

359. The paragraph is intended to prevent the type of extraterritorial taxation that would occur if a country taxed dividends paid by a foreign company on the basis that the dividends are paid out of profits originating from that country or if the country levied a tax on undistributed profits on the profits of that company because these profits originated from that country.

360. The Commentary on paragraph 5 explains that it does not have the effect of preventing that application of rules on the taxation of controlled foreign companies,[151] a result that, since 2017, is confirmed by paragraph 3 of Article 1 of the UN and OECD models.

Branch profit taxes

361. Under their domestic law, some countries impose an additional tax on the profits attributable to the local permanent establishment of a non-resident. This tax is intended to provide broadly equivalent treatment of profits earned though a permanent establishment and through a subsidiary. Since the distribution of the profits of a subsidiary in the form of dividends would attract the payment of a withholding tax, the branch tax is intended to pay a similar role in the case of a permanent establishment. The additional tax may take different forms, including the imposition of a higher rate of tax on the profits of a permanent establishment, a tax on the after-tax profits of the permanent establishment at the same rate as the withholding tax on dividends or a tax on remittances of permanent establishments to their head offices.

362. Neither the UN Model nor the OECD Model deals expressly with the application of such branch profits taxes. Countries that levy such taxes, however, typically wish to provide in their treaties that the

151 Paragraph 16 of the Commentary on Article 10 of the UN Model, quoting paragraphs 37–39 of the Commentary on Article 10 of the OECD Model.

treaty provisions will not prevent the application of these taxes. This issue is discussed in paragraphs 18 to 24 of the Commentary on Article 10 of the UN Model. Paragraph 21 of the Commentary proposes an additional provision that could be added to Article 10 in order to deal with this issue. Although the proposed provision refers to the additional taxation of the profits of the permanent establishment rather than to any distribution or remittance of these profits, it is commonly found in Article 10 since its purpose is to provide broad equivalence with taxation of dividends.

363. If that proposed provision is included in a treaty, the additional tax should be limited to the same percentage as that applicable to direct investment dividends in order to ensure maximum consistency between taxation of profits of subsidiaries and branches.[152]

364. Since a branch profits tax may be inconsistent with the non-discrimination provisions of paragraph 3 of Article 24 (Non-discrimination),[153] some countries include in Article 24 a specific exclusion for branch profits tax. If the proposed provision set out in paragraph 21 of the Commentary on Article 10 is used, such an exclusion is not required because that provision applies "[n]otwithstanding any other provision of this Convention". In any event, the Commentary on Article 24 makes it clear that measures that are expressly authorized by treaty provisions cannot be considered to violate the non-discrimination rules.[154]

6. Article 11—Interest

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

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152 Paragraphs 22 and 23 of the Commentary on Article 10 of the UN Model.

153 Paragraph 3 of Article 24 of the UN Model; see paragraph 632 below.

154 Paragraph 1 of the Commentary on Article 24 of the UN Model, quoting paragraph 4 of the Commentary on Article 24 of the OECD Model.

366. It should be noted that Article 11 of the UN Model does not deal with interest arising in the residence state or in a third state.[155] Such income is dealt with under Article 21 (Other income).

Paragraph 1

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

Paragraph 2

368. Paragraph 2 of the UN Model provides that the source state may also tax interest arising in one state and paid to a resident of the other state but that tax is limited if the interest is beneficially owned by a resident of the other Contracting State.[156] As previously mentioned, the UN Model does not propose a specific limit for the source state tax on interest. A limit of 10 per cent of the gross amount of the interest is provided in the OECD Model. In practice, the limit that is found in treaties with developing countries vary from full exemption to 25 per cent. Most treaties, however, limit the source state tax on interest to 10 or 15 per cent of the gross amount. Some regional models, such as the Association of Southeast Asian Nations (ASEAN) Model, specify 15 per cent.

369. The limit on source taxation under Articles 10, 11, 12 and 12A is often one of the most controversial aspects of a treaty negotiation, especially in treaties between developed and developing countries. It is most important, particularly for developing countries, to achieve a balance between collecting revenue and attracting foreign investment. Interest to which the treaty applies will mostly arise in the developing country, since debt capital is typically provided by the developed to the developing country. Accordingly, the immediate impact of revenue

155 Interest arising in the residence state is, however, dealt with under Article 11 of the OECD Model.

156 By contrast, paragraph 2 of the OECD Model applies to any interest arising in one state and provides that the source tax is limited only if the interest is beneficially owned by a resident of the other Contracting State.

reductions as a consequence of a treaty limit on the source taxation of interest will fall on the developing country (although there may be long-term revenue gains as a result of increased capital flows). Developing countries will need to decide what rate they can accept in their treaties, bearing in mind that high rates of withholding may deter investment or may result in the tax cost being passed on to resident payers through increased interest rates.

370. If, for example, a developing country agrees to a limit in one of its treaties that is significantly lower than the limits found in its other treaties, the negotiators from other countries will typically insist in getting an equivalent lower limit in order to avoid the competitive disadvantage that the higher source taxation of interest would create for their resident creditors. Negotiators of developed countries that are concerned that a developing country may agree, in future treaties, to a lower limit of source taxation of interest will often seek the inclusion in the treaty of a most favored nation (MFN) provision that will require the developing country, in the event that it agrees on a lower rate with a third country, to provide similar treatment to its existing treaty partner. The pros and cons of such provisions are discussed in paragraphs 119 to 121 above.

371. While negotiators should seek to maintain a consistent general limit on the source taxation of interest, they may have greater flexibility with respect to certain categories of interest. Consideration should be given to whether a lower limit, or even an exemption, could be accepted in certain circumstances. Such a lower limit or exemption could apply to specified categories of interest, such as those discussed in paragraphs 12 to 17 of the Commentary on Article 11 of the UN Model.[157]

372. In particular, most countries exempt interest paid by the government from source-country tax, either unilaterally or through treaties, although the scope of that exemption differs.[158] Such exemption takes into account the fact that since creditors would typically require that any withholding tax on such interest be borne by the borrowing state, the revenues derived by the borrowing state from the tax would be offset by the additional interest costs that would have to be borne by that state.

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157 Paragraphs 7.1 to 7.12 of the Commentary on Article 11 of the OECD Model also discuss these and other exemptions and suggest wording that could be used by countries wishing to include them in a treaty.

158 Paragraphs 15 and 16 of the Commentary on Article 11 of the UN Model.

373. A reduction or elimination of the source-country tax on interest derived by financial institutions may also be beneficial to developing countries (which are typically net recipients of foreign debt capital) in some circumstances. On the hand, given the cost of funds to financial institutions, and the narrow margins of profit obtained on funds lent by those institutions, even a low withholding tax on the gross amount of the interest will frequently absorb (or even exceed) the whole amount of the profit on the lending activities. As explained in the example below, this is likely to deter lending by the financial institutions to residents of the other country or will result in a higher rate of interest being charged on the debt-claim or in a requirement by the financial institution that any withholding tax on the interest be borne by the borrower. This, of course, increases the cost of borrowing to residents of the developing country. Similar considerations apply to sales on credit.

Example

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

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

	state X	**state Z**
Interest derived by Z Bank	800	800
Deductible expenses	0	700
Taxable income	800	100
Tax	80	5
Tax credit	-	25 (max)
Total tax	80	0

The result is that, although the net interest (before tax) derived by Z Bank is 100, the tax paid by Z Bank is 80, an effective tax rate of 80 per cent. To avoid such excessive taxation and to make a reasonable profit from the transaction, Z Bank is likely to require X Ltd. to bear the cost of the state X tax, either directly, or by increasing the interest rate payable on the loan.

374. On the other hand, the state of source may be concerned that granting an exemption or reduction of source taxation for interest paid to financial institutions may result in back-to-back arrangements through which a loan that would otherwise be made directly by a different creditor, such as a related company, is made indirectly through a financial institution in order to take advantage of that reduction or elimination of tax. That state may also consider that the possibility of borrowing from local financial institutions will make it unlikely that a foreign creditor will be able to pass on the full costs of the withholding tax to local borrowers.

375. The limit on source taxation of interest provided in paragraph 2 applies only where the beneficial owner of the interest is a resident of the treaty partner. If that is not the case, the source country is not obliged to reduce its tax and may apply the tax rates provided under its domestic law. Thus, for example, if interest arising in state A is paid to a resident of state B who receives it as agent or nominee for a resident of state C, then state A is not obliged to limit its source taxation under the treaty between state A and state B.

376. On the other hand, if the resident of state B receives the interest as agent for another resident of state B and the latter person is the beneficial owner of the interest, then the limit provided by paragraph 2 of the treaty between state A and state B applies since the beneficial owner is a resident of state B. Where the immediate recipient of the interest (acting as agent or nominee) is a resident of a third state, the Commentary of the UN Model states that the limit provided in the treaty between the source state and the treaty partner remains available if the beneficial owner of the interest is a resident of the treaty partner.[159]

377. The explanations of the concept of "beneficial owner" provided above[160] with respect to the use of these words in the context of Article 10 are equally applicable in the context of Article 11.

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159 Paragraph 18 of the Commentary on Article 11 of the UN Model, quoting paragraph 11 of the Commentary on Article 11 of the 2010 OECD Model. The wording of paragraph 2 of Article 11 of the OECD Model was modified in 2014 to provide expressly for that result: that paragraph indicates that the limit applies to any interest arising in one state and beneficially owned by a resident of the other state.

160 Paragraphs 349 to 351.

378. The treaty does not prescribe how the limit provided for in paragraph 2 is to be applied. The second sentence in paragraph 2 authorizes the competent authorities to settle by mutual agreement the mode of application of the limitation. Each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment.[161] Most countries collect tax on interest paid to non-residents through the imposition of a withholding tax which is deducted by the payer of the interest and remitted by that payer to the tax authority of the source state. Since withholding tax is generally imposed on the gross amount of the interest, the introduction of a limit expressed as a percentage of the gross amount of the interest does not present particular difficulties. The source state may either limit the tax withheld to the treaty rate or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.[162] Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

Paragraph 3

379. Paragraph 3 specifies the meaning of the term "interest" for purposes of the treaty. The definition covers income from debt claims of every kind, including government securities, bonds and debentures.[163] The definition found in the UN and OECD models is exhaustive, so countries that, under their domestic law, tax as interest items of income not listed in the definition law — for example, amounts payable on certain non-traditional financial arrangements — may wish to define "interest" for treaty purposes by reference to its meaning under domestic law. This may be achieved, for example, by including in the definition a reference to any other amount assimilated to (or subjected to the same tax treatment as) income from money lent under the domestic law of

161 Paragraph 18 of the Commentary on Article 11 of the UN Model, quoting, in particular, paragraph 12 of the Commentary on Article 11 of the OECD Model.

162 Paragraph 109 of the Commentary on Article 1 of the OECD Model expresses a strong preference for application of treaty limits at source, rather than through subsequent refunds.

163 Paragraph 19 of the Commentary on Article 11 of the UN Model.

the country in which the income arises.[164] Countries may also wish to include in the definition income from certain Islamic financial instruments where the substance, but not the form, of the arrangement is effectively that of a loan.[165]

380. Although the UN and OECD models exclude penalty charges for late payment from the definition of "interest", some countries prefer to include them, particularly when the charge takes the form of a higher interest rate payable on the remainder of the loan. Negotiators should be prepared to discuss the forms of penalty charges for late payment imposed in their country, and have a view on the extent, if any, to which they should be included within the scope of Article 11.

381. In some countries, excessive interest payments between related enterprises may be treated under domestic law as dividend distributions. Where this is the case, it is desirable to ensure that the provisions of Article 10 (Dividends), and not Article 11 (Interest), apply to the recharacterized income.[166]

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164 Draft wording could be along the following lines: "3. The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures, *as well as all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises*. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."

165 Paragraph 19.3 of the Commentary on Article 11 of the UN Model.

166 This could be done by ensuring that the definition of "dividends" in Article 10 is amended to cover such income and by amending paragraph 3 of Article 11 to ensure the priority of the definition of dividends, which could be done by using wording along the following lines: "3. The term "interest" as used in this Article means income from debt claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures, as well as all other income that is treated as income from money lent by the taxation law of the Contracting State in which the income arises. *The*

Paragraph 4

382. Under paragraph 4, the rules of paragraphs 1 and 2 for the allocation of taxing rights over interest do not apply where the interest is paid on a debt claim that is effectively connected with a permanent establishment or fixed base situated in the country of which the debtor is a resident (the source state). In that case, the source state is not required to limit its tax on the interest and may instead tax the interest as business profits attributable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business profits) or Article 14 (Independent personal services), as the case may be. The references to a fixed base and to Article 14 should be deleted from treaties that do not include Article 14.

383. Paragraph 4 of the UN Model also applies where the debt-claim is not effectively connected to the permanent establishment that the beneficial owner has in the source state but is effectively connected with other business activities carried on in the source state that are of the same or similar kind as the activities of the permanent establishment and which are covered by paragraph 1 (*c*) of Article 7. If the treaty does not include paragraph 1 (*c*) in Article 7, negotiators should delete this reference in paragraph 4 of Article 11.

384. Paragraph 4 requires that the debt claim in respect of which the interest is paid be "effectively connected" with, as the case may be, the permanent establishment, the fixed base or the business activities referred to in paragraph 1 (*c*) of Article 7. Broadly speaking, the paragraph only applies where the loan or other debt claim is related to the activities of a local permanent establishment or fixed base or, in those treaties where paragraph 4 also applies to business activities referred to in paragraph 1 (*c*) of Article 7 (1), to these business activities. The following example illustrates the application of paragraph 4.

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term "interest" shall not include any item of income which is considered as a dividend under the provisions of paragraph 3 of Article 10. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."

Example

Bank A, a resident of state A, has a permanent establishment (branch) in state B. That branch makes loans to customers in state B and state C; these loans are funded and managed by the branch.

The head office of Bank A is also actively involved in the trading, on a stock exchange established in State A, of corporate bonds issued by companies that are residents of State B.

In this situation, the loans made by the branch to residents of state B and state C would be regarded as debt claims which are effectively connected with the permanent establishment. The provisions of paragraph 4 of Article 11 will apply to the interest paid on those loans, with the result that the interest may be taxed in state B in accordance with Article 7.

On the other hand, interest received on corporate bonds issued by companies resident of State B that Bank A may receive as part of its trading activities will not be covered by paragraph 4 since the bonds will not be debt claims "effectively connected" with the permanent establishment or with business activities carried on in State B that are of the same or similar kind as those effected through the permanent establishment as referred to in paragraph 1 (*c*) of Article 7. State B will be allowed to tax such interest in accordance with paragraph 2 of Article 11.

Paragraph 5

385. Paragraph 5 provides the source rule for determining, for treaty purposes, whether interest arises in a state and may therefore be taxed by that state under Article 11. The paragraph applies regardless of the domestic source rules of each Contracting State and provides that interest income is deemed to arise in the country of which the payer is a resident. As an exception, however, where the interest is, in effect, an expense of a permanent establishment or fixed base, that interest is deemed to arise in the country where the permanent establishment or fixed base[167] is located. This approach will generally ensure that, if interest derived by a resident of one state is a deductible expense of the

167 If Article 14 (Independent personal services) is not included in the treaty, the references to "fixed base" should be deleted.

payer in the other state, the interest is sourced in that other state and that state is allowed to tax it under Article 11.[168]

386. Some difficulties can arise in determining whether a sufficient economic connection exists between the interest and a permanent establishment or fixed base for the application of the exception to the general rule. These difficulties frequently occur, for example, where a loan is contracted by one part of an enterprise (for example, the head office) for funds that are used by one or more permanent establishments. The guidance on these issues found in the Commentaries should be followed in these cases.[169]

387. Finally, if the treaty provides for taxation only in the residence state for all categories of interest, it is not necessary to include paragraph 5 since the source of the interest will not be relevant where all taxing rights are allocated exclusively to the residence state. Paragraph 5, however, will remain relevant, and should not be deleted, if only some categories of interest are exempted from source taxation.

Paragraph 6

388. Paragraph 6 deals with a particular form of tax avoidance where a non-resident seeks to reduce source state taxes by inflating deductible interest payments from related parties. Where interest exceeding an arm's length amount is paid as a result of a special relationship between the borrower and the lender (or between both of them and a third party), paragraph 6 provides that the treaty limit on source taxation applies only to the arm's length amount, that is, the interest that would have been payable if an arm's length interest rate had applied to the loan.

389. "Special relationship" commonly refers to the relationship between associated enterprises such as that described in Article 9 (Asso-

168 While paragraph 21 of the Commentary on Article 11 of the UN Model indicates that countries might prefer a rule that would identify the source of interest as the state in which the loan giving rise to the interest was used, such alternative is rarely, if ever, used in treaties.

169 Paragraph 21 of the Commentary on Article 11 of the UN Model, quoting, in particular, paragraph 27 of the Commentary on Article 11 of the OECD Model.

ciated enterprises). It may, however, also refer to a relationship between individuals, such as individuals related by marriage or family ties, or between individuals and companies, such as the relationship between a company and its majority shareholder.

390. While paragraph 6 applies where the interest rate is excessive, it does not allow the source state to disregard an excessive loan or part thereof. The Commentary discuss amendments to paragraph 6 that could be made to allow reclassification of a part of a loan as an equity contribution.[170] Depending on the circumstances, such a case might also be dealt with through the general anti-abuse rule of paragraph 9 of Article 29 (Entitlement to benefits). As explained in the report on Action 4 of the OECD/G20 BEPS project,[171] however, issues related to excessive payments of interest may be more appropriately dealt with through domestic rules that would restrict the amount that may be deducted as interest.

7. Article 12—Royalties

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

392. There is a fundamental difference between the UN and OECD versions of Article 12: while the UN Model allows source taxation of royalties, the OECD Model provides for their exclusive taxation in the residence state. Treaties of developing countries almost invariably provide for source taxation, and a significant number of the member countries of the OECD also seek source taxing rights on royalties.[172] To prevent excessive taxation and to achieve a sharing of revenue from such income between the two countries, however, the UN Model limits source taxation to a percentage of the gross amount of the royalties.

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170 Paragraph 22 of the Commentary on Article 11 of the UN Model, quoting paragraph 35 of the Commentary on Article 11 of the OECD Model.

171 OECD (2015), *Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action 4—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241176-en.

172 See the reservations of OECD member countries in paragraphs 32–37 of the Commentary on Article 12 of the OECD Model.

393. Article 12 of both the UN and OECD models does not deal with royalties arising in the residence state or in a third state. Such income is dealt with under Article 21 (Other income).

Paragraph 1

394. Paragraph 1 of the UN Model provides that royalties arising in one state and paid to a resident of the other state may be taxed in the residence state. By contrast, paragraph 1 of Article 12 of the OECD Model provides that the residence state shall have an exclusive right to tax royalties arising in one state and "beneficially owned" by a resident of the other state.[173]

395. There are no limits imposed under the treaty on the taxing rights of the residence state (although the residence state is required to relieve double taxation where the source state is also permitted under the treaty to tax the income).

Paragraph 2

396. Paragraph 2 of the UN Model provides that the source state may also tax royalties arising in one state and paid to a resident of the other state but that tax is limited if the royalties are beneficially owned by a resident of the other Contracting State.

397. The UN Model does not specify the limit on the source tax applicable on royalties that are beneficially owned by residents of the other country, leaving this for negotiation between treaty partners. In practice, limits in developing-country treaties typically range between 5 and 15 per cent.

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

173 In the UN Model, the "beneficial owner" requirement is included in paragraph 2 of Article 12.

they can accept in their treaties, bearing in mind that high rates of withholding may deter the flow of technology or may result in the tax cost being passed on to resident payers through increased royalty charges.

399. When negotiating the limit in their treaties, countries are advised to take into account the considerations set out in paragraphs 4 to 11 of the Commentary on Article 12 of the UN Model. In designing its treaty model and in its treaty negotiations, a country should aim to have a reasonably consistent treaty practice with respect to the limit of tax on royalties. If, for example, a developing country agrees to a limit in one of its treaties that is significantly lower than the limits found in its other treaties, the negotiators from other countries will typically insist in getting an equivalent lower limit in order to avoid the competitive disadvantage that the higher source taxation of royalties would create for their residents. Negotiators of developed countries that are concerned that a developing country may agree, in future treaties, to a lower limit of source taxation of royalties will often seek the inclusion in the treaty of a most favoured nation (MFN) provision that will require the developing country, in the event that it agrees on a lower rate with a third country, to provide similar treatment to its existing treaty partner. The pros and cons of such provisions are discussed in paragraphs 119 to 121 above.

400. While negotiators should seek to maintain a consistent general limit on the source taxation of royalties, they may have greater flexibility with respect to certain categories of royalties. Consideration should be given to whether a lower limit could be agreed upon or accepted in certain circumstances. Such a lower limit, or even an exemption, could apply to specified categories of royalties. The Commentary discuss the pros and cons of such reduced limits or exemptions for film rentals and copyright royalties.[174] When considering a reduction or exemption for royalties for the use or right to use literary, artistic or scientific work, treaty negotiators should first review the scope of their domestic copyright law since computer software is treated as literary work under the copyright law of many countries.

401. The limit on source taxation of royalties provided in paragraph 2 applies only where the beneficial owner of the royalties is a resident

174 Paragraphs 10 and 11 of the Commentary on Article 12 of the UN Model.

of the treaty partner. If that is not the case, the source country is not obliged to reduce its tax and may apply the tax rates provided under its domestic law.[175] Thus, for example, if royalties arising in state A are paid to a resident of state B who receives them as agent or nominee for a resident of state C, then state A is not obliged to limit its source taxation under the treaty between state A and state B.

402. On the other hand, if the resident of state B receives the royalties as agent for another resident of state B and the latter person is the beneficial owner of the royalties, then the limit provided by paragraph 2 of the treaty between state A and state B applies since the beneficial owner is a resident of state B. Where the immediate recipient of the royalties (acting as agent or nominee) is a resident of a third state, the Commentary of the UN Model states that the restriction on source taxation provided in the treaty between the source state and the treaty partner remains available if the beneficial owner of the royalties is a resident of the treaty partner.[176]

403. The explanations of the concept of "beneficial owner" provided above[177] with respect to the use of these words in the context of Article 10 are equally applicable in the context of Article 12.

404. The treaty does not prescribe how the rate limit is to be applied. The second sentence in paragraph 2 authorizes the competent authorities to settle by mutual agreement the mode of application of the limitation. As with source tax limits imposed under Articles 10 and 11, each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment. The source state may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.[178] Most countries, before grant-

175 Paragraph 5 of the Commentary on Article 12 of the UN Model, quoting paragraphs 4 – 4.2 of the Commentary on Article 12 of the 2010 OECD Model.

176 Paragraph 5 of the Commentary on Article 12 of the UN Model, quoting paragraph 4.2 of the Commentary on Article 12 of the 2010 OECD Model.

177 Paragraphs 349 to 351.

178 Paragraph 109 of the Commentary on Article 1 of the OECD Model expresses a strong preference for application of treaty limits at source, rather than subsequent refund.

ing treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

Paragraph 3

405. Paragraph 3 of the UN Model and paragraph 2 of the OECD Model include the definition of the term "royalties" for purposes of the treaty. Both definitions cover payments for the use of, or the right to use copyright of literary, artistic or scientific work (including copyright in cinematograph films), patents, trademarks, designs, models, plans, secret formulae or processes as well as payments for information concerning industrial, commercial or scientific experience ("know-how"). An important difference, however, is that the definition found in the UN Model also covers payments for equipment rentals, i.e. payments for the use, or the right to use, industrial, commercial or scientific equipment. In addition, the definition found in the UN Model adds the example of films or tapes used for radio or television broadcasting in the category of literary, artistic or scientific work referred to in the definition.

406. While the inclusion of payments for equipment rentals, including container leasing, are quite widely accepted in treaties with developing countries (and even in treaties between OECD member countries),[179] some countries feel strongly that only a very low rate of withholding should apply. Leasing income will have costs associated with it, and even a low withholding tax rate imposed on the gross amount of the income may well result in excessive taxation which would discourage cross-border equipment leasing or may be passed on to resident lessees. A few treaties provide for a limit of about half of the general rate for royalties.

407. The Commentary was modified in 2017 to address various interpretation issues related to the phrase "payments for the use, or the right to use, industrial, commercial or scientific equipment."[180] Other aspects of the definition of "royalties" may also give rise to difficul-

179 Wim Wijnen and Jan de Goede, "The UN Model in Practice 1997–2013", *Bulletin for International Taxation*, No. 3 (2014), sections 2.13.2.1 and 2.13.3.1.

180 Paragraphs 13 to 13.4 of the Commentary on Article 12 of the Un Model.

ties, particularly with respect to payments for computer software or for know-how. These issues are discussed in the Commentary.[181] These matters should also be discussed during negotiations and, if necessary, clarifications should be included in the treaty or agreed upon through the mutual agreement procedure.

Paragraph 4

408. Under paragraph 4, which corresponds to paragraph 3 of Article 12 of the OECD Model, the rules of paragraphs 1 and 2 for the allocation of taxing rights over royalties do not apply where the royalties are paid in respect of a right or property that is effectively connected with a permanent establishment or fixed base situated in the country of which the payer of the royalties is a resident (the source state). In that case, the source state is not required to limit its tax on those royalties and may instead tax the royalties as business profits attributable to the permanent establishment or fixed base in accordance with the provisions of Article 7 (Business profits) or Article 14 (Independent personal services), as the case may be. The references to a fixed base and to Article 14 should be deleted from treaties that do not include Article 14.

409. Paragraph 4 also applies where the right or property is not effectively connected to the permanent establishment that the beneficial owner has in the source state but is effectively connected with other business activities carried on in the source state that are of the same or similar kind as the activities of the permanent establishment and which are covered by paragraph 1 (*c*) of Article 7.[182] If the treaty does not include paragraph 1 (*c*) in Article 7, negotiators should delete this reference in paragraph 4 of Article 12.

410. Paragraph 4 requires that the right or property in respect of which the royalties are paid be "effectively connected" with, as the case may be, the permanent establishment, the fixed base or the business activities referred to in paragraph 1 (*c*) of Article 7. The meaning of

181 Paragraph 12 of the Commentary on Article 12 of the UN Model, quoting paragraphs 8 to 19 of the Commentary on Article 12 of the OECD Model, and paragraphs 14–16 of the Commentary on Article 12 of the UN Model.

182 This part of paragraph 4 of the UN Model has no equivalent in paragraph 3 of the OECD Model.

the term "effectively connected" with a permanent establishment or fixed base is not discussed in the Commentary on Article 12 of the UN Model.[183] The same principles described in relation to paragraph 4 of Article 10 and paragraph 4 of Article 11 will apply. Broadly speaking, the paragraph only applies where the right or property is related to the activities of a local permanent establishment or fixed base or, in those treaties where paragraph 4 also applies to business activities referred to in paragraph 1 (*c*) of Article 7 (1), to these business activities.

Paragraph 5

411. Paragraph 5 provides the source rule for determining, for treaty purposes, whether royalties arise in a state and may therefore be taxed by that state under Article 12. The paragraph applies regardless of the domestic source rules of each state and provides that royalties are deemed to arise in the state of which the payer is a resident. As an exception, however, where the royalties are, in effect, an expense of a permanent establishment or fixed base, these royalties are deemed to arise in the country where the permanent establishment or fixed base[184] is located. This approach will generally ensure that, if royalties derived by a resident of one state is a deductible expense of the payer in the other state, the royalties are sourced in that other state and that state is allowed to tax them under Article 12.[185]

412. Article 12 of the OECD Model does not include a provision equivalent to paragraph 5. In treaties that follow Article 12 of the OECD Model, most countries do not consider it necessary to include paragraph 5 since the source of the royalties will not be relevant where all taxing rights are allocated exclusively to the residence state.

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183 The explanations provided in paragraphs 21.1 and 21.2 of the Commentary on Article 12 of the OECD Model may be partly relevant even though they reflect an analysis that originated from the work on the Authorized OECD Approach for applying Article 7 of the OECD Model (see paragraphs 295 to 296 above).

184 If Article 14 (Independent personal services) is not included in the treaty, the references to "fixed base" should be deleted.

185 While paragraph 21 of the Commentary on Article 11 of the UN Model indicates that countries might prefer a rule that would identify the source of interest as the state in which the loan giving rise to the interest was used, such alternative is rarely, if ever, used in treaties.

Paragraph 6

413. Paragraph 6 deals with a particular form of tax avoidance where a non-resident seeks to reduce source state taxes by inflating deductible royalty payments from related parties. Where royalties exceeding an arm's length amount are paid as a result of a special relationship between the payer and the recipient (or between both of them and a third party), paragraph 6 provides that the treaty limit on source taxation applies only to the arm's length amount, that is, the royalties that would have been payable if an arm's length rate of royalties had been agreed to.

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

415. Depending on the circumstances, tax avoidance arrangements involving the payments of excessive royalties might also be dealt with through the general anti-abuse rule of paragraph 9 of Article 29 (Entitlement to benefits). Issues related to excessive payments of royalties would, however, more typically be addressed through domestic transfer pricing rules.[186]

8. Article 12A—Fees for technical services

416. Article 12A on fees for technical services was added to the UN Model in 2017. Under this new Article, which is based on Article 12 (Royalties) and has no equivalent in the OECD Model, a state is entitled to tax fees for technical services arising in that state and paid to a resident of the other state. If the recipient of such fees is the beneficial owner of the fees, the tax is subject to a limit, expressed as a percentage of the gross amount of the fees, to be agreed to through bilateral negotiations.

417. For a country to be able to tax fees for technical services under Article 12A, it is not necessary for the technical services to be per-

186 See the section "Intangibles" of OECD (2015), Aligning Transfer Pricing Outcomes with Value Creation, Actions 8–10—2015 Final Reports, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241244-en.

formed in that country or for the non-resident service provider to have a permanent establishment or fixed base in that country. Article 12A therefore constitutes a significant change to the treaty rules concerning the taxation of services.

418. While it corresponds to a rule that is found in the domestic law of many developing countries, some developed countries oppose its inclusion in treaties for various reasons, including the fact that it results in a different tax treatment, on the one hand, of services performed abroad and acquired by resident taxpayers and, on the other hand, of goods manufactured abroad and acquired by resident taxpayers. The inclusion of Article 12A in a treaty between a developing and a developed country may therefore be a very controversial issue during the negotiation of that treaty. The Commentary provides the pros and cons of the inclusion of Article 12A in a treaty and discusses different arguments that may be raised during such negotiation.[187]

419. The Commentary also refers to an alternative version of the article that is found in a number of bilateral tax treaties between developing and developed countries. Under that alternative version, the scope of the article is limited to "fees for included services", which correspond essentially to fees for technical services that are closely connected to the transfer of property that produces royalties subject to Article 12.[188] The Commentary indicates, however, that when Article 12A was added to the UN Model, a majority of the members of the UN Committee of Experts objected to that alternative primarily because they saw "no principled justification for restricting the taxation of fees for technical services to services directly related to property producing royalties".[189]

420. The Commentary also includes, however, a more detailed discussion of another alternative version of the Article which had more support within the members of the UN Committee. That alternative may be of interest for countries that are concerned with the wide scope

187 Paragraphs 2 to 23 of the Commentary on Article 12A of the UN Model.

188 Paragraph 24 of the Commentary on Article 12A of the UN Model. See, for instance, Article 12 of the treaty between India and the United states signed on 12 September 1989 as well as the Memorandum of Understanding concluded at that time.

189 Paragraph 25 of the Commentary on Article 12A of the UN Model.

of Article 12A and the uncertainty of the concept of "fees for technical services".[190] Under that alternative version, Article 12A would apply to all fees for services (technical or not) but only to the extent that these services are either performed in the source state or are services performed outside that state by persons related to the payer.

421. Negotiators from developing countries considering the inclusion of Article 12A (or one of its alternatives) should take the following factors into account:

— For the article to have effect, the domestic law of the source state must allow the taxation of income from technical services derived by non-resident service providers.

— An efficient withholding system should be adopted to ensure that the tax imposed on non-resident service providers can be collected effectively.

— Some developed countries may be reluctant to agree to the inclusion of the new article without significant concessions on other issues.

— The applicable rate of tax on the relevant services should not be too high so as to discourage cross-border services or resulting in the fees for these services being systematically grossed-up to include the amount of the tax.

Paragraph 1

422. Paragraph 1, like paragraph 1 of Article 12 of the UN Model, provides that fees for technical services arising in one state and paid to a resident of the other state may be taxed in the residence state. There are no limits imposed under the treaty on the taxing rights of the residence state (although the residence state is required to relieve double taxation where the source state is also permitted to tax the income).

Paragraph 2

423. Paragraph 2 provides that the source state may also tax fees for technical services arising in one state and paid to a resident of the other state but, if the fees are beneficially owned by a resident of the

190 Paragraphs 26 to 31 of the Commentary on Article 12A of the UN Model.

other state, the tax is limited to a percentage of the gross amount of the fees. If the source country imposes a tax in accordance with paragraph 2, the residence country is required by Article 23 to eliminate any double taxation.[191]

424. The UN Model does not specify the limit on the source tax applicable on fees for technical services, leaving this for negotiation between treaty partners. The negotiators should take account of the factors listed in the Commentary[192] in determining this limit.

425. Paragraph 2 applies "notwithstanding Article 14." Thus, although payments for technical services to a service provider who is a resident of one state are not taxable under Article 14 if the service provider does not have a fixed base in the source country or is not present in the source country for 183 days or more, such payments are subject to tax under the new article. A similar result applies with respect to Article 7.[193] Therefore, even if a non-resident service provider does not have a permanent establishment in the source country, any fees for technical services paid to the service provider by a resident of the source country or by a non-resident carrying on business through a permanent establishment in the source country are subject to tax by the source country under paragraph 2.[194]

426. Paragraph 2 is, however, subject to Articles 8, 16 and 17. Therefore, if any of those provisions applies to payments for technical services, it would take priority over the provisions of paragraph 2. However, any fees for technical services outside the scope of those provisions (for example, fees for entertainment activities performed outside the source country) would potentially be taxable under paragraph 2.[195]

427. The limit on source taxation of fees for technical services provided in paragraph 2 applies only where the beneficial owner of the fees is a resident of the treaty partner. If that is not the case, the source country is not obliged to reduce its tax and may apply the tax rates

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191 The obligation to eliminate double taxation applies even where the services are performed in the residence country.

192 Paragraph 45 of the Commentary on Article 12A of the UN Model.

193 This priority results from the provisions of paragraph 6 of Article 7.

194 Paragraphs 47 and 48 of the Commentary on Article 12A of the UN Model.

195 Paragraphs 49 to 51 of the Commentary on Article 12A of the UN Model.

provided under its domestic law. Thus, for example, if fees for technical services arising in state A are paid to a resident of state B who receives them as agent or nominee for a resident of state C, then state A is not obliged to limit its source taxation under the treaty between state A and state B.

428. On the other hand, if the resident of state B receives the fees as agent for another resident of state B and the latter person is the beneficial owner of the fees, then the limit provided by paragraph 2 of the treaty between state A and state B applies since the beneficial owner is a resident of state B. Where the immediate recipient of the fees (acting as agent or nominee) is a resident of a third state, the Commentary of the UN Model states that the restriction on source taxation provided in the treaty between the source state and the treaty partner remains available if the beneficial owner of the fees is a resident of the treaty partner.[196]

429. The Commentary[197] provides detailed explanations of the concept of "beneficial owner" in the context of Article 12A which mirror the explanations of that concept found in the OECD Commentaries on Articles 10, 11 and 12 since 2014.[198]

430. Paragraph 2 does not prescribe how the limit is to be applied. As with source tax limits imposed under Articles 10, 11 and 12, each country is free to apply the procedures applicable under its domestic law, for example, taxation by withholding or by assessment. The source state may either limit the tax withheld to the treaty rate, or it can impose tax at the domestic law rate and subsequently refund the portion that exceeds the treaty rate.[199] Most countries, before granting treaty benefits, require non-resident recipients to produce a certificate of residence from the tax administration or competent authority of their country of residence.

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196 Paragraphs 59 of the Commentary on Article 12A of the UN Model.

197 Paragraphs 52 to 58 of the Commentary on Article 12A of the UN Model.

198 See paragraph 349 above and paragraphs 12 to12.7 of the Commentary on Article 10 of the OECD Model.

199 Paragraph 109 of the Commentary on Article 1 of the OECD Model expresses a strong preference for application of treaty limits at source, rather than subsequent refund.

Paragraph 3

431. Paragraph 3 defines the term "fees for technical services" to mean payments in consideration for managerial, technical or consultancy services. The terms "managerial," "technical" and "consultancy" are not defined and the Commentary explains[200] that they are intended to have their ordinary meaning. The Commentary also indicates[201] that the definition is intended to preclude any reference to the domestic law meaning of "fees for technical services" or the domestic law meaning of any of the terms used in the definition in paragraph 3.

432. The Commentary explains that the definition of fees for technical services is intended to apply only to services that involve the application of specialized knowledge, skills and expertise and not to routine services.[202] It also provides separate explanations for each of the terms "managerial",[203] "technical"[204] and "consultancy"[205] but adds that these terms may overlap (for example, services may be both of a technical and consultancy nature).

433. The definition of "fees for technical services" in paragraph 3 provides three specific exclusions:

— Payments to an employee by an employer;
— Payments for teaching in or by an educational institution; and
— Payments for services for the personal use of an individual.

434. The exclusion of payments to employees means that employment income is covered exclusively by Article 15 of the United Nations Model Convention. Thus, payments to a non-resident employee by an employer for employment services performed outside the country in which the employer is resident or carrying on business through a permanent establishment or fixed base are not taxable by that country even if the services are of a managerial, technical or consultancy nature.[206]

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200 Paragraphs 62 of the Commentary on Article 12A of the UN Model.
201 Paragraphs 68 of the Commentary on Article 12A of the UN Model.
202 Paragraphs 62 of the Commentary on Article 12A of the UN Model.
203 Paragraphs 63 of the Commentary on Article 12A of the UN Model.
204 Paragraphs 64 and 65 of the Commentary on Article 12A of the UN Model.
205 Paragraphs 66 of the Commentary on Article 12A of the UN Model.
206 Paragraphs 69 of the Commentary on Article 12A of the UN Model.

435. The exclusion of payments for teaching in or by an educational institution covers payments that an educational institution of one state would make for teaching services provided by an individual or an enterprise resident of the other state if these services would otherwise be considered to be fees for technical services. It also covers payments that an educational institution of one state receives from an enterprise resident of the other state, for example for teaching services provided by that institution to some of the enterprise's employees. As the Commentary recognizes,[207] this exclusion for teaching services is somewhat controversial and may be open to abuses; countries may therefore omit it or limit its application to teaching services that are provided as part of a degree program offered by an educational institution.

436. The exclusion of payments for technical services for the personal use of an individual reflects common sense. Otherwise, certain payments for personal services might be inappropriately subject to withholding tax. For example, an individual resident in one country might pay a non-resident medical specialist for medical treatment. In the absence of the exclusion, the payments would be fees for technical services subject to tax by the country in which the individual is resident. Although it is unlikely that countries would impose withholding tax on such payments under their domestic law, the new article prevents the imposition of such a tax.[208]

437. The Commentary also addresses different issues raised by the definition of "fees for technical services" such as the extent to which the definition applies to reimbursements of expenses,[209] the exact scope of the concept of "services"[210] and the distinction between royalties and fees for technical services.[211]

438. Finally, the Commentary includes several examples that attempt to show the types of services that are covered by the definition.[212] These examples indicate, among other things, that although an en-

207 Paragraphs 71 of the Commentary on Article 12A of the UN Model.

208 Paragraphs 72 of the Commentary on Article 12A of the UN Model.

209 Paragraphs 74 to 82 of the Commentary on Article 12A of the UN Model.

210 Paragraphs 83 to 85 of the Commentary on Article 12A of the UN Model.

211 Paragraphs 99 to 103 of the Commentary on Article 12A of the UN Model.

212 Paragraphs 86 to 98 of the Commentary on Article 12A of the UN Model.

terprise may use technical knowledge, skills and expertise to develop services that it sells to customers, those services may not constitute technical services within the definition in paragraph 3. For example, a financial institution may apply its technical knowledge, skill and expertise to develop various financial services that it provides to its customers on a routine basis. Payments for such services would not be fees for technical services because the financial institution is providing standardized, routine services, rather than technical services to its clients. On the other hand, if a financial institution provided customized research, analysis and advice to a particular client in connection with a merger or acquisition, payment for those services would likely be within the definition of fees for technical services in paragraph 3.

Paragraph 4

439. Under paragraph 4, which corresponds to paragraph 4 of Article 12, the rules of paragraphs 1 and 2 for the allocation of taxing rights over fees for technical services do not apply where the fees for technical services are effectively connected with a permanent establishment or fixed base situated in the country of which the payer of the fees for technical services is a resident (the source state) or are effectively connected with other business activities carried on in the source state that are of the same or similar kind as the activities of a permanent establishment and which are covered by paragraph 1 (*c*) of Article 7. In these cases, the source state is not required to limit its tax on those fees for technical services and may instead tax the fees for technical services as business profits falling under Article 7 (Business profits) or as income covered by Article 14 (Independent personal services), as the case may be. The references to a fixed base and to Article 14 should be deleted from treaties that do not include Article 14; similarly, if the treaty does not include paragraph 1 (*c*) in Article 7, negotiators should delete this reference in paragraph 4 of Article 12A.

440. Thus, for tax treaties containing Article 12A, the existence of a permanent establishment or fixed base in a country (or the conduct in that country of activities referred to in paragraph 1 (*c*) of Article 7) determines whether fees for technical services are taxable on a net or gross basis, rather than whether the source country is entitled to impose tax on such fees at all. If a non-resident service provider receives fees for technical services from the source country, those fees

are taxable by the source country on a net basis if the fees are earned through a permanent establishment or fixed base in the source country (or are effectively connected with activities referred to in paragraph 1 (*c*) of Article 7), but are otherwise taxable under Article 12A on a gross basis.

441. Paragraph 4 requires that the fees for technical services be "effectively connected" with, as the case may be, the permanent establishment, the fixed base or the business activities referred to in paragraph 1 (*c*) of Article 7. The Commentary explains[213] that this requires a determination on the basis of all the relevant facts and circumstances of each case and adds that, as a general rule, such a connection would exist if the technical services are closely related to or connected with the permanent establishment or fixed base or if the business activities are similar to those carried out through the permanent establishment. It also indicates that where the remuneration paid to the person providing the services on behalf of the recipient of the fees is borne by a permanent establishment or fixed base of that recipient, the fees should be considered as effectively connected to that permanent establishment or fixed base.

Paragraph 5

442. Paragraph 5 provides the source rule for determining, for treaty purposes, whether fees for technical services arise in a state and may therefore be taxed by that state under Article 12A. The paragraph, which applies regardless of the domestic source rules of each state and regardless of where the services are performed, provides that fees for technical services are deemed to arise in the state of which the payer is a resident. As an exception, however, where the fees for technical services are, in effect, an expense of a permanent establishment or fixed base situated in the other state, these fees are deemed to arise in the state where the permanent establishment or fixed base[214] is located. This approach will generally ensure that, if fees for technical services derived by a resident of one state is a deductible expense of the payer in the other state, the fees are sourced in that other state and that state is allowed to tax them under Article 12A.

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213 Paragraph 106 of the Commentary on Article 12A of the UN Model.

214 If Article 14 (Independent personal services) is not included in the treaty, the references to "fixed base" should be deleted.

443. The source rule of paragraph 5 is, however, subject to exception provided in paragraph 6.

444. The Commentary provides additional explanations as well a number of examples illustrating the application of paragraphs 5 and 6.[215] It also provides various alternative source rules that countries may prefer to use in their treaties.[216] For example, paragraph 5 might be revised to include only fees for technical services performed in a country or consumed or used in a country. In that case, there would no need to include the exception of paragraph 6.

Paragraph 6

445. Under paragraph 6, fees for technical services are deemed not to arise in a state if the payer has a permanent establishment or fixed base in the other state and the fees are borne by that permanent establishment or fixed base. The effect of this negative source rule is that a state cannot impose tax on fees for technical services paid by residents of that state where the fees are deductible in computing the profits of a permanent establishment or fixed base in the other state. In this situation, the fees relate to a business carried on in that other state and as a result, the link between the fees for services and that other state is stronger than the link with the state in which the payer is a resident, which justifies not allowing the latter state to tax the fees.

Paragraph 7

446. Paragraph 7 is similar to paragraph 6 of Article 12 and deals with a particular form of tax avoidance where a non-resident seeks to reduce source state taxes by inflating deductible payments for technical services from related parties. Where payments of fees for technical services exceeding an arm's length amount are paid as a result of a special relationship between the payer and the recipient (or between both of them and a third party), paragraph 7 provides that the treaty limit on source taxation applies only to the arm's length amount, that is, the fees that would have been payable if an arm's length amount of fees had been agreed to.

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215 Paragraphs 108 to 122 of the Commentary on Article 12A.

216 Paragraphs 123 and 124 of the Commentary on Article 12A.

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

448. Depending on the circumstances, tax avoidance arrangements involving the payments of excessive fees for technical services might also be dealt with through the general anti-abuse rule of paragraph 9 of Article 29 (Entitlement to benefits). Issues related to excessive payments of services would, however, more typically be addressed through domestic transfer pricing rules.

9. Article 13—Capital gains

449. Article 13 allocates taxing rights over capital gains from the alienation of property. In general, the country that has primary taxing rights over the income from immovable property, assets of a permanent establishment and ships and aircraft used in international traffic is allocated taxing rights over capital gains from the alienation of such property. For other gains, treaty practice varies, as discussed below.

450. Not all countries tax capital gains, and countries vary in how they apply tax to capital gains under their domestic law: they may, for example, be added to other income or they may be subject to a special tax. Tax treaties do not dictate how a capital gain should be calculated, whether and when it should be taxed or what kind of tax should apply. They only allocate taxing rights between the two treaty partners and, within the limits set by the treaty, each country may apply its domestic law when taxing a capital gain.[217]

451. If one state does not tax capital gains, or taxes only a limited range of gains, the other state may consider that it should limit its taxation on those gains only to the extent necessary to relieve double taxation, that is to say, only where the treaty partner country exercises its right to tax the gains under its domestic law.[218]

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217 Paragraphs 3 of the Commentary on Article 13 of the UN Model, quoting paragraph 3 of the Commentary on Article 13 of the 2010 OECD Model.

218 Paragraph 4 of the Commentary on Article 13 of the UN Model, quoting paragraph 21 of the Commentary on Article 13 of the OECD Model.

452. Alienation of property generally refers to a change of ownership of that property, for example, through sale, exchange, appropriation, gift or death. Gains on such alienations, whether they are taxed as ordinary income or as a separate category, are covered by Article 13. As explained in the Commentary, however, in certain circumstances some states tax capital appreciation even if there is no alienation (for example, on a revaluation of business assets for accounting purposes). The application of tax treaties in such situations is discussed in the Commentary.[219]

Paragraph 1

453. Under paragraph 1 of both the UN and OECD models, the country in which immovable property is situated may tax capital gains from alienation of that property. The gains may also be taxed in the country of which the person alienating the immovable property is a resident (although that country must provide relief for any double taxation in accordance with Article 23).

454. The term "immovable property" has the same meaning in this Article as it has in Article 6 (Income from immovable property). It may therefore be broader than the domestic law definition of immovable property.[220]

455. Paragraph 1 applies only to gains derived by a resident of one treaty partner country from immovable property situated in the other country. Gains from alienation of immovable property situated in the alienator's country of residence or in a third state are dealt with under paragraph 6 (paragraph 5 in the OECD Model).[221]

Paragraph 2

456. Capital gains from the alienation of business assets (other than immovable property[222]) of a permanent establishment or, in treaties

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219 Paragraph 4 of the Commentary on Article 13 of the UN Model, quoting paragraphs 7–10 of the Commentary on Article 13 of the OECD Model.

220 See the discussion of paragraph 2 of Article 6.

221 Paragraph 5 of the Commentary on Article 13 of the UN Model, quoting paragraph 22 of the Commentary on Article 13 of the OECD Model.

222 As previously explained, gains from the alienation of immovable property attributable to a permanent establishment or fixed base are dealt with under paragraph 1 of this Article.

that include Article 14 (Independent personal services), a fixed base, may be taxed in the country in which the permanent establishment or fixed base is situated.

457. It should be noted that paragraph 2 does not operate as a "force of attraction" rule. Accordingly, gains from other movable property, including assets used for the purposes of activities described in paragraphs 1 (*b*) and *c*) of Article 7 of the UN Model, are dealt with under paragraph 6 (paragraph 5 in the OECD Model) of Article 13 and not under paragraph 2.

Paragraph 3

458. Paragraph 3 provides that capital gains arising from the disposal of ships or aircraft used in international traffic are generally taxable only in the state of residence. This rule applies irrespective of whether Article 8 (alternative A) or Article 8 (alternative B) of the UN Model is adopted. In treaties that allocate taxing rights in Article 8 on the basis of the place of effective management of the enterprise (rather than the state of residence), paragraph 3 must be amended to follow the same approach.[223]

459. The term "international traffic" is defined in paragraph 1 *d*) of Article 3 (1).[224]

Paragraph 4

460. Paragraph 4, which is identical in the UN and OECD models, addresses the situation where, instead of disposing of immovable property directly, an interest in an interposed entity is alienated. The paragraph ensures that the capital gain, where that gain primarily represents an increase in the value of immovable property held directly or indirectly through one or more companies, partnerships or trusts, may be taxed in the country where the immovable property is situated.

461. Paragraph 4 applies to gains derived from the alienation of shares or comparable interests (such as interests in a partnership or

223 Paragraph 7 of the Commentary on Article 13 of the UN Model, quoting paragraph 28 of the Commentary on Article 13 of the OECD Model.

224 See the discussion on Article 8.

trust) where, at any time during the 365 days preceding the alienation, more than 50 per cent of the value of these shares or comparable interests derived directly or indirectly from immovable property situated in a state. It allows the state in which the immovable property is located to tax such gains.

462. Paragraph 4 was changed in 2017 in order to cover situations where the shares or comparable interests derive their value primarily from immovable property at any time within the 365 days preceding the alienation as opposed to at the time of the alienation only. That change was made as a result as a result of the report on Action 6 of the OECD/G20 BEPS project[225] with a view to address possible tax-avoidance strategies.[226]

463. The Commentary explains that where it applies, paragraph 4 allows a state to tax the full capital gain derived from the alienation of the relevant shares or interests even though part of that gain may not be attributable to immovable property situated in that state. It also explains how the 50 per cent test should be applied in practice.[227]

464. The Commentary on Article 13 of the UN and OECD models offer different alternative versions of paragraph 4 for countries that want to either extend or narrow the scope of the paragraph.[228]

Paragraph 5

465. Paragraph 5 of the UN Model, which has no equivalent in the OECD Model, allows a state to tax gains on the alienation of shares in a company, or comparable interests such as interests in a partnership or trust, where the company or relevant entity is a resident of that state in which the alienator holds directly or indirectly (or has held at any time during the preceding 365 days) a substantial participation. The minimum participation is not specified in paragraph 5 but

225 Note 19.

226 As explained in paragraph 8.1 of the Commentary on Article 13 of the UN Model.

227 Paragraph 8.3 of the Commentary on Article 13 of the UN Model.

228 Paragraph 8.4 of the Commentary on Article 13 of the UN Model as well as paragraphs 28.6 to 28.10 of the Commentary on Article 13 of the OECD Model.

it is often 25 per cent. The 365-day rule is an anti-avoidance provision designed to ensure that a taxpayer cannot escape source taxation by selling off multiple small parcels of shares that together form a substantial holding.

466. Treaty practice varies with respect to this provision. Some treaties do not include a minimum participation, although it should be recognized that there are significant administrative and compliance difficulties in enforcing taxation in respect of gains from small shareholdings. Some countries specifically exclude gains from the alienation of quoted shares.[229] Others provide for a concessional rate of tax on gains from the alienation of shares. Still others limit taxing rights over gains from disposal of shares to gains by individuals who are former residents of that state. Many countries do not include paragraph 5 at all in their treaties. There is no equivalent to paragraph 5 in the OECD Model.

467. In deciding their position on this paragraph, countries should take into account their ability to identify, and collect tax on, sales of shares by non-residents. They should also take into account the fact that since the paragraph applies only to the alienation of shares or comparable interests of resident companies and entities, it does not apply, for example, where the shares of a company that is resident of a state in which it has significant business operations are held through a non-resident holding company and it is the shares of that holding company that are alienated. That situation, which is covered under paragraph 4 (if the resident company derives its value primarily from immovable property in that state) but not under paragraph 5, is sometimes referred to as an "offshore indirect transfer".[230]

Paragraph 6

468. Paragraph 6 (paragraph 5 in the OECD Model) is a "sweep-up" provision allocating taxing rights over all capital gains that are not

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229 See the alternative provision included in paragraph 13 of the Commentary on Article 13 of the UN Model.

230 For a discussion of offshore indirect transfers, see Platform for Collaboration on Tax, *The Taxation of Offshore Indirect Transfers—A Toolkit*, discussion draft available at http://www.un.org/esa/ffd/wp-content/uploads/2017/08/Taxation-of-Offshore-Indirect-Transfers-A-Toolkit.pdf.

dealt with in the previous paragraphs of the Article. In both the UN and OECD models, these gains may be taxed only in the country of residence of the alienator.[231]

469. Some countries, however, including many developing countries, prefer to retain taxing rights over capital gains arising in their state.[232] This approach will allow both countries to tax such gains in accordance with their domestic law, with the country of residence of the alienator providing double tax relief where necessary. Since the place where capital gains may be said to "arise" can give rise to difficulties, negotiators adopting this approach should clarify during negotiations how the source of capital gains is to be determined.

470. Some countries also seek to confirm in a treaty their right to subject capital gains accrued before a change of residence to an "exit" or "departure" tax provided under their domestic law. As indicated in the Commentary[233] and confirmed by paragraph 3 of Article 1, nothing in Article 13 or in the rest of the treaty would prevent the application of such a tax to the extent that the liability to that tax arises when a person is still a resident of the state that applies the tax and does not extend to income accruing after the cessation of residence. Where, however, the liability to such a tax arises after the cessation of residence or the tax applies to the part of a gain that arose after the cessation of residence, a specific exception to the general rule of paragraph 6 would be required in order to allow taxation of assets which may not otherwise be taxed under paragraphs 1 to 5.

471. In negotiating provisions on capital gains, countries should consider, in particular, which gains are taxable under their domestic law, and the extent to which their tax administration is able to enforce tax liabilities of non-residents on such gains.

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231 Paragraph 5 of Article 13 of the OECD Model.

232 Paragraph 18 of the Commentary on Article 13 of the UN Model, which includes a suggested alternative version of paragraph 6 that would achieve that result.

233 Paragraph 61 of the Commentary on Article 1 of the UN Model.

10. Article 14—Independent personal services

472. Article 14 (which is no longer found in the OECD Model)[234] deals with income from professional services and other independent services such as those of contractors. It does not deal with income from industrial or commercial activities or employment income.[235]

473. According to paragraph 9 of the Commentary on Article 14 of the UN Model, Article 14 applies to income derived only by individuals while Article 7 applies to income from services provided by enterprises. Paragraph 11 of the Commentary indicates, however, that some countries may not agree with that view and suggests that these countries may wish to address the question bilaterally.

474. If Article 14 is not included in a treaty, a number of consequential changes need to be made in that treaty. These include the deletion of references to Article 14 and to "fixed base" in many other articles. A full list of necessary changes to these articles is included in paragraphs 15.4 to 15.26 of the Commentary on Article 5 of the UN Model.

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

234 Article 14 was deleted from the OECD Model in 2000. Under the current OECD Model, income from independent personal services is dealt with under Article 7 (Business profits).

235 Paragraph 10 of the Commentary on Article 14 of the UN Model, quoting paragraphs 1 and 2 of the Commentary on Article 14 of the 1997 OECD Model.

independent personal services to an individual resident of state R and the payment falls within the definition of "fee for technical service" in paragraph 3 of Article 12A, Article 12A shall govern the taxation of the fee unless the fee is attributable to a fixed base in state S that is regularly available to the individual.

Paragraph 1

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

477. The "fixed base" criterion (paragraph 1 (a) of Article 14) mirrors the former Article 14 criterion of the OECD Model and is widely accepted in treaties with developing countries, even since the deletion of Article 14 in that Model.[236] Most countries consider the concept of "fixed base" to be essentially the same as the "fixed place of business" concept in the permanent establishment definition, so this criterion effectively provides the same threshold for source taxation as is provided for income under Article 7 (Business profits).

478. A length-of-stay criterion (paragraph 1 (*b*) of Article 14) is found in most treaties with developing countries, although the time during which the person must be present in the source country sometimes varies.[237] As the Commentary of the UN Model explains, a length of stay criterion for source taxation of independent personal services income is comparable to the 183-day presence test for employment income.[238]

479. The provision in the current UN Model refers to 183 days in any 12-month period beginning or ending in a fiscal year. This ensures that source countries do not lose taxing rights where the 12-month period

236 Wim Wijnen and Jan de Goede, "The UN Model in Practice 1997–2013", *Bulletin for International Taxation*, No. 3 (2014), section 2.16.2.1.

237 Ibid., section 2.16.2.2.

238 Paragraph 6 of Article 14 UN Model.

during which the person is present in that country extends over two fiscal years.

480. It should be noted that even where the agreed period of presence has been exceeded, only income attributable to relevant activities performed in the country may be taxed in that country under Article 14.

481. Most, but not all, countries tax the income covered by Article 14 on a net basis (that is to say, deductions are allowed for expenses). This should be discussed during negotiations and, if necessary, clarified in the treaty or through the mutual agreement procedure.

Paragraph 2

482. Paragraph 2 provides a non-exhaustive definition of "professional services". It clarifies that services such as independent scientific, literary, artistic, educational and teaching activities are covered, as well as traditional professions such as doctors and lawyers. Income of an entertainer that is dealt with by Article 17 (Artistes and sportspersons) is, however, not covered by Article 14.[239]

11. Article 15—Dependent personal services

483. Article 15 deals with income from employment (also known as dependent personal services). Generally, such income may be taxed in the country in which the employment is exercised. The income will, however, be exempt from taxation in that country where all the conditions specified in paragraph 2 are met.

484. The Article is identical in all material respects (other than the title and references to "fixed base") to Article 15 (Income from employment) in the OECD Model.

485. The position of teachers and professors requires special mention. The majority of countries apply the provisions of Article 15 to remuneration of teachers and professors. A significant minority of countries, however, prefer to include a special provision granting exemption from source taxation for a limited period to this category of employment. This is discussed further in a subheading under Article 20.

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239 The provisions of Article 17 include ordering rules which give priority to Article 17.

Paragraph 1

486. Paragraph 1 sets out the general rule that income from employment may be taxed in the country where the employment is exercised, that is to say, where the services are performed by the employee.

487. The term "salaries, wages and other similar remuneration" is generally understood to include payments in kind (sometimes called "fringe benefits") in respect of employment, such as use of cars, health insurance, stock options, and so forth. If necessary, in order to avoid doubt, the treaty can specify that the term includes particular types of benefits; or this can be clarified by mutual agreement.

Paragraph 2

488. Paragraph 2 provides an exception to the general rule for certain short-term employment activities performed in a state. An exemption from source taxation is provided where the following three conditions are met:

- The person is present in the source country for not more than 183 days in aggregate in any 12-month period beginning or ending in the relevant fiscal year;
- The employer is not a resident of the source country, and
- The remuneration is not borne by a permanent establishment or fixed base of the employer in the source country.

489. All three conditions must be met. Source taxation may be imposed on employment income derived during a short-term visit if, for example, the employer is a resident of the source country. Similarly, if the employer is a non-resident, but the employment is exercised for the benefit of its permanent establishment or fixed base (which will generally result in a deduction being allowed in the source country in respect of the remuneration), the exception to the general rule in paragraph 1 does not apply.

490. A number of practical difficulties may arise in the application of this exception. Negotiators and tax administrators are strongly advised to read the guidance on these issues found in the Commentary.[240]

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240 Paragraph 1 of the Commentary on Article 15 of the UN Model, quoting paragraphs 1 to 12.5 of the Commentary on Article 15 of the 2010 OECD Model.

Paragraph 3

491. Paragraph 3 governs the taxation of the remuneration of individuals employed on ships and aircraft that are operated in international traffic.

492. Before 2017, both the UN and OECD models allowed taxation of that income, as well as income from employment aboard a boat engaged in inland waterways transport, by the state where the place of effective management of the transportation enterprise was situated. The wording of that rule, however, did not seem to restrict taxation by the state of residence of the employee and by the state where the services where provided, which meant that the effect of the rule was unclear.

493. The 2017 version of both models includes a new rule that assigns the exclusive taxing right on such remuneration to the state of residence of the individual employee. This change, in conjunction with the changes to the definition of the term "international traffic" discussed above, establish a rule that is clearer, easier to administer, and achieves the appropriate policy outcomes especially in "triangular" cases in which the transportation enterprise is from a third state. For example, if an individual resident in state R exercises an employment aboard a ship operated by an enterprise of a third state, and such ship, as part of its operations in international traffic, enters the territory of state S, paragraph 3 would assign the exclusive taxing right of the individual's remuneration to state R.

494. The Commentary explains how this new rule applies and offers various alternatives that countries may wish to consider if they do not agree with the policy underlying the new rule.

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

495. Article 16 allocates non-exclusive taxing rights over directors' fees and wages of officials in a top-level managerial position of companies to the country of residence of that company.

496. The country of which the director or official in a top-level managerial position is a resident may also tax the remuneration, but must provide relief from double taxation in accordance with Article 23.

497. Directors' fees and the remuneration of top-level managerial officials may fall within the scope of both Articles 12A and 16. Where both Articles apply, the unlimited taxation right assigned by Article 16 prevails over the limited right to tax provided by Article 12A, as recognized by the phrase "subject to the provisions of Articles 8, 16 and 17" found at the beginning of paragraph 2 of Article 12A. Take, for example, the case of an individual resident in state R who is a director of a company resident in state S. Even if the directors' fees would fall within the definition of "fee for technical service" in paragraph 3 of Article 12A, the taxation of the directors' fees will be governed by paragraph 1 of Article 16, which allows for full taxation under the domestic law of state S, even though paragraph 2 of Article 12A would allow source taxation limited to a certain percentage of the payment.

Paragraph 1

498. Paragraph 1 of Article 16 of the UN Model, which deals with directors' fees, is identical to Article 16 of the OECD Model. It applies to "remuneration received by a resident of a Contracting State, whether an individual or a legal person, in the capacity of a member of a board of directors of a company which is a resident of the other Contracting State". The relevant remuneration includes payments in kind (fringe benefits) received in that person's capacity as a board member, but does not include wages or other remuneration that person may receive from the company in another capacity, for example, as an employee or consultant, except to the extent provided under paragraph 2 of the Article.[241]

499. Negotiators should clarify during discussions which persons would be regarded as "a member of the board of directors" for the purposes of this Article. In some countries, the governing body of the company, that is to say, the ultimate decision-making body which is responsible for setting the policy and direction of the company, may not be a board of directors. In this case, negotiators should ensure that references to relevant bodies are substituted for, or added to, the reference to "the board of directors". In cases of difference, it might be helpful to mention the specific names of the bodies that should be covered by Article 16.

241 Paragraph 2 of the Commentary on Article 16 of the UN Model, quoting the Commentary on Article 16 of the OECD Model.

500. The domestic law of some countries provides for taxation of directors' fees only where the services as a director are actually performed in that country. If both countries agree with that approach, the text of paragraph 1 could be amended accordingly.[242] Some countries may prefer to omit Article 16 and provide for similar tax treatment of directors' fees as for employees. In this case, a paragraph should be added to Article 15 to deal with directors' fees.

Paragraph 2

501. Paragraph 2, which has no equivalent in the OECD Model, extends the same treatment as that provided for directors to officials in a top-level managerial position of companies, that is to say, their remuneration may be taxed in the country of residence of the company.

502. The term "an official in a top-level managerial position of a company" is not defined in the UN Model. The Commentary notes, however, that this term "refers to a limited group of positions that involve primary responsibility for the general direction of the affairs of the company, apart from the activities of the directors".[243]

503. The provision is not found in many tax treaties,[244] but it is favored by a few developing countries whose domestic law provides for taxation of such remuneration on the basis that it is paid by a domestic company and is therefore allowed as a deduction to the company.

504. Countries that cannot exercise the taxing right provided under paragraph 2 of Article 16 (for example, where they can tax only if the activities are exercised in their jurisdiction) should omit this paragraph. In the absence of this provision, the income of these individuals would fall within the scope of Article 15 (Dependent personal

242 Draft wording could be along the following lines: "Directors' fees and other remuneration derived by a resident of a Contracting State for services rendered in the other Contracting State in his capacity as a member of the Board of Directors of a company which is a resident of the other Contracting State may be taxed in that other state."

243 Paragraph 5 of the Commentary on Article 16 of the UN Model.

244 According to Wim Wijnen and Jan de Goede, "The UN Model in Practice 1997–2013", *Bulletin for International Taxation*, No. 3 (2014), section 2.17, less than 10 per cent of treaties include this provision.

services). Under that Article, the remuneration is taxable in the country in which the individual's activities are exercised (the exemption provided in paragraph 2 of Article 15 does not apply where the employer company is a resident of that state).

505. Some countries do not consider that paragraph 2 should apply to allow another country to tax the remuneration of a resident top-level managerial official where that remuneration is borne by a permanent establishment situated in the state of residence of that official. states that share that view could restrict the scope of paragraph 2 by adding at the end of the paragraph the phrase "except to the extent that such salaries, wages and other similar remuneration are borne by a permanent establishment which the company has in the first-mentioned State."

13. Article 17—Artistes and sportspersons

506. Article 17 allows the source taxation of income relating to performances by non-resident entertainers and sportspersons in a country. The only condition for source taxation is that the entertainment or sporting activities be exercised in the country. The Article as found in the UN Model does not differ in any material respects from Article 17 of the OECD Model.

Paragraph 1

507. Paragraph 1 provides that artistes and sportspersons who are residents of one state may be taxed in the other state on the income derived from their entertainment or sporting activities performed in that other state.

508. The paragraph applies to both independent activities and activities provided as employees. It expressly provides an exception to the rules of Articles 14 and 15.[245] It also prevails over Article 7 since paragraph 6 of Article 7 of the UN Model[246] provides that Article 7 does not affect the application of other articles.

509. The Commentary suggests that some countries may wish to apply the rules of Article 17 only in respect of independent services, so

245 The reference to Article 14 is omitted in the OECD Model, where that article no longer appears.

246 Paragraph 4 of Article 7 of the OECD Model.

that Article 15 applies to income of employed entertainers and sportspersons.[247] This, however, is rarely seen in existing treaties.

510. More commonly, an exception is made to the provisions of Article 17 for events supported by government funds of either or both countries, or employees of organizations which are subsidized out of public funds. In these treaties, a specific provision allocates exclusive taxing rights to the entertainer's country of residence.[248] In some treaties, the exception is limited to such events taking place under a cultural agreement between the two countries. This is intended to facilitate cultural exchanges.

511. Article 17 does not specify how the income of the entertainer or sportsperson is to be computed, or whether expenses incurred in deriving the income must be allowed. Some countries consider taxation of the income on a gross basis, even at a low rate, to be inappropriate and prefer to include an option for the taxpayer to be taxed on a net basis.[249] The method by which entertainers' and sportspersons' income is taxed should be discussed during negotiations.

512. Article 17 as drafted applies regardless of the amount of the remuneration. Some countries, however, consider that the unlimited source taxation allowed under Article 17 is appropriate primarily for individuals that are highly remunerated for a performance that requires only a short period of physical presence in a country (which, absent Article 17, would likely not trigger any source taxation according to the other provisions of the treaty). Those countries consider that Article 17 should not apply to entertainers and sportspersons who derive only small amounts of remuneration from a country during a year and that these persons should be subject to the same rules as other service providers. Countries that share that view may include the alternative

247 Paragraph 2 of the Commentary on Article 17 of the UN Model, quoting paragraph 2 of the Commentary on Article 17 of the OECD Model.

248 Paragraph 2 of the Commentary on Article 17 of the UN Model, quoting paragraph 14 of the Commentary on Article 17 of the 2010 OECD Model, proposes possible wording for this purpose.

249 Paragraph 2 of the Commentary on Article 17 of the UN Model, quoting paragraph 10 of the Commentary on Article 17 of the 2010 OECD Model. That paragraph suggests a provision that could be included in a treaty to ensure taxation on a net basis.

provision found in paragraph 10.1 of the Commentary on Article 17 of the OECD Model.[250]

513. The practical application of Article 17 often gives rise to difficulties. A number of these difficulties are addressed in the Commentary.[251]

Paragraph 2

514. Paragraph 2 deals with the situation where the income from the activities of an entertainer or sportsperson does not accrue directly to the entertainer or sportsperson but rather to another person. That other person may be, for example, a management company, a team constituted as a legal entity or a company owned and controlled by the entertainer (known as a "star company").

515. In these circumstances, if the state in which the activities are performed cannot "look through" the person receiving the income and attribute that income to the entertainer or sportsperson, it may not be able, absent paragraph 2, to tax the income derived from that state in respect of the entertainer's performance. For example, if a contract for the performance of an entertainer in a country is concluded with a foreign company wholly-owned by that entertainer and that company receives a huge fee for the performance but only pays a small salary to the entertainer, paragraph 2 will ensure that the country in which the performance takes place is able to tax the amount paid to the company for that performance regardless of the provisions of Article 7, which provides that the profits of a foreign enterprise may only be taxed in a country if they are attributable to a permanent establishment situated in that country.[252]

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250 Paragraphs 10.1 to 10.4 of the Commentary on the OECD Model explains various features of that provision.

251 Paragraph 2 of the Commentary on Article 17 of the UN Model, quoting paragraphs 3–9 of the Commentary on Article 17 of the 2010 OECD Model. Additional guidance was included in 2014 in the Commentary on the OECD Model (see paragraphs 8.1 to 9.5 of the Commentary on Article 17 of the OECD Model.

252 Paragraph 2 of the Commentary on Article 17 of the UN Model, quoting paragraphs 11 to 11.2 of the Commentary on Article 17 of the OECD Model. Additional guidance on the application of paragraph 2 was included in 2014 in the Commentary on the OECD Model (see paragraphs 11.3 to 11.5 of the Commentary on Article 17 of the OECD Model.

14. Article 18—Pensions and social security payments

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

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

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

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

519. Although this provision is limited to pensions from past private employment, some countries prefer to provide for the same tax treatment of all pensions, including annuities, pensions paid in respect of independent personal services and government service pensions. The

Commentary notes that countries are free to agree on this bilaterally.[253]

520. Allocation of sole taxing rights to the country of residence of the recipient simplifies the taxation affairs of pensioners. Many countries also consider that the residence country is in a better position to determine the pensioners' overall ability to pay tax, since their total income is often relatively low.[254]

521. A significant number of countries, however, consider that the source country should also have a right to tax pensions arising in their jurisdiction, particularly those countries where pensions are regarded as deferred compensation for income from employment exercised in that country, or where tax incentives have previously been provided in that country in respect of retirement savings.[255] The UN Model therefore offers Article 18 (alternative B), pursuant to which pensions paid in respect of past employment may be taxed in both the residence state of the recipient (paragraph 1) and the treaty partner country if paid by a resident of, or permanent establishment in, that country (paragraph 2).

522. Taking into account differences in the tax treatment of retirement savings and pension payments under the domestic laws of various countries, the Commentary offers a number of variations of these two basic approaches. If pensions are not taxable in the recipient's country of residence, negotiators should discuss whether to include a provision intended to avoid non-taxation in these circumstances.[256] Conversely, some countries may wish to ensure that the tax-exempt status of certain pensions paid from sources in their jurisdiction is preserved where the recipient is a resident of a treaty partner.[257]

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253 Paragraph 4 of the Commentary on Article 18 of the UN Model, quoting paragraphs 3 – 7 of the Commentary on Article 18 of the OECD Model.

254 Paragraph 4 of the Commentary on Article 18 of the UN Model, quoting paragraph 1 of the Commentary on Article 18 of the OECD Model.

255 Paragraph 4 of the Commentary on Article 18 of the UN Model, quoting paragraph 9 of the Commentary on Article 18 of the OECD Model, and paragraph 11 of the Commentary on Article 18 of the UN Model.

256 Paragraph 5 of the Commentary on Article 18 of the UN Model.

257 Paragraph 6 of the Commentary on Article 18 of the UN Model, quoting paragraphs 22 – 23 of the Commentary on Article 18 of the OECD Model.

523. Another option discussed in the Commentary is to provide for source taxation where tax relief has been granted in a country in respect of contributions to a pension scheme.[258] As explained in the Commentary, however, this approach would give rise to administrative difficulties where individuals have worked in, and contributed to the fund from, more than one country.

524. Where paragraph 2 of alternative B is adopted, negotiators should discuss whether the source state should grant to a resident of the other state any personal allowances, reliefs or reductions for tax purposes granted to its own residents. This may be specifically addressed in the Article in order to avoid excessive taxation.[259]

525. Other options for source taxation of pensions, and examples of possible provisions, are discussed in the Commentary on Article 18 of the OECD Model.[260] These include exclusive source taxation of pensions, non-exclusive source taxation, limited source taxation and source taxation of pension payments only where the state of residence does not tax these payments. The policy arguments for and against these provisions, which are also discussed in the Commentary, should be considered by negotiators prior to the negotiations[261] and not only when differences of views arise during the negotiations.

Paragraph 2 of alternative A, paragraph 3 of alternative B

526. Paragraph 2 of alternative A and paragraph 3 of alternative B give to the source state sole taxing rights over pensions and other payments made under that country's social security system. The rationale for this is described in the Commentary as being that "the payments involved are wholly or largely financed out of the tax revenues of the State of source".[262]

527. There is no equivalent to this paragraph in the OECD Model, although the Commentary on Article 18 of that Convention proposes an alternative provision which provides for non-exclusive source tax-

258 Paragraph 16 of the Commentary on Article 18 of the UN Model.

259 Paragraph 12 of the Commentary on Article 18 of the UN Model.

260 Paragraphs 12–21 of the Commentary on Article 18 of the OECD Model.

261 See section II.B dealing with the development of a country's tax treaty policy framework and model treaty.

262 Paragraph 7 of the Commentary on Article 18 of the UN Model.

ing rights.[263] The Commentary on the UN Model also recognizes non-exclusive source taxation as an alternative, particularly in the case of countries that provide double tax relief through the credit method.[264]

528. For countries where parts of the social security system have been privatized, extension of the provision to payments made under a mandatory private scheme that is part of the social security system might be appropriate.[265]

529. In the absence of paragraph 2 of alternative A (paragraph 3 of alternative B), social security payments made by one country to a resident of the other country would, unless covered by paragraph 1 (if paid in respect of past employment) or by Article 19 (Government service), fall within Article 21 (Other income). Under Article 21 of the UN Model, both countries would be able to tax these payments (with the residence country providing relief from double taxation). Under the OECD Model, however, Article 21 would allocate sole taxing right to the country of residence of the recipient.

Other provisions

530. The Commentary includes other alternative provisions that address a number of important issues such as:

- Tax treatment of contributions to foreign pension schemes
- Tax obstacles to the portability of pension rights, and
- Tax-exempt treatment of investment income derived by pension funds established in a treaty partner country[266]

531. The Commentary notes that "allowing recognition of cross-border pension contributions and facilitating cross-border transfer of pension rights from a pension scheme to another will also stimulate the movement of personnel to foreign countries".[267]

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263 Paragraphs 24 – 28 of the Commentary on Article 18 of the OECD Model.

264 Paragraph 9 of the Commentary on Article 18 of the UN Model.

265 Paragraph 10 of the Commentary on Article 18 of the UN Model.

266 Paragraphs 17 and 18 of the Commentary on Article 18 of the UN Model, quoting paragraphs 31 – 69 of the Commentary on Article 18 of the OECD Model.

267 Paragraph 18 of the Commentary on Article 18 of the UN Model.

15. Article 19—Government service

532. Article 19, which is identical in the UN and OECD models, generally reserves the sole right to tax remuneration from, and pensions paid in respect of, government services to the paying state, unless the recipient is an individual who is both a resident of, and a national of, the other state.

533. The Article applies only to state employees and persons receiving a pension in respect of past employment by a state. It does not apply to persons rendering independent services.[268]

534. The provisions of this Article provide exceptions to the usual rules of Article 15 (Dependent personal services) and Article 18 (Pensions and social security payments). Both Articles 15 and 18 therefore give priority to Article 19.

Paragraph 1

535. Paragraph 1 (*a*) sets out the general rule that salary, wages and other similar remuneration paid in respect of services rendered in the course of employment by a Government of a treaty partner country will be taxable only in that country.

536. The Commentary notes that "the principle of giving the exclusive taxing right to the paying State is contained in so many of the existing conventions between OECD member countries that it can be said to be already internationally accepted".[269] It is also consistent with the provisions the *Vienna Convention on Diplomatic Relations*[270] and the *Vienna Convention on Consular Relations.*[271]

537. An exception to this general rule is provided by paragraph 1 (*b*) where the services are rendered in the receiving state and the recipient is a resident of that state who is either a national of that state or did

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268 Paragraph 2 of the Commentary on Article 19 of the UN Model, quoting paragraph 2.1 of the Commentary on Article 19 of the OECD Model.

269 Paragraph 2 of the Commentary on Article 19 of the UN Model, quoting paragraph 2 of the Commentary on Article 19 of the OECD Model.

270 Available at http://legal.un.org/ilc/texts/instruments/english/conventions/9_1_1961.pdf.

271 Available at http://legal.un.org/ilc/texts/instruments/english/conventions/9_2_1963.pdf.

not become a resident of the receiving state solely for the purpose of providing those services. Where the conditions of the exception are met, exclusive taxing rights over the remuneration are allocated to the receiving state. This exception commonly applies to "locally engaged" staff such as secretarial staff, drivers or security personnel who are employed in the receiving state by an embassy, consular office or other diplomatic representation of the country to which the services are provided.

538. Some countries prefer to restrict the scope of paragraph 1 to services rendered "in the discharge of functions of a governmental nature", an expression that was found in the 1963 version of the OECD Model.[272] Negotiators who wish to do so should ensure that the two teams reach a common understanding of the phrase "functions of a governmental nature" as the concept can differ from country to country.

Paragraph 2

539. Paragraph 2 deals with pensions paid out of state funds to a person in respect of past employment by that state. It applies both to pensions paid directly by the state and to pensions paid out of a separate fund created by a government body.[273]

540. Paragraph 2 (*a*) provides the general rule that such pensions may be taxed only in the paying state. Paragraph 2 (*b*), however, makes an exception in the case of a recipient who is a resident and national of the other state. In these circumstances, the pension will be taxable only in that other state.

541. Difficulties in the application of paragraph 2 can arise where the same pension is paid partly in consideration of private services and partly for government services, for example, where pension rights have been transferred from a private scheme to a public scheme. Apportionment of the pension would be one way to address these difficulties and the Commentary offers an alternative provision that

272 Paragraph 2 of the Commentary on Article 19 of the UN Model, quoting paragraph 5 of the Commentary on Article 19 of the OECD Model.

273 Paragraph 2 of the Commentary on Article 19 of the UN Model, quoting paragraph 5.2 of the Commentary on Article 19 of the OECD Model.

would ensure that only the part of the pension paid in respect of government service would fall within the scope of paragraph 2 (*a*) of paragraph 2.[274]

542. A further alternative favored by a few countries is to extend the operation of Article 18 (Pensions and social security payments) to all pensions, including government service pensions. In this case, paragraph 2 of Article 19 should be deleted.[275]

Paragraph 3

543. Paragraph 3 provides that the provisions of paragraphs 1 and 2 do not apply with respect to salaries and pensions in respect of government services if these services are performed in connection with a business carried on by the state. In these cases, the normal rules of Articles 15, 16, 17 and 18 apply to these salaries and pensions.

544. The Commentary notes that countries which prefer to apply the provisions of paragraphs 1 and 2 to such remuneration may delete paragraph 3. If it is intended that paragraphs 1 and 2 should apply only to certain business activities conducted by public bodies, such as public railways or postal services, this may be specified in those paragraphs.[276]

16. Article 20—Students

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

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

547. The Article applies only to students, business trainees and apprentices who are visiting the country solely for the purpose of their

274 Paragraph 2 of the Commentary on Article 19 of the UN Model, quoting paragraphs 5.2 – 5.6 of the Commentary on Article 19 of the OECD Model.

275 Paragraph 3 of the Commentary on Article 19 of the UN Model.

276 Paragraph 2 of the Commentary on Article 19 of the UN Model, quoting paragraph 6 of the Commentary on Article 19 of the OECD Model.

education or training and covers payments for maintenance, education or training only when the source of these payments is outside the country being visited. The Article does not cover payments for services (which are covered by Article 15 or 19 in the case of employment services and by Article 7, 12A or 14 in the case of independent services). A number of countries, however, prefer to extend the exemption to remuneration for services rendered by the student or trainee, particularly where the services that are provided are connected with the student's studies or training.[277] This approach can lead to difficulties in the country being visited as it provides for a better treatment of foreign students compared to domestic students.

548. Some treaties include an additional paragraph which requires the country in which the student is studying or training to give the same tax exemptions, reliefs or reductions as would be given to domestic students with respect of grants, scholarships and employment income of the student. This paragraph was formerly included in the UN Model, but was deleted because of difficulties concerning its practical application. Countries that wish to include such a provision should be aware of the policy considerations and administrative difficulties described in the Commentary.[278] In the absence of this provision, Article 21 will apply to such grants and allowances to the extent that other Articles, such as Article 15, do not cover them.

Article for teachers

549. Although neither the UN Model nor the OECD Model includes a separate provision dealing with income derived by visiting teachers or professors, a limited exemption from source taxation is often found in treaties of developing countries that wish to attract the services of foreign educators.

550. In the absence of a special provision, the remuneration would fall within Article 14 or Article 15. Under these Articles, teachers and

277 Draft wording could be along the following lines: "2. Notwithstanding the provisions of Articles 14 and 15, remuneration for services rendered by a student or a 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."

278 Paragraphs 3 – 9 of the Commentary on Article 20 of the UN Model.

professors who visit a country for an extended period on a teaching assignment are likely to be taxable in that country on the income derived from their teaching activities; they may also become taxable as residents of that country. Countries that wish to encourage teachers to undertake teaching assignments in their country (for example, as part of a development program) may want to include in a tax treaty a specific provision under which the remuneration of foreign teachers is exempt from source taxation.

551. Typically, such a provision would exempt from tax in the host country the remuneration of visiting teachers, professors and, sometimes, researchers derived from their teaching or research activities in that country.[279] These provisions are, however, often difficult to apply and administer, so negotiators should be careful in drafting the article to ensure that the scope and application of the exemption is clear.

552. The Commentary on Article 20 (Students) of the UN Model includes a discussion of the factors that should be taken into account when considering a provision dealing with remuneration of teachers and professors, including:

— The possibility of creating double exemption (for instance, if the teacher ceases to be a resident for tax purposes in the other country or qualifies for some form of exemption in the other country).
— The inclusion of a time limit (normally two years) and the application of that limit.
— The possibility of limiting the exemption to teaching services performed at "recognized" institutions or research performed in the public (versus private) interest.

279 The following is an example of such a provision: "Notwithstanding the provisions of Article 15, a professor or teacher who makes a temporary visit to one of the Contracting States for a period not exceeding two years from the date of first arrival in that state, solely for the purpose of teaching or carrying out research at a university, college, school or other educational institution in that state and who is, or immediately before such visit was, a resident of the other Contracting State shall, in respect of remuneration for such teaching or research, be exempt from tax in the first-mentioned state." The scope of application of some of these provisions is restricted to remuneration derived by the professor or teacher from outside the host state.

— Whether an individual should be entitled to benefits under the Article in respect of more than one visit.[280]

553. It should be noted that a tax exemption for visiting educators could be achieved with more precision through domestic law, unless the intention is to achieve a reciprocal treatment in both treaty partners or to limit the exemption to teachers and professors of treaty partners.

17. Article 21—Other income

554. Article 21 allocates taxing rights over all income that is not otherwise dealt with under the other distributive rules of the treaty, namely, Articles 6 to 20 of the UN Model.

555. The income covered by this Article may be:

— A category of income that is not covered under any other article, for example, lottery winnings or pensions that are not paid in respect of past employment;

— Income from sources not mentioned in an article, for example, income of a resident of one state derived from immovable property situated in the same state (to which Article 6 does not apply because it only deals with income derived by a resident of one state from immovable property situated in the other state), or

— Income from sources outside the two treaty partner countries, that is, income derived by a resident of one state from sources in a third state.

Paragraph 1

556. Paragraph 1 gives exclusive taxing rights over other income to the country of residence of the recipient. Paragraph 1 of the UN Model is identical to paragraph 1 of the OECD Model and, like that paragraph, is subject to the exception of paragraph 2. It is, however, also subject to the exception of paragraph 3, which is not found in the OECD Model.

Paragraph 2

557. Paragraph 2, like its equivalent in the OECD Model, makes an exception to the rule of paragraph 1 where the income is paid in re-

280 Paragraphs 10 – 12 of the Commentary on Article 20 of the UN Model.

spect of right or property that is effectively connected with a permanent establishment (or fixed base, if Article 14 is included in the treaty). In that case, income (other than income from immovable property[281]) may be taxed in accordance with the provisions of Article 7 or Article 14, that is to say, the income may be taxed in the country in which the permanent establishment or fixed base is situated.

558. The paragraph addresses the case of income that does not constitute business profits but is paid with respect to assets effectively connected with a permanent establishment or fixed base. It covers such income even where the payer and the person deriving the income are residents of the same state but the income is paid in respect of right or property that is effectively connected with a permanent establishment or fixed base of the recipient in the treaty partner country. For example, interest paid by a resident of state A may be beneficially owned by another resident of state A but paid in respect of right or property that is effectively connected with a permanent establishment of that person situated in state B. In this case, paragraph 2, in combination with Article 7, will allow state B to tax the income, and Article 23 will require state A to relieve double taxation.

559. If state A relieves by the exemption method, however, this will result in that state not being able to tax the income at all, notwithstanding that the interest arises in state A. Some countries do not agree with this outcome and seek to include a provision that ensures that state A may impose tax as the source country (limited, where appropriate, in accordance with treaty provisions such as Articles 10, 11, 12 or 12A). Under paragraph 3 of Article 24, state B, in which the permanent establishment is situated, should give relief to the permanent establishment for any double taxation to the same extent as it would give relief to a local enterprise deriving similar income from state A.[282]

560. Opportunities for abuse may arise in cases where an item of other income arising in one state is attributed to a permanent estab-

281 The Commentary describes the tax treatment of income from immovable property. Paragraph 4 of the Commentary on Article 21 of the UN Model, quoting paragraph 4 of the Commentary on Article 21 of the OECD Model.

282 Paragraph 4 of the Commentary on Article 21 of the UN Model, quoting paragraph 5 of the Commentary on Article 21 of the 2014 OECD Model.

lishment of a resident of the other state, that other state applies the exemption method to the profits attributable to the permanent establishment and that permanent establishment is located in a third state that does not tax such income (or taxes it lightly). Since neither the residence state nor the third state would fully tax the income attributable to the permanent establishment, there would generally be no justification for restricting the source state's right to tax the relevant income. Paragraph 8 of Article 29, which was introduced in the UN and OECD models in 2017, addresses such cases and provides that the benefits of the treaty between the source and residence states would generally be denied with respect to such income.

Paragraph 3

561. Paragraph 3, which has no equivalent in the OECD Model, provides an exception to paragraph 1 and permits source taxation of other income that arises from a Contracting State.

562. Paragraph 3 is frequently found in treaties of developing countries as well as in treaties of some developed countries.[283] Some countries which generally do not include paragraph 3 of Article 21 in their tax treaties might agree, in negotiations with countries that seek its inclusion, to limit the scope of this paragraph by listing specific items of income which may be subjected to source country taxation under the paragraph. Another option, which may be suited to countries that impose withholding tax on payments to non-residents, is to provide for limited source taxation, that is, by imposing a rate limit on such taxation.

Additional paragraphs

563. The Commentary on Article 21 includes alternative provisions which some countries include in their treaties. The first is an anti-abuse provision along the lines of paragraph 6 of Article 11 and paragraph 6 of Article 12, dealing with excessive payments between related parties.[284]

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283 Wim Wijnen and Jan de Goede, "The UN Model in Practice 1997–2013", *Bulletin for International Taxation*, No. 3 (2014), section 2.20.1.

284 Paragraph 7 of the Commentary on Article 21 of the UN Model, quoting paragraphs 7–11 of the Commentary on Article 21 of the OECD Model.

564. Another alternative provision seeks to clarify when income may be said to "arise" in a state of the purposes of paragraph 3. That source rule is similar to that in paragraph 5 of Article 11, Article 12 and Article 12A.[285]

E. Chapter IV—Taxation of capital

1. Article 22—Capital

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

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

567. As discussed in relation to Article 2 (Taxes covered), when negotiating a tax treaty, countries must decide whether or not to cover capital taxes. If neither country imposes such taxes, or if double taxation of capital is unlikely to arise because only one country has capital taxes, negotiators may decide not to cover capital taxes in the treaty and, therefore, to omit Article 22. Consequential changes would then also be required to the title of the treaty, paragraphs 1 and 3 of Article 23 A, paragraphs 1 and 2 of Article 23 B and paragraph 4 of Article 24 in order to remove all references to capital taxes.[286]

Paragraph 1

568. Paragraph 1 permits the country in which immovable property is situated to tax capital represented by that immovable property owned by a resident of the other country. "Immovable property" takes its meaning from the definition of the term in Article 6. The allocation of taxing rights under paragraph 1 therefore mirrors the allocation of taxing rights over income from immovable property under Article 6.

Paragraph 2

569. Paragraph 2 provides that the country in which a permanent establishment or fixed base of a non-resident is situated may tax capital

285 Paragraph 9 of the Commentary on Article 21 of the UN Model.

286 See Commentary on paragraph 4 of Article 24 of the UN Model.

represented by movable business property of the permanent establishment or fixed base.

570. This corresponds to the rules for taxing income attributable to a permanent establishment or fixed base. If Article 14 is not included in the treaty, the reference to "fixed base" should therefore be omitted from paragraph 2.

571. Paragraph 2 applies to property, other than immovable property, that forms part of the business property of a permanent establishment or fixed base. As a general rule, where income from property is effectively connected with a permanent establishment or fixed base for the purposes of Article 7, 14 or paragraph 2 of Article 21, it would be expected that such property would form part of the business property of that permanent establishment or fixed base.

Paragraph 3

572. Under paragraph 3, where an enterprise of one state operates ships or aircraft in international traffic, the taxing rights over the capital represented by such ships or aircraft and by movable property (that is to say, property other than immovable property) that relates to such operation are allocated exclusively to that state, i.e. the state of residence.

573. The treaty treatment of the capital of transport enterprises under paragraph 3 therefore corresponds to that of the income derived by such enterprises. Accordingly, if, under Article 8, two states decide that taxing rights over income from international transport should be allocated to the state in which the place of effective management of the enterprise is situated rather than to the state of residence, the same change should be made to paragraph 3 of Article 22.

574. The Commentary provides an alternative version of paragraph 3 that is intended to make it clear that this paragraph does not apply where the enterprise that owns the ships or aircraft does not also operate them in transport activities, for example, where the ships or aircraft are operated by another enterprise.[287]

287 Paragraphs 4.1 and 4.2 of the Commentary on Article 22 of the UN Model.

Paragraph 4

575. Paragraph 4 of Article 22 of the UN Model is enclosed in square brackets to indicate that the taxation of elements of capital not mentioned in paragraphs 1 to 3 is a matter left to bilateral negotiations. The option shown in brackets in the UN Model, like paragraph 4 in the OECD Model, allocates exclusive taxing rights to the country of residence of the owner of that capital. A note to Article 22 of the UN Model Convention, however, recognizes that the states could prefer wording that would give taxation rights over such capital to the state in which the capital is located.

576. If double taxation were to arise as a result of treaty provisions allowing taxation by the state in which an element of capital is situated or as a result of treaty provisions allowing both countries to apply their domestic law in respect of the taxation of capital,[288] the country of residence of the taxpayer should be required to provide relief in accordance with Article 23.

F. Chapter V—Methods for the elimination of double taxation

577. The distributive rules of a tax treaty (that is, the provisions that allocate taxing rights over income) frequently permit both countries to tax the same taxpayer on the same income or capital. When this occurs, Article 23 of the UN and OECD Models require the country of residence of the taxpayer to provide relief from double taxation by one of two methods. Article 23 A provides for relief by the exemption method, while Article 23 B provides for relief by the credit method.

578. When drafting Article 23, many countries depart from the wording of the two models to some extent. In particular, it is usual to include in a treaty distinct relief of double taxation provisions for each state. When analyzing the wording proposed by another state, each state will want to ensure that the basic principles of the models are captured and that the proposed wording reflects an obligation on the state of residence to eliminate double taxation on an item of income

288 See, for example, paragraph 4 of Article 23 of the Argentina-France treaty signed on 4 April 1979.

or capital that is taxed by the state of source in accordance with the provisions of the treaty.

579. Also, the relief of double taxation provisions proposed by a state will often indicate that relief will be provided subject to the provisions of the domestic law of that state. Such a condition should be drafted and interpreted in the sense that domestic law will govern the practical application of the method provided for in the treaty but will not relieve the residence state from its obligation to provide relief in accordance with the treaty.[289]

580. If the treaty does not cover capital taxes, the references to capital and to capital taxes should naturally be omitted from Article 23.

581. Since the application of Article 23 to the double taxation of income is far more frequent than its application to the double taxation of capital, the following explanations deal primarily with the taxation of income even though most of them are equally relevant to the taxation of capital.

1. Article 23 A—Exemption method

582. Under the exemption method provided for in Article 23 A, the country of residence is required to exempt items of income derived by its residents that may be taxed by the other state in accordance with the treaty. For example, the residence state will exempt income derived by its residents from immovable property situated in the other state, or will exempt business profits derived by its residents through a permanent establishment situated in the other state.

583. In effect, under the exemption method, only the source country will have the right to tax that income. By granting an exemption to its residents with respect to an item of foreign-source income, the residence country ensures that its residents are not subjected to higher taxation rates than residents of the source country with respect to that income. Indeed, if the source state provides tax incentives targeted at foreign investors, those investors may be treated more favorably than residents of the source state if their country of

289 See, for example, paragraph 14 of the Commentary on Article 23 of the UN Model, quoting paragraph 32.8 of the Commentary on Article 23 of the OECD Model.

residence exempts the income from taxation. Where the residence state applies the exemption method, the benefit of tax incentives of the source state is not reduced or cancelled by taxation in the country of residence of the investor as would be the case under the credit method.

Paragraph 1

584. Paragraph 1 of Article 23 A provides the central rule that the taxpayer's country of residence will exempt from tax income that may be taxed in the other state in accordance with the treaty.

585. The exemption applies irrespective of the amount, if any, of tax imposed in the treaty partner country. Since this can result in partial taxation where the treaty imposes limits on source taxation or in effective non-taxation where the income is not taxed in the source country, countries may want to restrict the operation of paragraph 1 to income that is effectively taxed in the source country, or may extend the application of paragraph 2 (which provides for the credit method) to additional categories of income.[290] Some countries may also wish to include a provision that applies a "switchover" to the credit method in certain circumstances, for example, with respect to income that benefits from a preferential regime that is introduced in the source country after signature of the treaty.[291]

586. Paragraph 1 makes it clear that the obligation for the state of residence to apply the exemption method only applies where the income may be taxed by the other state as the state of source or as the state of location of a permanent establishment or fixed base to which the income is attributable. This addresses situations where the two states tax the same item of income as states of residence because they attribute that income to different taxpayers who have a different residence for treaty purposes. This may happen, for instance, where one state taxes a partnership that is a resident of that state on income derived from a third state, while the other state taxes the partners, who are its own

290 Paragraphs 14 of the Commentary on Article 23 of the UN Model, quoting paragraphs 33 – 35 of the Commentary on Article 23 of the 2014 OECD Model, and paragraph 15 of the Commentary on Article 23 of the UN Model.

291 Paragraph 31.1 of the Commentary on Article 23 of the OECD Model.

residents, on the same income. In that case, unless the income is attributable to a permanent establishment or fixed base in one of the two states, each state will tax solely by reason of the residence of the person it considers to be the relevant taxpayer and paragraph 1 clarifies that each country will not be required to provide relief for the other state's tax levied on that basis. This principle, which was expressly incorporated in the wording of paragraph 1 in 2017, is explained in the Commentary where it is illustrated with a series of examples. [292]

587. Since the amount of a taxpayer's taxable income or capital may be relevant for non-tax purposes, for example, for social benefits, the Commentary provides an alternative formulation of paragraph 1. Under this alternative provision, instead of reducing the taxpayer's income or capital by the amount of the foreign income or capital, the taxpayer's tax liability is reduced by the amount of tax applicable to that foreign income or capital. [293]

588. The Commentary discusses a number of issues that can arise in the application of the exemption method, including the amount to be exempted, the treatment of losses, and taxation of the rest of the income. [294]

Paragraph 2

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

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

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292 Paragraph 14 of the Commentary on Article 23 of the UN Model, quoting paragraph 11.1 and 11.2 of the Commentary on Article 23 of the OECD Model.

293 Paragraph 16 of the Commentary on Article 23 of the UN Model, quoting paragraph 37 of the Commentary on Article 23 of the OECD Model.

294 Paragraph 16 of the Commentary on Article 23 of the UN Model, quoting paragraphs 38 – 46 of the Commentary on Article 23 of the OECD Model.

591. As is generally the case in respect of the credit method, the residence country is not obliged to provide a credit for the foreign tax to the extent that the foreign tax exceeds the amount of tax which is payable on that income in the residence state (ordinary credit).[295]

Paragraph 3

592. Countries using the exemption method may apply either the "full exemption" or "exemption with progression" approach.[296] Under the full exemption approach, income which may be taxed in the other country is not taken into account at all for purposes of taxation in the state of residence state whereas it is taken into account for tax purposes under the "exemption with progression" approach. Examples of the application of the full exemption and exemption with progression approaches are found in the Commentary.[297]

593. Paragraph 3 expressly provides for the exemption with progression approach pursuant to which the income, while it is exempt from tax in the country of residence, may nevertheless be taken into account in determining the rate of tax applied to other income of that resident.[298]

594. For similar reasons, since the amount of a taxpayer's taxable income or capital may be relevant for non-tax purposes, for example for social benefits, the Commentary provides an alternative formulation of paragraph 1 that allows exempt income to be taken into account when determining the taxable income. Under this alternative provision, instead of reducing the taxpayer's income or capital by the

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295 See the different methods of credit ("ordinary credit" and "full credit") in paragraph 14 of the Commentary on Article 23 of the UN Model, quoting, in particular, paragraph 16 of the Commentary on Article 23 of the OECD Model.

296 Paragraph 14 of the Commentary on Article 23 of the UN Model, quoting, in particular, paragraphs 14 and 20–22 of the Commentary on Article 23 of the OECD Model.

297 Paragraph 14 of the Commentary on Article 23 of the UN Model, quoting paragraph 20 of the Commentary on Article 23 of the OECD Model.

298 Paragraph 16 of the Commentary on Article 23 of the UN Model, quoting paragraphs 55 and 56 of the Commentary on Article 23 of the OECD Model.

amount of the foreign income or capital, the taxpayer's tax liability is reduced by the amount of tax applicable to that foreign income or capital.[299] If this alternative formulation of paragraph 1 of Article 23A is adopted in a treaty, paragraph 3 is not necessary and may be omitted.

2. Article 23 B—Credit method

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

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

Paragraph 1

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

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

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

299 Paragraph 16 of the Commentary on Article 23 of the UN Model, quoting paragraph 37 of the Commentary on Article 23 of the OECD Model.

types of income regardless of source ("separate basket limitation"). Some countries apply an "overall credit" system under which the total of all foreign taxes is credited against the domestic tax applicable to the total foreign income.

600. In theory, a country could wish to give full credit for the source taxation under the treaty, for example, where the source tax permitted under the treaty would exceed the tax that would be imposed in the residence country.[300] While the Commentary recognizes that possibility,[301] it would be very unusual for a country to agree to do so in a treaty.

601. Paragraph 1 of Article 23 B, like paragraph 1 of Article 23 A, makes it clear that the obligation for the state of residence to provide relief of double taxation only applies where the income is taxed by the other state as the state of source or as the state of location of a permanent establishment or fixed base to which the income is attributable. As already explained,[302] this addresses situations where the two states tax the same item of income as states of residence because they attribute that income to different taxpayers who have a different residence for treaty purposes.

602. The Commentary also provides guidance on various issues related to the application of the credit method, such as the computation of the credit, the treatment of losses, etc.[303]

Paragraph 2

603. Paragraph 2 provides for exemption with progression where income is exempted by the provisions of the treaty from taxation in the residence state. In effect, this paragraph allows the country of resi-

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300 Examples of the application of the full credit and the ordinary credit are found in paragraph 14 of the Commentary on Article 23 of the UN Model, quoting paragraphs 23 – 26 of the Commentary on Article 23 of the OECD Model.

301 Paragraph 16 of the Commentary on Article 23 of the UN Model, quoting paragraph 48 of the Commentary on Article 23 of the OECD Model.

302 Paragraph 586 above.

303 Paragraph 16 of the Commentary on Article 23 of the UN Model, quoting paragraphs 60 – 69.3 of the Commentary on Article 23 of the OECD Model.

dence to take the exempt income into account in determining the tax liability in respect of other income of the taxpayer.[304]

604. Exemption with progression is discussed above in relation to paragraph 3 of Article 23 A.

Capital taxes

605. As noted in the Commentary, credit is to be allowed for income tax only against income tax, and for capital tax only against capital tax.[305]

606. If one state does not impose capital taxes, or both countries tax only domestic assets with the result that no double taxation arises, the references to capital may be deleted.

Intercorporate dividends

607. Where a parent company receives dividends from a subsidiary, juridical double taxation of the dividends is relieved by the credit method under Article 23 A or Article 23 B. However, recurrent corporate taxation may still occur where corporate profits are taxed first at the level of the subsidiary and again upon distribution at the level of the parent company.

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

609. The Commentary discusses this issue[306] and identifies three possible solutions:

— Exemption with progression in respect of the dividends received by a parent company from its subsidiary in a treaty partner country

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304 Paragraph 18 of the Commentary on Article 23 of the UN Model, quoting paragraph 79 of the Commentary on Article 23 of the OECD Model.

305 Paragraph 16 of the Commentary on Article 23 of the UN Model, quoting paragraphs 70 and 71 of the Commentary on Article 23 of the OECD Model.

306 Paragraph 16 of the Commentary on Article 23 of the UN Model, quoting paragraphs 49 – 54 of the Commentary on Article 23 of the OECD Model.

— Credit for underlying taxes imposed on the subsidiary in respect of the profits out of which the dividends are paid (in addition to credit for tax on the dividends themselves)
— Assimilation to a holding in a domestic subsidiary, for example, access to imputation credits or participation exemptions

Tax sparing

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

611. By contrast, the exemption method ensures that no further tax will be imposed in the country of residence on the income that has benefited from the tax incentive in the source country. However, if the treaty partner is not prepared to use the exemption method, developing countries often seek to include tax-sparing provisions in their treaties. For some developing countries, preservation of the benefit of their tax incentives through relief of double taxation by the exemption method or by the inclusion of tax-sparing provisions "is a basic and fundamental aim in the negotiation of tax treaties".[307]

612. Tax sparing is an arrangement under which the developed country will agree to provide a credit for the source tax of the developing country notwithstanding that the tax has not actually been imposed because of tax incentives provided by the developing country. The purpose of tax sparing is to ensure that the benefit of the incentive is not lost to the taxpayer as a result of taxation of the income by the country of residence.[308]

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307 Paragraph 4 of the Commentary on Article 23 of the UN Model.

308 See, for example, paragraph 3 of Article 23 of the Canada-Argentina treaty (1993):
"For the purposes of subparagraph (a) of paragraph 1, tax payable in Argentina by a company which is a resident of Canada in respect of profits attributable to manufacturing activities or to the exploration or exploitation of natural resources carried on by it in Argentina shall be deemed to include any amount which would have been payable thereon as Argentine tax for any year but for an exemption from, or reduction of, tax granted for that year or any part thereof under specific provisions

613. While some developed countries are prepared to agree to such provisions with their least developed treaty partners, many are resistant to a tax-sparing provision, as recognized in the OECD report entitled *Tax Sparing: a Reconsideration,* which recommended caution as regards the inclusion to tax-sparing provisions in treaties.[309] In particular, the report noted that tax sparing was vulnerable to taxpayer abuse and was not necessarily an effective tool for promoting economic development.[310] The report did not recommend that tax-sparing should never be granted but suggested that it should be considered only in the case of states whose economic level was considerably below that of OECD member states. It also recommended the use of "best practices", such as the inclusion of the limitations described below, in order to minimize the potential for abuse.

614. The Commentary suggests three different forms that tax-sparing provisions may take, namely, a deduction for the tax that the source state could have imposed, a deduction for a fixed rate of tax or an exemption of the income.[311]

615. Countries that are prepared to include tax-sparing provisions should ensure that the incentives for which tax sparing is sought are described with sufficient precision so that the other country knows exactly which measures are covered. This may involve a reference to legislation that sets out which income or projects are eligible for the incentive. Increasingly, tax-sparing provisions include certain limitations, for example:

— The eligible incentives may be limited to certain types of investment or activities, for instance, genuine investments aimed at developing the domestic infrastructure of the developing country.

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of Argentine legislation that the competent authority of Canada agrees should be covered by this provision, and only to the extent that the said provisions have the effect of exempting or relieving a source of income for a period not in excess of ten years."

309 OECD (1998), *Tax Sparing: A Reconsideration*, OECD Publishing, Paris, https://doi.org/10.1787/9789264162433-en.

310 Paragraph 18 of the Commentary on Article 23 of the UN Model, quoting paragraph 75 of the Commentary on Article 23 of the OECD Model.

311 Paragraph 16 of the Commentary on Article 23 of the UN Model quoting paragraph 74 of the Commentary on Article 23 of the OECD Model.

— Tax sparing may apply only to active business income (not passive income such as interest, royalties or leasing payments).

— Tax sparing may not apply to financial activities such as banking and insurance.

— A "sunset" clause may apply, for instance, a provision that states that tax sparing will apply only for a limited period (such as 10 years), unless further extended by agreement between the two countries.[312]

616. The Commentary discusses other approaches that may be adopted by countries seeking to preserve the benefit of their tax incentives, namely:

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

— Providing in a treaty that income benefiting from a tax incentive will be exempt from tax in the investor's country of residence until repatriated, or

— Allowing the residence country to tax the income but requiring it to transfer to the source country amounts of tax that are reasonably attributable to that country's tax incentives.[313]

617. Negotiators from countries that wish to include tax-sparing provisions in their treaties should read paragraphs 3 to 12, as well as paragraphs 16 to 18 of the Commentary on Article 23 of the UN Model, quoting paragraphs 72 to 78.1 of the Commentary on Article 23 of the OECD Model.

G. Chapter VI—Special provisions

618. Chapter VI of both the UN and OECD models includes so-called "special" provisions dealing with non-discrimination, the mutual agreement procedure, exchange of information, assistance in the collection of taxes, fiscal privileges of members of diplomatic missions or consular posts and entitlement to treaty benefits.

312 Paragraph 12 of the Commentary on Article 23 of the UN Model.

313 Paragraphs 3 – 9 of the Commentary on Article 23 of the UN Model.

1. Article 24—Non-discrimination

619. Tax discrimination can be a significant barrier to cross-border investment and activities where different tax treatment puts foreign investors at a competitive disadvantage vis-à-vis local investors conducting similar activities. Article 24 seeks to address common forms of tax discrimination by preventing Contracting States from applying discriminatory measures in certain situations.

620. It should be noted that the Article precludes discrimination only on the basis of specific criteria (for example, nationality or foreign ownership) where the relevant circumstances are otherwise comparable. The Article does not preclude all tax distinctions, only the particular forms of discrimination specified therein. Some differences in tax treatment are recognized as being legitimate, for example, different methods of taxing residents and non-residents. Other forms of tax discrimination may be less acceptable but are nevertheless not precluded by the treaty.

621. It should also be noted that tax treatment that is specifically allowed by other Articles of the treaty cannot be regarded as being in violation of Article 24. For example, Article 9 (Associated enterprises), which expressly allows transfer pricing adjustments in non-arm's length situations, could in certain cases justify treating differently a domestic company owned by a non-resident parent and a domestic company owned by a resident parent. Furthermore, while Article 24 is not intended to provide more favorable treatment to foreign investors than to locals, a domestic law treatment that does in fact provide such favorable treatment is not a violation of the article.

622. If a domestic law treatment is found to violate the non-discrimination rules of a tax treaty, the domestic law is not itself invalidated. The domestic law will continue to apply in cases that are not covered by the treaty, for example, in relation to persons who do not come within the scope of the treaty. The domestic law of a country, however, must be applied in a way that does not discriminate against a resident or national of a treaty partner where that law would otherwise constitute a breach of Article 24. For example, if the domestic law of a country provides for more onerous tax treatment for persons that are not nationals of the country, then nationals of the treaty country (but not others) must be given the same treatment as nationals of the country applying the law.

623. The general principles governing the application of Article 24 are discussed in the Commentaries.[314]

624. Even if a particular type of tax discrimination is not addressed in Article 24, developing countries wishing to attract foreign investment should, as far as possible, try to avoid discriminatory tax treatment in their domestic law. If, however, a measure included in the domestic law of a country would potentially breach Article 24 but the country, for valid policy reasons (such as the prevention of tax avoidance or evasion), considers that a tax treaty should not prevent its application, the treaty negotiators for that country should be prepared to explain the measure during treaty negotiations in order to try to exclude that measure from the scope of application of Article 24. This is sometimes done, for example, as regards certain thin capitalization rules.

Paragraph 1

625. Paragraph 1 stipulates that a Contracting State may not tax nationals of the other state differently from its own nationals.

626. The term "national" is defined in Article 3,[315] and includes legal persons, partnerships and associations that derive their status as such from the law of the country, as well as individuals who are nationals of that country. For legal persons, partnerships and associations, this generally means that the entity is incorporated or established in that country.

627. Nationals of a treaty partner country cannot be taxed at a higher rate, or subjected to different or more onerous administrative or compliance obligations than those applicable to a state's own nationals who are, for tax purposes, in the same circumstances. The text of paragraph 1 makes it clear that the comparison must be made between nationals of the two countries that have the same residential status, that is to say, a national of state A who is a resident of state B is not "in the same circumstances" as a national of state A who is a resident of state A. Issues relating to the meaning of "in the same circumstances" should be resolved by reference to the Commentaries and the examples provided therein.[316]

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314 Paragraph 1 of the Commentary on Article 24 of the UN Model, quoting paragraphs 1 – 4 of the Commentary on Article 24 of the OECD Model.

315 Paragraph 1 (*f*) of Article 3 of the UN Model.

316 Paragraph 2 of the Commentary on Article 24 of the UN Model, quoting

628. The second sentence of paragraph 1 provides that tax discrimination against nationals of the treaty partner country who are residents of a third state must also be eliminated.

Paragraph 2

629. Paragraph 2 precludes tax discrimination against stateless persons who are residents of one of the states. In the absence of this provision, stateless persons would not be protected against discrimination on the basis of nationality. Many treaties, however, omit paragraph 2. The Commentary on Article 24 also offers alternatives that modify the scope of the paragraph.[317]

Paragraph 3

630. Paragraph 3 ensures that a permanent establishment in a treaty partner country is not less favorably taxed than a local enterprise carrying on the same activities.

631. Difficult issues can arise with respect to the application of this provision, and negotiators are strongly advised to read the Commentaries for guidance on the implications of the equal treatment requirement for:

— Assessment of tax;
— Treatment of dividends received in respect of holdings owned by permanent establishments;
— Structure and rate of tax;
— Withholding tax on dividends, interest and royalties received by a permanent establishment;
— Credit for foreign tax;
— Extension to permanent establishments of the benefit of the credit provisions of double taxation conventions with third states.[318]

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paragraphs 5 – 25 of the Commentary on Article 24 of the OECD Model.

317 Paragraph 2 of the Commentary on Article 24 of the UN Model, quoting paragraphs 30 – 31 of the Commentary on Article 24 of the OECD Model.

318 Paragraph 2 of the Commentary on Article 24 of the UN Model, quoting paragraphs 33 – 72 of the Commentary on Article 24 of the OECD Model.

632. One issue of particular importance to many developing countries is that paragraph 3 would preclude the application of branch profits taxes that take the form of an additional tax (or higher tax rate) on the profits of a permanent establishment. Countries that wish to continue to impose such taxes commonly include a specific provision—generally in Article 10 (Dividends)—that allows them to impose an additional tax on the taxable profits of a permanent establishment.[319] As the application of the branch profits tax is then specifically authorized by the treaty, such treatment cannot be regarded as a violation of paragraph 3 of Article 24.

Paragraph 4

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

634. The paragraph clarifies, however, that domestic law restrictions on deductions for payments to non-residents do not violate paragraph 4 to the extent that paragraph 1 of Article 9 or paragraph 6 of Articles 11, 12 or 12A permit the application of these restrictions. As explained in the Commentary, paragraph 4 would not, therefore, prevent the application of a thin capitalization rule applicable only to payments to non-residents as long as the rule would be compatible with paragraph 1 of Article 9 or paragraph 6 of Article 11.

635. In some developing countries, deductibility of payments to non-residents may be conditional upon these payments being taxed in these countries. The Commentary[320] suggests that where this is the case, the issue should be discussed during the negotiations.

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319 Paragraphs 18–24 of the Commentary on Article 10 of the UN Model.

320 Paragraph 3 of the Commentary on Article 24 of the UN Model.

Paragraph 5

636. Paragraph 5 provides that foreign-owned enterprises of a state shall not be subjected in that state to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which locally-owned similar enterprises of that state are subjected. It is aimed at ensuring that local enterprises are taxed in the same way irrespective of who owns or controls their capital.

637. This paragraph is concerned only with taxation of the enterprise itself, and not with taxation of the owners or of the distributions made by the enterprise, or with rules that depend on the relationship between the enterprise and other enterprises, for example, consolidation or loss transfers rules.

638. Countries that have special rules relating to foreign-owned companies that they consider important to maintain should raise this matter during negotiations and, if necessary, make specific provision for them.

Paragraph 6

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

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

2. Article 25—Mutual agreement procedure

641. Article 25 provides a mechanism, the mutual agreement procedure (MAP), which allows states, through their competent authorities, to consult together and resolve issues and uncertainties relating to the application or interpretation of a tax treaty and even to the elimination of double taxation in cases not covered by the treaty.

642. The G20/OECD BEPS project that began in 2013 recognized that its recommendations to counter base erosion and profit shifting had to be complemented with work aimed at improving the effectiveness of the mutual agreement procedure as a mechanism for resolving treaty-related disputes. That work was done under Action 14 (Making dispute resolution mechanisms more effective) of the BEPS Action Plan. While the final report on Action 14[321] did not propose major changes to the wording of Article 25, it introduced a minimum standard with respect to the resolution of treaty-related disputes that had the following objectives:

— Ensure that treaty obligations related to the mutual agreement procedure are fully implemented in good faith and that MAP cases are resolved in a timely manner;

— Ensure the implementation of administrative processes that promote the prevention and timely resolution of treaty-related disputes; and

— Ensure that taxpayers can access the MAP when eligible.[322]

643. The large number of countries that have joined the Inclusive Framework on BEPS[323] have committed to implement that minimum standard. Since parts of the minimum standard relate to what these countries should include in Article 25 of their treaties, negotiators for these countries (and for countries that enter into treaty negotiations with these countries) must be aware of the relevant parts of the BEPS minimum standard on the resolution of treaty-related disputes. The minimum standard requires that these countries include paragraphs 1, 2 and 3 of Article 25 of the OECD Model in their treaties, although it allows them to use alternative mechanisms instead of strictly following the wording of the first sentence of paragraph 1 and the second sentence of paragraph 2.[324]

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321 OECD (2015), *Making Dispute Resolution Mechanisms More Effective, Action 14—2015 Final Report*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/9789264241633-en.

322 Page 9 of the report.

323 Note 23.

324 Pages 13, 22 and 26 of the report.

644. Statistics[325] prepared in accordance with the minimum standard show that the vast majority of mutual agreement procedure cases involve two developed countries. Few mutual agreement cases involve developing countries (other than large emerging economies such as India and China). Despite that fact, countries that enter into tax treaties must be in a position to meet their obligations with respect to the mutual agreement procedure, that is to say, they must establish processes within their tax administrations to enable taxpayers, or competent authorities from treaty partner countries, to present cases for consideration. Suitably trained senior personnel must also be chosen to perform the role of competent authority and be available to resolve cases and, where necessary, to consult with the competent authority of the treaty partner country with a view to reaching a solution. If these countries have joined the Inclusive Framework on BEPS, they must also follow the various requirements of the minimum standard on the resolution of treaty-related disputes that address various aspects of the mutual agreement procedure.

645. The UN Model has two versions of Article 25. The only difference between the two alternative versions (alternative A and alternative B) is that alternative B includes an additional paragraph (paragraph 5) that provides for the mandatory arbitration of issues that the competent authorities are unable to resolve within three years. As explained below, that paragraph, which is similar to paragraph 5 of Article 25 of the OECD Model, is rarely found in treaties concluded by developing countries.

646. The term "competent authority" is defined in paragraph 1 (*e*) of Article 3. While countries are free to choose who is designated for that purpose, it is important that the persons or authorities so designated have sufficient authority to effectively negotiate with their counterparts in the other country and to make binding decisions with respect to the cases brought before them. The competent authority will therefore generally be defined as the relevant minister or head of the tax administration and its authorized representatives, which means that senior officials in the tax administration or the ministry in charge of finance will perform the role assigned to the competent authority by the treaty.

325 See the statistics for 2016 at http://www.oecd.org/tax/dispute/mutual-agreement-procedure-statistics-2016-per-country-all.htm.

647. The Commentary provides extensive guidance on how Article 25 should be interpreted and applied.[326] One of the issues that it addresses is the relationship between the mutual agreement procedure and the administrative and judicial recourses available under domestic law. The mutual agreement procedure is separate from, and additional to, these domestic law recourses. For instance, procedural requirement and time limitations for domestic recourses are not applicable to the mutual agreement procedure. In order to avoid conflicting decisions, however, most countries will not allow a taxpayer to pursue both the mutual agreement and domestic law recourses simultaneously. In most countries, a solution reached under the mutual agreement procedure cannot override a previous court decision rendered in the same case in accordance with domestic law remedies. Conversely, no agreement will be concluded under the mutual agreement procedure unless the taxpayer renounces to pursue domestic law recourses with respect to the same issues.[327]

648. In addition to the guidance found in the Commentary, detailed explanations on the practical application of the mutual agreement procedure may be found in the Chapter on Mutual Agreement Procedure of the proposed United Nations *Handbook on Dispute Avoidance and Resolution*.[328]

Paragraph 1

649. Paragraph 1 provides an avenue for taxpayers to ask the tax authorities to address potential violations of the provisions of a tax treaty. The requirements are:

— The person considers that its tax treatment in one or both states is not, or will not be, in accordance with the treaty.[329]

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326 See, in particular, paragraph 9 of the Commentary on Article 25 of the UN Model, which quotes various paragraphs of the Commentary on Article 25 of the 2014 and 2017 versions of the OECD Model.

327 Paragraph 9 of the Commentary on Article 25 of the UN Model, quoting paragraphs 42 to 45 of the Commentary on Article 25 of the 2014 OECD Model.

328 The latest version of that Chapter is available at https://www.un.org/esa/ffd/events/event/tax-eighteenth-session.html.

329 It should be noted that the Mutual Agreement Procedure does not

— The case must be presented to the competent authority of the state of residence of the taxpayer or, in cases involving a claim of discrimination based on nationality to which paragraph 1 of Article 24 could apply, of the state of nationality of the taxpayer.
— The case must be presented within three years from the time the person is notified of the action that allegedly will result in taxation not in accordance with the treaty (for instance, a notice of assessment).

650. The only difference with paragraph 1 of the OECD Model relates to the second requirement. Paragraph 1 of the OECD Model was modified in 2017 to allow a person to present a case to the competent authority of either state. The Commentary on the OECD Model, however, provides that states may decide to use the formulation that is found in the UN Model.[330] While the minimum standard introduced by the final report on BEPS Action 14 requires the countries that are members of the Inclusive Framework on BEPS to include paragraph 1 of the OECD Model in their treaties,[331] it allows the use of the version found in the UN Model as long as the country implements "a bilateral notification or consultation process for cases in which the competent authority to which the MAP case was presented does not consider the taxpayer's objection to be justified".[332] Developing countries that need to comply with the minimum standard should implement such a notification or consultation process if they are not willing to allow their residents to present a MAP case (other than a case related to paragraph 1 of Article 24) to the competent authority of the other state.

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deal with claims that there is a violation of domestic law except to the extent that the alleged violation would give rise to taxation that is not in accordance with the treaty.

330 Paragraph 18 of the Commentary on Article 25 of the OECD Model. Conversely, the Commentary on the UN Model provides that the countries may agree to use the same formulation as that found in the OECD Model: see paragraph 9 of the Commentary on Article 25 of the UN Model, quoting paragraph 19 of the Commentary on Article 25 of the 2014 OECD Model.

331 See paragraph 643 above.

332 Note 321, page 22.

651. Countries may wish to allow more time for taxpayers to present their cases, for instance by providing a time limit that would better align with time limits for challenges to tax actions under their domestic law. While the Action 14 minimum standard prevents countries that are members of the Inclusive Framework on BEPS from agreeing to a period that would be shorter than three years, a longer period may be agreed upon to reflect the period allowed for objections under domestic law.

652. The Commentary does not stipulate any special procedure as to how requests for mutual agreement are to be presented.[333] Appropriate procedures, conditions, methods and techniques may be agreed to by the competent authorities under paragraph 4 of Article 25 of the UN Model. The Commentary[334] highlights some of the information that a state would typically require in order to consider that a MAP request has been correctly presented. Given that, under paragraph 5 of alternative B, the presentation of a MAP request that includes all the necessary information is the starting point of the period of time after which arbitration may be requested, more details on the information required for that purpose would typically be provided in the mutual agreement that provide the details of the arbitration process.[335]

Paragraph 2

653. Paragraph 2 sets out the obligations of the competent authority to whom the case is presented.

654. Paragraph 2 is identical in the UN and OECD models. The minimum standard introduced by the final report on BEPS Action 14 requires the countries that are members of the Inclusive Framework on BEPS to include paragraph 2 in their treaties but, as discussed below, allows them to depart from the requirement of the second sentence if they adopt a different approach.[336] It does allow these countries, how-

333 Paragraph 9 of the Commentary on Article 25 of the UN Model, quoting paragraph 16 of the Commentary on Article 25 of the OECD Model.

334 Paragraphs 22–24 of the Commentary on Article 25 UN Model.

335 Paragraph 18 of the Commentary on Article 25 UN Model, quoting paragraph 75 of the Commentary on Article 25 of the OECD Model.

336 See paragraph 643 above.

ever, not to include the second sentence of the paragraph (according to which an agreement reached under the MAP must be implemented regardless of any time limit found in domestic law) provided that they are willing to accept alternative treaty provisions that limit the time during which a state may make an adjustment to the profits of an enterprise or a permanent establishment under paragraph 2 of Article 7 or paragraph 1 of Article 9.[337]

655. As explained in the first sentence of paragraph 2, the first stage of the MAP process concerns the competent authority of the state that receives a request for MAP that conforms to paragraph 1. That competent authority must first consider whether the request is justified.[338] If it concludes that this is the case and that the taxation not in accordance with the treaty results from the action of its own state, the competent authority must resolve the matter through unilateral action, for example, by providing relief of double taxation in accordance with Article 23.[339]

656. If, on the other hand, it considers that the taxation not in accordance with the treaty results from the action of the other state, it must initiate the second stage of the mutual agreement procedure, which requires that it consult the competent authority of the other state with a view to resolving the case.[340]

657. If a solution is reached, the second sentence of paragraph 2 provides that this solution must be implemented notwithstanding any time limits in domestic law, for instance a time limit beyond which the tax administration should not make any tax adjustment with respect to a given tax year. While some countries consider that the time limit for implementation of mutual agreements should be linked to domestic law time limits, it should be noted that the application of domestic law time limits may effectively remove the taxpayer's ability to obtain relief under the mutual agreement procedure, for example, if a late adjustment is

337 Note 321, page 26. See also paragraph 331 above.

338 Paragraph 9 of the Commentary on Article 25 UN Model, quoting paragraph 31 of the Commentary on Article 25 of the 2014 OECD Model.

339 Paragraph 9 of the Commentary on Article 25 UN Model, quoting paragraph 32 of the Commentary on Article 25 of the 2014 OECD Model.

340 Paragraph 9 of the Commentary on Article 25 UN Model, quoting paragraph 33 of the Commentary on Article 25 of the 2014 OECD Model.

made in one country and domestic law time limits prevent a corresponding adjustment in the other country. In any event, countries that are members of the Inclusive Framework on BEPS are, in principle, required to include the second sentence of paragraph 2 in their treaties. The minimum standard on Action 14 allows them, however, to depart from this requirement provided that they are willing to accept alternative treaty provisions that limit the time during which a state may make an adjustment to the profits of an enterprise or a permanent establishment under paragraph 2 of Article 7 or paragraph 1 of Article 9.[341]

Paragraph 3

658. According to the first sentence of paragraph 3, which is the same in the UN and OECD models, the competent authorities shall try to resolve by mutual agreement issues relating to interpretation or application of the treaty. The second sentence of the paragraph also authorizes them to consult each other for the elimination of double taxation in cases not dealt with under the treaty, for example, where a resident of a third state has a permanent establishment in both Contracting States and the double taxation involves the profits of these two permanent establishments.

659. The laws of some countries do not permit the elimination of double taxation in cases not dealt with under the treaty. While these countries may be tempted not to include the second sentence of paragraph 3 in their treaties, they should remember that the minimum standard on Action 14 requires countries that are members of the Inclusive Framework on BEPS to include both parts of paragraph 3 in their treaties.[342] They should also note, however, that the second sentence of paragraphs 3 merely authorizes a consultation between the competent authorities and does not require them to eliminate double taxation is cases not covered by the treaty.

Paragraph 4

660. Paragraph 4 authorizes the competent authorities to communicate with each other directly for purposes of the mutual agreement procedure. They may consult, without the need for diplomatic formali-

341 Note 321, page 26. See also paragraph 331 above.

342 Note 323, page 13.

ties, through any means, for example, by letter, e-mail, telephone or face-to-face meetings. They may also establish a formal joint commission consisting of themselves or their representatives.

661. Some countries prefer to address cases solely through direct, informal means, and not through a joint commission. These countries omit the words "including through a joint commission consisting of themselves or their representatives".

662. The second sentence of paragraph 4 of the UN Model, which has no equivalent in the OECD Model, allows the competent authorities to develop, through consultation, bilateral procedures for the implementation of the mutual agreement procedure. Procedural issues, and suggestions for possible procedures that could be adopted by the competent authorities, are discussed in paragraphs 20 to 46 of the Commentary on Article 25 of the UN Model. These paragraphs cover:

- Aspects of the mutual agreement procedure that should be dealt with;
- Necessary cooperation of the person who makes the request;
- Information on adjustments;
- Initiation of competent authority consultation at the point of proposed or finalized adjustments;
- Correlative adjustments;
- Publication of competent authority procedures and determinations;
- Procedures to implement adjustments, and
- Unilateral procedures.

663. As already mentioned, more detailed guidance on the practical implementation of the mutual agreement procedure may be found in Chapter 5 of the United Nations *Handbook on Dispute Avoidance and Resolution*.[343]

Paragraph 5

664. Paragraph 5, which is only found in alternative B of Article 25 of the UN Model and corresponds to paragraph 5 of Article 25 of the

343 See paragraph 648.

OECD Model, provides for the binding arbitration of unresolved issues that prevent the competent authorities from resolving a case submitted to the mutual agreement procedure by a taxpayer.

665. Developing countries rarely agree to include paragraph 5 in their treaties. As shown by the fact that there are two alternative versions of Article 25 in the UN Model, one with the arbitration provision and the other without, the inclusion of that provision in the UN Model was a controversial issue. This is confirmed by paragraphs 3 to 5 of the Commentary on Article 25, which discuss various policy and administrative considerations relevant to whether or not an arbitration provision should be included in a tax treaty and present a series of arguments that were raised in favor and against such a provision when the issue was discussed by the UN Committee of Experts. These arguments should be carefully evaluated when a country develops its tax treaty policy framework and country model (see section II.B).

666. There are four main differences between the arbitration provision found in alternative B of the UN Model and that in the OECD Model. These are discussed in paragraph 13 of the Commentary on Article 25 of the UN Model.

667. Countries for which mandatory arbitration as provided for in the UN and OECD models is not appropriate may wish to consider alternatives proposed in the Commentary, such as voluntary arbitration (pursuant to which both competent authorities must agree, on a case-by-case basis, to submit the matter to arbitration),[344] or limitation to a certain range of cases, for example, issues of fact such as those found in transfer pricing matters or whether a permanent establishment exists.[345]

668. Although paragraph 5 provides that unresolved issues arising from a MAP case presented under paragraph 1 must be submitted to arbitration, it does not provide the details of the arbitration process. Even countries that agree in principle to provide for arbitration may have different views as regards the type of arbitration that they would like to have. Some countries address certain aspects of the arbitration process in Article 25 itself, in a protocol or through an exchange of dip-

344 Paragraphs 14 – 16 of the Commentary on Article 25 of the UN Model.

345 Paragraph 18 of the Commentary on Article 25 of the UN Model, quoting paragraph 66 of the Commentary on Article 25 of the OECD Model.

lomatic notes. In addition, the last sentence of paragraph 5 indicates that the competent authorities of the two states shall settle the mode of application of paragraph 5 by mutual agreement. The Commentary indicates that, ideally, such a "procedural" mutual agreement should be drafted at the same time as the treaty so that it can be implemented as soon as the arbitration provision becomes effective.[346]

669. Various design issues related to MAP arbitration are discussed in the Commentary.[347] In addition, the Annex to the Commentary on paragraph 5 of Article 25 (alternative B) reproduces with the necessary adaptations the sample mutual agreement with detailed explanations that is found in the Annex to the Commentary on Article 25 of the OECD Model. That sample mutual agreement is intended to be used by the competent authorities as a basis for drafting the mutual agreement that would provide the practical details of the arbitration process.

Interaction with the General Agreement on Trade in Services

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

671. The dispute resolution mechanism of the GATS cannot be invoked with respect to disputes relating to the application of the national treatment rule in Article XVII of the GATS if the disputed measure falls within the scope of a tax treaty. If, however, countries do not agree as to whether a measure falls within the scope of a tax treaty, this matter may be subjected to arbitration under GATS but, in the case of a tax treaty that existed at the time of entry into force of the GATS, only if both states agree.[348] Countries that wish to ensure that this exception applicable to tax treaties that existed at the time of entry into force of

346 Paragraph 18 of the Commentary on Article 25 of the UN Model, quoting paragraph 85 of the Commentary on Article 25 of the OECD Model.

347 Paragraph 18 of the Commentary on Article 25 of the UN Model, quoting paragraphs 63–85 of the Commentary on Article 25 of the OECD Model, as well as paragraph 19 of the Commentary on Article 25 of the UN Model.

348 Footnote to paragraph 3 of Article XXII of the GATS.

the GATS is extended to subsequent treaties should include in these treaties the provision set out in the Commentary.[349]

3. Article 26—Exchange of information

672. As the economy has become increasingly globalized, cooperation between tax authorities has become a vital part of international tax systems. All modern tax treaties provide for the exchange of tax information between the competent authorities of the two countries while ensuring that confidentiality with respect to taxpayer information is maintained. As explained under Article 27 below, an increasing number of treaties also provide for reciprocal assistance between the two tax administrations in collecting outstanding tax liabilities.

673. A tax treaty authorizes and requires tax administrations to obtain and exchange relevant tax information, including information held by financial institutions. This is a very powerful tool in preventing tax evasion and, as noted in the Commentary on Article 26 of the UN Model, is, from the perspective of many developing countries, also important in "curtail[ing] the capital flight that is often accomplished through such evasion and avoidance".[350]

674. Exchange of information has been a key focus of tax administrations since the early 2000s when the OECD *Global Forum on Transparency and Exchange of Information for Tax Purposes* was established with a view to implementing internationally agreed standards on transparency and exchange of information on request. As of 15 August 2018, 153 jurisdictions participated in the work of the Global Forum. Comparable standards for exchange of tax information are now found in the UN and OECD models, the model Agreement on Exchange of Information on Tax Matters[351] and the Council of Europe-OECD *Multilateral Convention on Mutual Administrative Assistance in Tax Matters*.[352] On 20 April 2017, the United Nations Economic and Social

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349 Paragraph 47 of the Commentary on Article 25 of the UN model, quoting paragraph 93 of the Commentary on Article 25 of the OECD Model.

350 Paragraph 1.1 of the Commentary on Article 26 of the UN Model.

351 Available at http://www.oecd.org/ctp/exchange-of-tax-information/2082215.pdf.

352 Available at http://www.oecd.org/ctp/exchange-of-tax-information/ENG-Amended-Convention.pdf.

Council adopted the UN *Code of Conduct on Cooperation in Combating International* Tax Evasion,[353] whose main goal is that all states that follow the code "provide that high levels of transparency and exchange of information in tax matters are adhered to, in particular, automatic exchange of information".

675. As a result of these efforts, any country wishing to enter into a tax treaty must now be prepared to commit to the current international standards for exchange of information reflected in Article 26 of the UN Model. The *Global Forum on Transparency and Exchange of Information for Tax Purposes* monitors country practices to ensure that countries adhere to internationally agreed wording in their tax treaties and in their tax information exchange agreements. The Global Forum also monitors how countries apply the exchange of information provisions of their international agreements to ensure effective exchanges of information.

676. Countries also need to ensure that their tax administrations have the legal and administrative ability to obtain and exchange tax information. Some developing countries may have concerns about the administrative burden placed on their revenue agencies by the obligation to exchange tax information, but should always take account of the benefits of access to tax information in addressing these concerns. These countries may wish to include in their model a provision requiring extraordinary costs incurred in providing information to be borne by the party requesting the information.[354]

677. The Commentary on Article 26 of the UN Model provides detailed guidance on the interpretation and application of the provisions of the Article and should be carefully read by negotiators and competent authorities. In particular, it addresses the different mechanisms for exchanging tax information[355] and provides practical guidance on:

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353 E/RES/2017/3, available at http://www.un.org/ga/search/view_doc.asp?symbol=E/RES/2017/3.

354 Paragraphs 29.3 and 29.4 of the Commentary on Article 26 of the UN Model.

355 See Section C, Inventory of exchange mechanisms, paragraph 30 of the Commentary on Article 26 of the UN Model.

— Automatic exchanges of information.
— Transmittal on specific request.
— Spontaneous (discretionary) transmittal of information.
— Use of information received.
— Consultation among several competent authorities.
— Factors affecting the implementation of exchange of information and the structure of exchange of information processes.

678. The OECD 2006 *Manual on the implementation of exchange of information provisions for tax purposes*[356] also provides practical assistance to officials dealing with exchange of information, and may be helpful in designing or revising national manuals. It covers:

— General and legal aspects of exchange of information.
— Exchange of information upon request.
— Spontaneous information exchange.
— Automatic exchange of information.
— Industry-wide exchange of information.
— Simultaneous tax examinations.
— Tax examinations abroad.
— Country profits regarding information exchange.
— Information exchange instruments and models.

679. When negotiating a new treaty or revising an existing one, it is important to be clear as to when new provisions related to exchange of information will become effective. As noted in the Commentary,[357] the wording of the UN model does not prevent the application of the provisions of Article 26 to the exchange of information that existed prior to the entry into force of a new treaty. In many cases, a new treaty will provide that its provisions, including those of Article 26, will have effect with respect to taxes arising or levied from a certain time after the entry into force of the treaty. In such cases, it will be possible to exchange pre-existing information as long as the request for exchange

356 Available from http://www.oecd.org/ctp/exchange-of-tax-information/36647823.pdf.

357 Paragraph 5.5 of the Commentary on Article 26 of the UN Model.

is made after the treaty has entered into force and the information is requested for the purpose of the application of taxes with respect to which the provisions of the treaty have effect. The negotiators may want to clarify the temporal application of Article 26. Also, some countries may prefer to limit the period for which information may be requested.

680. A detailed discussion of administrative issues relating to exchange of information may also be found in chapter IX of the United Nations *Handbook on Selected Issues in Administration of Double Tax Treaties for Developing Countries*.[358]

681. While historically the exchange of information upon request has been considered the most crucial form of transparency, over the past decade exchange of information on an automatic basis has grown significantly in importance. For example, one of the international minimum standards that was established in 2013 as part of the OECD/G20 BEPS project was that all participating countries should engage in the automatic exchange of so-called "country-by-country" data that shows the business activities of multinational groups across all of the jurisdictions in which they operate. This data is intended to be used strictly for transfer pricing risk assessment purposes. Additionally, many countries are now implementing agreements or arrangements that provide for the automatic exchange of information about the bank activities of their residents in other countries as a means to improve income tax compliance.[359] While as a theoretical matter the exchange of information on an automatic basis has the potential to improve tax compliance, countries must be equipped with sufficient technological capabilities to handle and process large amounts of data properly, as well as both legal and administrative protections to keep the data confidential.

Paragraph 1

682. Paragraph 1 authorizes and requires the exchange of relevant information on all taxes, whether or not they are taxes covered by the treaty. Information must be obtained and exchanged by the competent

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

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

authorities if it is "foreseeably relevant"[360] to the administration of either the treaty provisions or domestic law provisions (provided that the tax treatment under the domestic law is not contrary to the treaty).

683. The only difference between paragraph 1 of Article 26 of the UN Model and the equivalent paragraph in the OECD Model in that the paragraph of the UN Model specifies that "[i]n particular, information shall be exchanged that would be helpful to a Contracting State in preventing avoidance or evasion of such taxes". This statement of purpose is intended to provide explicit guidance to Contracting States on the interpretation of the Article.[361] Even in the absence of this statement, it is clear that this is the main purpose of the exchange of information provisions.

684. The paragraph is intended to have broad application. Provided the information sought is relevant to the application of the treaty or domestic taxes, exchange is not limited to information about residents of the two Contracting States, or indeed, to taxpayer-specific information at all. General information, for example, about tax avoidance schemes, may also be exchanged.

685. Information about all taxes, whether or not they are taxes covered by the treaty, may be exchanged. Countries for which this is problematic, for example, where the competent authority cannot obtain information about subnational taxes, may seek to limit the obligation to treaty taxes and other important taxes, such as the value added tax (VAT).[362]

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

Paragraph 2

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

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

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

362 For possible wording, see paragraph 8.1 of the Commentary on Article 26 of the UN Model.

tax purposes. That information may be disclosed to, and used by, officials in the tax administration of the country receiving the information for purposes of assessment, collection or enforcement of taxes in that country.

688. Paragraph 2 also allows disclosure of the information in public court proceedings and judicial decisions. As this can result in the information being made public, countries for which this is problematic should raise the matter during negotiations and may, for example, expressly provide that such disclosure be permitted only if the country supplying the information raises no objection.

689. As explained in the Commentary,[363] paragraph 2 also states that exchanged information may be disclosed to oversight bodies (for example, authorities that supervise tax administration) to the extent it is necessary to do so, provided the persons involved in the oversight activities are also subject to confidentiality requirements.

690. As a general matter, information that has been exchanged pursuant to a tax treaty may only be used for the purposes enumerated in paragraph 1, that is, only for tax purposes. However, an amendment to paragraph 2 included in the 2017 UN and OECD models permits the use of exchanged information for certain other purposes, as long as the use of information for such other purposes is permitted under the domestic laws of both Contracting States and the competent authority of the supplying state has authorized such non-tax use in writing. As the scope of such non-tax use of information exchanged under Article 26 depends on what is permitted under the domestic laws of both states, negotiators should take time to explain their respective domestic laws for the non-tax use of information exchanged under Article 26.

Paragraph 3

691. Paragraph 3 sets out the limits to the obligation to exchange information (subject to the provisions of paragraphs 4 and 5).

692. A country generally has to provide information to the other country only if that type of information would be obtainable under the law and normal practices of both countries. This should not, however, be interpreted in a way that would prevent effective exchange of

363 Paragraphs 14 and 14.1 of the Commentary on Article 26 of the UN Model.

information.[364] If there are certain types of information that cannot be obtained, this should be raised before or during negotiations.[365] Significant changes, after entry into force of a treaty, to domestic laws or administrative practices relating to obtaining or supplying information should be disclosed to the other country.[366]

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

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

Paragraph 4

695. Paragraph 4 clarifies that a state that is requested to provide information under Article 26 must use the information-gathering powers provided in its domestic law in order to obtain that information even though the information may not be required for purposes of that state's own taxation.

696. The Commentary[367] includes a possible alternative provision that countries could use instead of paragraph 4 to clarify expressly that each state must ensure that its competent authority have the necessary powers to obtain the necessary information.

Paragraph 5

697. Paragraph 5 ensures that the limitations in paragraph 3 cannot be used to prevent the exchange of information held by banks, financial institutions, nominees, agents, fiduciaries, and so forth, or of information related to ownership interests in a person. Thus, for example,

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364 Paragraph 15 of the Commentary on Article 26 of the UN Model.

365 Note that, in accordance with paragraph 5 of Article 26, domestic law bank secrecy requirements do not relieve a country's obligation to provide relevant tax information held by financial institutions.

366 See the second sentence of paragraph 4 of Article 2 of the UN Model.

367 Paragraph 26.3 of the Commentary on Article 26 of the UN Model.

bank secrecy rules in a country do not relieve the obligation on that country to supply information requested by the other country under Article 26. It is therefore important for negotiators to make sure that that their competent authorities have the necessary powers to obtain such information in response to requests from treaty partners.[368]

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

Paragraph 6

699. Paragraph 6 of Article 26 of the UN Model, which has no equivalent in Article 26 of the OECD Model,[369] provides that the competent authorities shall develop, through consultation, "appropriate methods and techniques" concerning exchange of information. Countries should consider what procedures are appropriate for the competent authority of their country to provide effective exchange of information, including exchanges made upon request or automatically or spontaneously.

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

4. Article 27—Assistance in collection

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

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368 Obviously, it is desirable that relevant tax information be obtainable for domestic law purposes as well as to satisfy requests from treaty partner countries.

369 Paragraph 10 of the Commentary on Article 26 of the OECD Model states that the manner in which the exchange of information will be effected may nevertheless be decided upon by the competent authorities of the two Contracting States.

702. It is recognized that not all countries will be in a position to accept to provide assistance in the collection of taxes.[370] While developing countries may be concerned about the practical implementation of the provisions of Article 27 and the administrative burden that these provisions could place on their tax administrations, these countries, often confronted with tax evasion and capital flight issues, may want to consider the use of these provisions to request the assistance from developed countries.

703. The provisions of Article 27 of the UN and OECD models are identical. They provide for comprehensive assistance in respect of all taxes owed to a Contracting State, provided that the conditions of the Article are met. The Commentary on Article 27 of the UN Model, however, provides drafting suggestions for more limited assistance for countries for which comprehensive assistance is not possible or is not considered to be appropriate.[371]

704. Article 27 provides not only that a state may request the other to collect taxes owed and finally determined that it cannot itself collect but also that a state can request the other state to take measures of conservancy with respect to taxes that are not finally determined, for example, where there is a risk that a taxpayer will move its assets outside a country before a tax claim becomes legally enforceable.

705. Paragraph 1 of the Article allows the competent authorities to settle how the Article is to be applied in practice. Before including an article providing for assistance in collection in a treaty, countries should have a clear view on the issues raised in paragraphs 6 to 9 of the Commentary on Article 27 of the UN Model, for example, what documentation is required, how costs will be dealt with, time limits on requests, possible minimum thresholds for requests, how amounts collected are to be remitted, and so forth.

706. Negotiators and competent authorities may also find it useful to read the provisions relating to assistance in recovery of the Council of

370 See footnote to Article 27 of the UN Model and paragraph 1 of the Commentary on Article 27 of the UN Model.

371 Paragraphs 2, 11, 12, 23, 24 and 37 of the Commentaries on Article 27 of the UN and OECD models.

Europe/OECD *Multilateral Convention on Mutual Administrative Assistance in Tax Matters* and the accompanying Explanatory Report.[372] They may also consult the OECD *Manual on Assistance in the Collection of Taxes*[373] for practical and technical guidance for tax officials involved in assistance in the collection of taxes.

5. Article 28—Members of diplomatic missions and consular posts

707. The purpose of Article 28 is to confirm that any tax-related benefits to which members of diplomatic missions or consular posts are entitled, either pursuant to customary international law or to specific agreements that countries have entered into, will not be affected by any provisions of the tax treaty. The article itself does not provide any additional tax benefits to those individuals.

708. Article 28 ensures in particular that the tax exemptions recognized in Article 34 of the *Vienna Convention on Diplomatic Relations*[374] and in Article 49 of the *Vienna Convention on Consular Relations*[375] are not affected by the provisions of the treaty.

709. The Commentary on Article 28[376] includes a few alternative provisions that countries may consider including in their treaties in order to

- Ensure that where a member of a diplomatic mission or consular post is entitled to tax exemptions in a country under international law, the right to tax the exempted income will revert to the state that sent that person to the country.
- Provide that such a person will be treated as a resident of the sending state for the purposes of the tax treaty.

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372 Available at http://www.oecd.org/ctp/exchange-of-tax-information/Explanatory_Report_ENG_%2015_04_2010.pdf.

373 Available at http://www.oecd.org/tax/exchange-of-tax-information/oecdmanualonassistanceinthecollectionoftaxes.htm

374 Note 270.

375 Note 271.

376 Commentary on Article 28 of the UN Model quoting paragraphs 2 – 4 of the Commentary on Article 28 of the OECD Model.

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

6. Article 29—Entitlement to benefits

710. Article 29 of the UN Model includes three rules that are designed to prevent the granting of treaty benefits in certain cases:

— The first rule, included in paragraphs 1 to 7, is referred to as the "limitation-on-benefits" (LOB) rule and seeks to prevent transactions or arrangements that are known to cause treaty-shopping concerns and that can be described by reference to some of their features (such as the foreign ownership of an entity).

— The second rule, in paragraph 8, denies treaty benefits to income that is attributable to a permanent establishment that an enterprise of one state has in a third state where that income is exempt from residence taxation in the state of the enterprise and is subject to no or low taxation in the state of the permanent establishment.

— The third rule, which is found in paragraph 9, is referred to as the "principal purposes test" (PPT) rule and is a general anti-abuse rule which denies treaty benefits where one of the principal purposes of transactions or arrangements is to obtain these benefits (unless it established that granting the benefits would be in accordance with the object and purpose of the treaty provisions).

711. These three rules were introduced in the UN Model in 2017 as a result of the report on BEPS Action 6 "*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*".[377] That report introduced a minimum standard on treaty-shopping that countries that are members of the Inclusive Framework on BEPS[378] have agreed to implement in their treaties. That minimum standard recognized that treaty-shopping arrangements through which persons who are not directly entitled to the benefits of a treaty seek to obtain these benefits indirectly frustrate the bilateral and reciprocal nature of tax treaties. In order to comply with that minimum standard, these countries must

377 Note 19.

378 Note 22.

include in their treaties a new preamble that indicates their intention to prevent treaty-shopping[379] and implement that intention through the inclusion in the treaty, with the necessary adaptations, of either

1) the principal purposes test rule of paragraph 9,
2) the limitation-on-benefits rule of paragraphs 1 to 7 (supplemented by the adoption of some mechanism that would deal with conduit arrangements not otherwise dealt with in the treaty); or
3) both the principal purposes test rule of paragraph 9 and the limitation-on-benefits rule of paragraphs 1 to 7 or a variation thereof. [380]

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

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

Paragraphs 1 to 7

714. The limitation-on-benefits rule found in paragraphs 1 to 7 of the UN Model constitutes a specific anti-avoidance rule that is intended to deny treaty benefits in various situations of treaty shopping. That

379 Paragraph 166 above.

380 Note 19, page 22. This minimum standard is also described in paragraph 1 of the Commentary on Article 29 of the UN Model.

rule applies to arrangements that are known to cause treaty-shopping concerns by referring to certain features of these arrangements (such as the fact that the majority of the shares of a company resident of one treaty state are owned by shareholders who are not residents of that state). It applies regardless of whether or not the arrangement was set up for treaty-shopping purposes while recognizing that in some cases, persons who are not residents of a treaty state may establish an entity in that state for legitimate business reasons; for instance, it allows the competent authority of a treaty state to grant treaty benefits that would otherwise be denied by the rule if the competent authority determines that the arrangement did not have as one of its principal purposes the obtaining of treaty benefits.

715. The limitation-on-benefits rule of the UN Model is extremely detailed. As already mentioned, the OECD model provides two alternative versions of the rule. The rule found in the UN Model corresponds to what is referred to as the "detailed version" in the OECD Model. The second version found in the OECD Model, referred to as the "simplified version", is substantially shorter even though it has most of the features of the detailed version; in some respects, however, the simplified version is not as robust as the detailed version and may allow some forms of treaty-shopping that the detailed version would prevent. For that reason, the Action 6 minimum standard on treaty shopping[381] does not allow the use of the simplified version without the addition of the principal-purposes-test rule of paragraph 9. The UN Model, however, does not include the "detailed" version included in the OECD Model because the UN Committee of Experts concluded "that the detailed version would provide the tax conventions concluded by developing countries with more robust protections against treaty shopping abuses."[382]

716. The Commentary explains that if a treaty adopts Article 29 as proposed in the UN Model and therefore includes both the limitation-on-benefits rule of paragraphs 1 to 7 and the principal-purposes-test rule of paragraph 9, the inclusion of the limitation-on-benefits rule should not be interpreted as restricting the scope of the principal-purposes-

381 Paragraph 711.

382 Paragraph 4 of the Commentary on Article 29 of the UN and OECD models.

test rule. As indicated in the Commentary "a transaction or arrangement should not be considered to be outside the scope of paragraph 9 simply because the specific anti-abuse rules of paragraphs 1 to 7, which only deal with certain cases of treaty shopping that can be easily identified by certain of their features, are not applicable."[383]

717. The Commentary also explains that if the limitation-on-benefits rule of paragraphs 1 to 7 is included in a treaty without the principal-purposes-test rule of paragraph 9, the Action 6 minimum standard on treaty-shopping will require the implementation of a mechanism that will address treaty-shopping strategies commonly referred to as "conduit arrangements". The Commentary explains that such a mechanism could take the form of an additional treaty provision or of domestic anti-abuse rules or judicial doctrines that would achieve a similar result. It also includes examples of conduit arrangements that would need to be addressed by such rules as well as examples of transactions that should not be treated as "conduit arrangements".[384]

718. The following provides a very brief overview of each of the seven paragraphs that compose the limitations of benefits rule. Detailed explanations on each of these paragraphs, which include a number of alternative provisions and adaptations that treaty negotiators wishing to adopt the limitation-on benefits rule should consider, are found in the Commentary:[385]

719. Paragraph 1 is the operative provision of the limitation-on-benefits rule. Subject to the relieving provisions of paragraphs 3 to 6, it denies treaty benefits to a resident of a Contracting State unless that person constitutes a "qualified person" as defined in paragraph 2. The paragraph provides, however, that some treaty benefits (i.e. those of the tie-breaker rule of paragraph 3 of Article 4, the corresponding

383 Paragraph 2 of the Commentary on Article 29 of the UN and OECD models.

384 Paragraph 39 of the Commentary on Article 29 of the UN Model, quoting paragraph 187 of the Commentary on Article 29 of the OECD Model.

385 Paragraphs 6 to 34 of the Commentary on Article 29 of the UN Model, which quote the parts of paragraphs 7 to 160 of the Commentary on Article 29 of the OECD Model that deal with the detailed version of the limitation-on-benefits rule.

adjustment rule of paragraph 2 of Article 9 or the mutual agreement procedure rules of Article 25) are not subject to this restriction and should therefore be granted regardless of whether or not the recipient constitutes a "qualified person".

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

- any individual;
- a Contracting State, its political subdivisions and their agencies and instrumentalities;
- certain publicly-traded companies and entities;
- certain affiliates of publicly-listed companies and entities;
- certain non-profit organizations and recognized pension funds;
- other entities that meet certain ownership and base erosion requirements;
- certain collective investment vehicles, if the two states agree to include this category in the treaty.

721. Under paragraph 3, a person is entitled to the benefits of the Convention with respect to an item of income even if it does not constitute a "qualified person" under paragraph 2 as long as that item of income emanates from, or is incidental to, the active conduct of a business in that person's state of residence (subject to certain exceptions).

722. Paragraph 4 is a "derivative benefits" provision that allows certain entities that are not "qualified persons" and are owned by residents of third states to obtain treaty benefits, under certain conditions, provided that these residents of third states would have been entitled to equivalent benefits if they had invested directly.

723. Paragraph 5 is a "headquarters company" provision under which a company that does not constitute a qualified person under paragraph 2 may nevertheless qualify for benefits with respect to particular items of income if it functions as a headquarters company for a multinational corporate group and satisfies the various conditions of the paragraph.

724. Paragraph 6 gives the discretion to the competent authority of a treaty state to grant treaty benefits where paragraph 1 would otherwise deny these benefits.

725. Paragraph 7 includes a large number of definitions applicable for the purposes of the limitation-on-benefits rule.

Paragraph 8

726. Paragraph 8 is a specific anti-abuse rule that addresses a risk of tax avoidance that arises from the fact that some countries apply the exemption method, under their domestic law or treaties, to eliminate the potential double taxation of profits of foreign permanent establishments. Assume, for example, that a company resident of such a country derives income from investments in another country (the source state) but that these profits are attributable a permanent establishment situated in a third country that does not levy a corporate tax. In that case, neither the third country nor the country of residence of the company (which applies the exemption method to these profits) would tax the profits attributable to the permanent establishment and, since there is no risk of double taxation, the source state should not have to apply the provisions of its tax treaty with the state of residence of the company.

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

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

728. Paragraph 8 (*b*) constitutes an exception to the rule. It provides that paragraph 8 (*a*) does not apply to income that "emanates from, or

is incidental to, the active conduct of a business through the permanent establishment, excluding an investment business that is not carried on by a bank, insurance enterprise or registered securities dealer."

729. Paragraph 8 (*c*) is a discretionary relief provision which, like paragraph 6 applicable to the limitation-on-benefits rule and the optional addition to the principal-purposes-test rule proposed by the Commentary,[386] gives the competent authority of the source state the discretion of granting the treaty benefits. Before granting or denying a request for such discretionary relief, however, the competent authority should consult the competent authority of the other state (although the final decision remains that of the competent authority of the source state.

730. The Commentary[387] explains various aspects of paragraph 8. It also includes an alternative provision that countries wishing to extend the scope of paragraph 8 could use.[388] Under that alternative, the paragraph applies not only where the state of the enterprise exempts the profits of the permanent establishment situated in a third jurisdiction but also where it subjects these profits to low taxation so that the combined rate of tax in the state of the enterprise and the permanent establishment jurisdiction is less than 60 per cent of the statutory corporate tax rate of the state of the enterprise. In addition, that alternative does not include the exception of paragraph 8 (*b*).

731. Recent treaty practice also shows that some countries prefer to amend paragraph 8 (*a*) so that the minimum level of tax that should be paid in the jurisdiction where the permanent establishment is situated for the rule not to apply is expressed only as 60 per cent of the tax that would have been payable in the state of the enterprise if the permanent establishment had been situated and does not include, therefore, any reference to a bilaterally agreed minimum rate. It also shows that some countries prefer not to include in their treaties the discretionary relief provision found in paragraph 8 (*c*).

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

387 Paragraphs 35 of the Commentary on Article 29 of the UN Model, quoting paragraphs 161 to 168 of the Commentary on Article 29 of the OECD Model.

388 Paragraphs 35 of the Commentary on Article 29 of the UN Model, quoting paragraph 168 of the Commentary on Article 29 of the OECD Model.

Paragraph 9

732. As previously mentioned, paragraph 9 constitutes a general anti-abuse rule intended to prevent taxpayers from obtaining treaty benefits in inappropriate circumstances. While paragraph 9 could address treaty-shopping situations that would be covered by paragraph 1 to 7, it could also address other forms of treaty-shopping (such as conduit arrangements using taxpayers entitled to treaty benefits under paragraphs 2 to 5) as well as any form of treaty abuse that would not involve treaty-shopping. Contrary to paragraphs 1 to 7 and to other specific treaty anti-abuse rules, however, paragraphs 9 does not apply unless tax-motivated arrangements or transactions have been entered into.

733. Paragraph 9 is identical in both the UN and OECD models. It is a relatively simple rule that denies treaty benefits where one of the principal purposes of transactions or arrangements is to obtain these benefits (unless it established that granting the benefits would be in accordance with the object and purpose of the treaty provisions).

734. The Commentary provides detailed explanations on the interpretation and application of paragraph 9. It also includes a number of examples illustrating its application.[389]

735. Given that the inclusion of paragraph 9 in a treaty will probably be the preferred approach for satisfying the BEPS Action 6 minimum standard on treaty-shopping, treaty negotiators are unlikely to propose alternative versions of that rule. The Commentary does not offer any such alternative. It does include, however, an optional addition to paragraph 9 that gives the competent authority of a country that applies paragraph 9 the discretion of granting the treaty benefits that would have been obtained in the absence of the transaction or arrangement that triggered the application of paragraph 9.[390] This additional discretionary relief provision, like the provisions of paragraph 6

389 Paragraphs 37 and 39 of the Commentary on Article 29 of the UN Model, quoting paragraphs 169 to 186 of the Commentary on Article 29 of the OECD Model. See also the additional example in paragraph 38 of the Commentary on Article 29 of the UN Model.

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

and paragraph 8 (*c*), therefore allows a state to mitigate the effect of completely denying specific treaty benefits to a taxpayer. Some treaty negotiators, however, consider that allowing a competent authority to exercise such a discretion could contravene domestic law.

736. The simplicity of the principal-purposes-test rule of paragraph 9 and the fact that it is potentially applicable to all forms of treaty abuse explains why most countries are willing to include it in their treaties. Some countries, however, do not like the uncertainty that is inherent to this general anti-abuse rule[391] and, for that reason, may oppose its inclusion in a tax treaty. If these countries are members of the Inclusive Framework on BEPS, however, they will only be able the satisfy the BEPS Action 6 minimum standard on treaty-shopping if they include the limitation-on-benefits rule of paragraphs 1 to 7. In that case, however, they still will need to satisfy the requirement of implement a mechanism that will address treaty-shopping strategies referred to as "conduit arrangements".[392] Since very few countries have such a mechanism in their domestic law, that may require the inclusion of a provision in the treaty for that purpose. Such a provision could take the form of principal-purpose-test rule similar to that in paragraph 9 but only applicable to transactions defined to constitute conduit arrangements.

H. Chapter VII—Final provisions

737. The UN Model, like the OECD Model, suggests provisions for the entry into force and termination of a tax treaty that are based on provisions typically found in international agreements. According to these provisions, a tax treaty enters into force when both countries have completed their respective procedures for the ratification of the treaty and have exchanged the instruments confirming such ratification; it remains in force until terminated, which may be done by either state giving notice of termination at least six months before the end of a calendar year. Once the treaty has entered into force or has been terminated, its provisions start to have effect or cease to have effect, as

391 Paragraph 39 of the Commentary on Article 29 of the UN Model, quoting paragraph 187 of the Commentary on Article 29 of the OECD Model.

392 Paragraph 717 above.

the case may be, from the date or dates which must be set out in the treaty. While these dates are usually in the future (for example, the beginning of the next fiscal year commencing after the date of entry into force), some provisions related to the entry into effect are sometimes given retroactive effect.

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

1. Article 30—Entry into force

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

Paragraph 1

740. Paragraph 1 provides that the treaty is to be ratified as soon as possible. As previously explained, the ratification of a treaty is the act through which a country expresses its consent to be bound by the terms of the signed treaty. The requirements for ratifying, or otherwise expressing consent to be bound by a treaty, differ between countries. For some countries it may involve endorsement of the signed treaty by parliament or by a person or committee authorized to accept on behalf of the state the rights and responsibilities arising from the treaty. Negotiators should be aware of the procedures applicable in their country and liaise with their ministry in charge of foreign affairs if necessary.

741. Once ratification has been completed in each country, paragraph 1 provides that the instruments of ratification (i.e. the documents expressing each state's consent to be bound by the treaty and usually signed by the countries heads of state shall be exchanged at a location to be mentioned in the paragraph. That location will generally be a city situated in either country, but may be in a third country if this is more convenient for both sides.

742. Some countries prefer a different process for the entry into force of the treaty which does not to require the formal exchange of instruments of ratification mentioned in paragraph 1 of Article 30 of the UN Model. The Commentary notes that it these countries may prefer to provide that each country will notify the other (generally through diplomatic channels) when the legal requirements for giving the treaty

the force of law in their country have been completed.[393] When negotiators draft their country model, they should ask for guidance on this provision from their ministry in charge of foreign affairs; guidance may also be necessary when, during the negotiations, countries express different preferences as to the process for entry into force of the treaty.

Paragraph 2

743. Paragraph 2 specifies when the treaty will enter into force, and when the provisions of the treaty will have effect.

744. According to that paragraph, the treaty enters into force (that is to say, becomes legally binding on the Contracting States) at the time when the exchange of instruments of ratification takes place. For treaties that use the above-mentioned alternative formulation providing for notification, the treaty will typically enter into force upon the later of the two notifications.

745. Some countries prefer to delay the entry into force of the treaty for a short time to allow taxpayers and tax administrations to put in place any procedural or other changes which may be required by the treaty. This can be achieved by providing that the treaty will enter into force upon the expiration of a specified period (for example, one month after either the exchange of instruments of ratification or the later of the notifications).

746. As already explained, the moment of the entry into force of the treaty must be distinguished from the moment when its provisions will start to have effect in each country. Paragraph 2 indicates that the time when the provisions of the treaty will begin to have effect should be specified for each country but does not provide guidance as to what that time should be. Each country will need to select dates that work well in relation to its domestic law. For example, if income taxes are assessed on a tax year basis, the paragraph may provide that, in that country, the provisions of the treaty will have effect with respect to such taxes from the first day of the first tax year that follows the entry-into force of the treaty. Many countries will provide

393 Commentary on Articles 30 and 31 of the UN Model, quoting paragraph 2 of the Commentary on Articles 31 and 32 of the OECD Model.

a different date of effect with respect to withholding taxes, as these taxes are collected upon payment without regard to the fiscal year; for example, the paragraph may provide that, in the case of taxes withheld at source, the provisions of the treaty will have effect with respect to amounts paid on or after the first day of the third month following the entry into force of the treaty. Countries should provide for at least a short delay between the date of entry into force and the date when the provisions of the treaty start to have effect in order to allow withholding agents to adjust their withholding arrangements to reflect the new treaty rates.

747. In the UN and OECD models, the articles dealing with non-discrimination, exchange of information and assistance in collection of taxes are not limited in their application to taxes covered by the treaty. It should therefore be understood, and clarified if necessary, that the provisions concerning the date when the treaty will begin to have effect shall apply not only with respect to taxes covered by the treaty under Article 2 but also with respect to other taxes covered by these articles. Negotiators may also want to discuss whether the provisions of Articles 26 and 27 dealing with exchange of information and assistance in collection should apply with respect to taxes that were payable before the entry into force of the treaty. Some countries prefer to specify expressly the date from which these provisions will apply, in particular when they agree that they should exchange information, or provide assistance in the recovery, as regards taxes that were payable before the entry into force of the treaty.

748. If the treaty is replacing an existing treaty, the existing treaty should be terminated by a provision to this effect in the new treaty. The paragraph should also specify that the provisions of the existing treaty will cease to have effect from the date or dates that the provisions of the new treaty have effect. In some cases, for example where the provisions of the earlier treaty are more beneficial to the taxpayer, the new treaty may provide for an extension of the application of certain provisions of the earlier treaty for a specified period.

749. In some cases, countries may wish to delay giving effect to certain provisions. This should be mentioned specifically in the treaty. The following is an example of wording that could be used to delay the application of the provisions of Article 27 (Assistance in collection) until the domestic laws of both countries allow them to provide assistance

(in case such domestic law changes are required): "Notwithstanding the provisions of paragraph 2, the provisions of Article 27 (Assistance in collection) shall not have effect until both countries confirm through diplomatic channels that they are able to provide such assistance under their domestic law, from which time the provisions of that Article shall have effect without regard to the taxable period to which the revenue claim relates".

2. Article 31—Termination

750. Article 31 provides that the treaty will continue to operate until terminated. Countries often agree on a minimum period of five years before a tax treaty may be terminated. This provides a measure of certainty and stability for taxpayers, revenue and tax administrations.

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

752. Countries will generally initiate termination procedures only after careful deliberation, when efforts to renegotiate an unsatisfactory treaty have failed, for example, where a treaty partner is unwilling to renegotiate an outdated treaty or in cases where a change of domestic law has a significant and highly detrimental effect on the operation of the tax treaty.

753. The Article also sets out the dates from which the provisions will cease to have effect once the treaty has been terminated. These will usually mirror the dates specified in paragraph 2 of Article 30 (Entry into force).

3. Terminal clause

754. Tax treaties typically include a terminal clause indicating when the treaty is signed and the official language or languages in which it is

concluded. The UN Model merely states that this clause will be drafted in accordance with the constitutional procedure of both Contracting States. In practice, these clauses are often formulated along the following lines in treaties that are done in two official languages:

> Done at [place] on [date], in [language] and [language], both texts being equally authoritative.

755. If countries agree that one language shall prevail in case of divergence of interpretation (e.g. if the country was negotiated in a third language), the clause could be formulated as follows:

> Done at [place] on [date], in [one country's] language, the [other country's] language and [a third] language, each text being authentic. In case of any divergence of interpretation, the [third language] text shall prevail.

Section IV

Improper use of treaties

A. Introduction

756. Tax avoidance strategies aimed at obtaining treaty benefits are an important concern for most countries but are particularly problematic for developing countries that have limited experience in dealing with sophisticated tax-avoidance strategies.[394] Tax treaty negotiators should be aware of these concerns and of the ways of addressing these strategies through tax treaty provisions or other mechanisms. A detailed discussion of tax avoidance strategies aimed at obtaining treaty benefits and of ways of addressing them is included in the section "Improper use of tax treaties" in the Commentary on Article 1 of the UN Model.[395] That discussion takes account of the various changes that were made in 2017 to the UN and OECD models in order to address some of these strategies. These changes, which are discussed in section III under the relevant articles of the UN Model, resulted primarily from the reports on Action 6 (*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015, Final Report*)[396] and Action 7 (*Preventing the Artificial Avoidance of Permanent Establishment Status, Action 7—2015 Final Report*)[397] of the G20/ OECD project.[398]

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

— Transactions involving dual residence or a transfer of residence.[399]

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394 Paragraph 10 on the Commentary on Article 1 of the UN Model.

395 Paragraphs 10 to 117 of the Commentary on Article 1 of the UN Model.

396 Note 19.

397 Note 66.

398 Note 19.

399 Paragraphs 58 to 63 of the Commentary on Article 1 of the UN Model.

- Treaty shopping arrangements.[400]
- Transactions involving triangular cases (i.e. situations where three states are involved).[401]
- Transactions through which income that would normally accrue to a taxpayer accrues to a related person or entity so as to obtain treaty benefits that would not otherwise be available,[402] including through
  - non-arm's length transfer prices,[403]
  - thin capitalization,[404]
  - the use of base companies,[405]
  - the payment of directors' fees and remuneration of top-level managers,[406] and
  - the attribution of interest to a tax-exempt or government entity.[407]
- Hiring-out of labor transactions.[408]
- Transactions involving the use of star-companies for entertainers and sportspersons in the case of older tax treaties do not include paragraph 2 of Article 17.[409]
- Transactions that modify the treaty classification of income[410] through
  - the conversion of dividends into interest,[411]
  - the mis-allocation of price under a mixed contract,[412]

400 Paragraphs 64 to 76 of the Commentary on Article 1 of the UN Model.
401 Paragraphs 77 to 80 of the Commentary on Article 1 of the UN Model.
402 Paragraph 81 of the Commentary on Article 1 of the UN Model.
403 Paragraph 82 of the Commentary on Article 1 of the UN Model.
404 Paragraphs 83 to 89 of the Commentary on Article 1 of the UN Model.
405 Paragraphs 90 to 92 of the Commentary on Article 1 of the UN Model.
406 Paragraphs 93 and 94 of the Commentary on Article 1 of the UN Model.
407 Paragraphs 95 to 98 of the Commentary on Article 1 of the UN Model.
408 Paragraph 99 of the Commentary on Article 1 of the UN Model.
409 Paragraphs 100 to 103 of the Commentary on Article 1 of the UN Model.
410 Paragraphs 104 to 105 of the Commentary on Article 1 of the UN Model.
411 Paragraph 106 of the Commentary on Article 1 of the UN Model.
412 Paragraphs 107 and 108 of the Commentary on Article 1 of the UN Model.

- the conversion of royalties into capital gains,[413] or
- the use of derivative transactions.[414]

— Transactions that seek to circumvent thresholds found in treaty provisions,[415] including time limits for certain permanent establishments[416] and thresholds for the source taxation of capital gains on shares.[417]

758. This section summarizes the discussion found in the part of the Commentary on "Improper use of tax treaties" that describe the various ways through which improper uses of tax treaties, including the situations referred to in the above example, may be addressed.[418] Since most existing bilateral tax treaties do not include the anti-abuse provisions that were added to the UN and OECD models in 2017 and, in particular, the general anti-abuse rule of paragraph 9 of Article 29, this section refers to various approaches that countries may adopt to combat treaty abuse even in the absence of these provisions.

759. Treaty negotiators and tax officials from developing countries concerned with treaty abuses may also want to consult the practical guidance that is found in the United Nations *Handbook on Selected Issues in Protecting the Tax Base of Developing Countries — Second Edition*[419] and in particular in Chapters VI ("Preventing tax treaty abuse")[420] and VII ("Preventing avoidance of permanent establishment status")[421] of that handbook.

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413 Paragraphs 109 and 110 of the Commentary on Article 1 of the UN Model.

414 Paragraph 111 of the Commentary on Article 1 of the UN Model.

415 Paragraphs 112 and 113 of the Commentary on Article 1 of the UN Model.

416 Paragraph 114 of the Commentary on Article 1 of the UN Model.

417 Paragraphs 115 to 117 of the Commentary on Article 1 of the UN Model.

418 Paragraphs 15 to 55, which reproduce paragraphs 57 to 80 of the Commentary on Article 1 of the OECD Model with appropriate modifications.

419 United Nations, *Handbook on Selected Issues in Protecting the Tax Base of Developing Countries – Second Edition,* New York, 2017, available at http://www.un.org/esa/ffd/wp-content/uploads/2017/08/handbook-tax-base-second-edition.pdf.

420 Page 337 of the handbook.

421 Page 365 of the handbook.

B. How to prevent the improper use of tax treaties

760. Different approaches may be used by countries to address the improper use of tax treaties. Some of these approaches are found in domestic law while others involve tax treaties. These approaches fall into the following categories:

1. Specific anti-abuse rules in domestic law;
2. General anti-abuse rules in domestic law;
3. Judicial doctrines and principles of interpretation that are part of domestic law;
4. Specific anti-abuse rules in tax treaties;
5. General anti-abuse rules in tax treaties, and
6. The interpretation of tax treaty provisions.

761. Before examining each of the approaches, it is useful to address the more general question of whether the benefits of a tax treaty that does not include the general anti-abuse rule of paragraph 9 of Article 29 or all the specific treaty anti-abuse rules proposed in the current version of the UN and OECD Models should be granted when transactions that constitute an abuse of the provisions of that treaty are entered into.

762. The Commentary addresses this question by first noting that some states consider that any abuse of the provisions of a tax treaty can also be characterised as an abuse of the provisions of domestic law under which tax is levied. For these states, the issue is therefore whether the provisions of tax treaties may prevent the application of the anti-abuse provisions of domestic law. Other States, however, prefer to view these cases as abuses of the treaty itself rather than as abuses of domestic law.[422]

763. The Commentary goes on to indicate that under both approaches, it is agreed that states do not have to grant the benefits of a tax treaty where arrangements that constitute an abuse of the provisions of the treaty have been entered into.[423] It also adds, however, that

422 Paragraphs 18 to 20 of the Commentary on Article 1 of the UN Model, quoting paragraphs 57 to 59 of the Commentary on Article 1 of the OECD Model.

423 Paragraph 21 of the Commentary on Article 1 of the UN Model, quoting paragraph 60 of the Commentary on Article 1 of the OECD Model.

> "… it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to above. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions. That principle applies independently from the provisions of Article 29, paragraph 9, which merely confirm it."[424]

764. The Commentary of the UN Model adds that this principle "serves an important purpose as it attempts to balance the need to prevent treaty abuses with the need to ensure that countries respect their treaty obligations and provide legal certainty to taxpayers". It goes on to analyse the two main elements of that principle and stress the importance of applying that principle on the basis of objective findings of facts, not solely the alleged intention of the parties.[425]

1. Specific anti-abuse rules found in domestic law

765. Many specific anti-abuse rules found in domestic law may be used to address abusive arrangements that involve tax treaty benefits. For instance, thin capitalization rules or earnings-stripping rules could restrict the deduction of base-eroding interest payments to residents of treaty countries and therefore reduce the scope for abusing the limit on the source taxation of interest imposed by paragraph 2 of Article 11 of a treaty. Another example would be that of exit or departure taxes rules that could prevent the avoidance of capital gains tax through a change of residence before the realization of a treaty-exempt capital gain.

766. A problem that may arise from the application of some domestic specific anti-abuse rules to arrangements involving the use of tax treaties is that of possible conflicts with the provisions of tax treaties.

767. Generally, where the application of provisions of domestic law and the provisions of tax treaties produces conflicting results, the pro-

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424 Paragraph 22 of the Commentary on Article 1 of the UN Model, quoting paragraph 61 of the Commentary on Article 1 of the OECD Model.

425 Paragraphs 23 to 26 of the Commentary on Article 1 of the UN Model.

visions of tax treaties are intended to prevail. This is a logical consequence of the principle of "*pacta sunt servanda*" which is incorporated in Article 26 of the *Vienna treaty on the Law of Treaties*. Thus, if the application of a specific anti-abuse rule found in domestic law were to result in a tax treatment that is not in accordance with the provisions of a tax treaty, this would conflict with the provisions of that treaty and the provisions of the treaty should normally prevail.

768. As explained below, however, such conflicts will often be avoided and each case must be analyzed based on its own circumstances.

769. First, a treaty may specifically allow the application of certain types of domestic anti-abuse rules. For example, paragraph 1 of Article 9 specifically authorizes the application of domestic transfer pricing rules that are based on the arm's length principle. Also, many treaties include specific provisions clarifying that there is no conflict or allowing the application of the specific domestic anti-abuse rule even if there is a conflict. This would be the case, for example, of a treaty provision that would expressly allow the application of the thin capitalization rules of each state even if they would otherwise conflict with the non-discrimination rule of paragraph 4 of Article 24.

770. Second, many tax treaty provisions depend on the application of domestic law. This is the case, for instance, for the determination of the residence of a person, the determination of what is immovable property and the determination of when income from corporate rights might be treated as a dividend. For example, even though a domestic law provision treats as dividends the profits realized by a shareholder upon a redemption of shares, such a redemption could be considered to constitute an alienation of shares that could be exempt from source taxation depending on the wording of paragraph 5 and 6 of Article 13. The Commentary,[426] however, recognizes that such profits fall within the definition of dividends in paragraph 3 of Article 10 if the profits are treated as dividends under domestic law.

771. Third, the application of tax treaty provisions in a case that involves an abuse of these provisions may be denied under the general anti-abuse rule of paragraph 9 of Article 29 or, in the case of a treaty

426 Paragraph 14 of the Commentary on Article 10, quoting what is now in paragraph 28 of the Commentary on Article 10 of the OECD Model.

that does not include that paragraph, under a proper interpretation of the treaty in accordance with the principle referred to in paragraph 763 above. There will therefore be no conflict with the treaty provisions if the benefits of the treaty are denied under both the interpretation of the treaty (or paragraph 9 of Article 29, as the case may be) and the application of domestic specific anti-abuse rules. Domestic specific anti-abuse rules, however, are often drafted by reference to objective facts, such as the existence of a certain level of shareholding or a certain debt-equity ratio. While this greatly facilitates their application and provides greater certainty, it may sometimes result in the application of these rules to transactions that do not constitute abuses. In such cases, the treaty will not allow the application of the domestic rule to the extent of the conflict.

772. For example, assume that state A has adopted a domestic rule to prevent temporary changes of residence for tax purposes under which an individual who is a resident of state B is taxable in state A on gains from the alienation of property situated in a third state if that individual was a resident of state A when the property was acquired and was a resident of state A for at least seven of the 10 years preceding the alienation. In such a case, to the extent that paragraph 6 of Article 13 would prevent the taxation of that individual by state A upon the alienation of the property, the treaty would prevent the application of state A's domestic rule unless the benefits of paragraph 6 of Article 13 could be denied, in that specific case, under paragraph 9 of Article 29 or the principles in paragraph 763 above.

773. Fourth, the application of tax treaty provisions may be denied under domestic judicial doctrines or principles applicable to the interpretation of the treaty (see below). In such a case, there will be no conflict with the treaty provisions if the benefits of the treaty are denied under both a proper interpretation of the treaty and as result of the application of domestic specific anti-abuse rules.

2. General anti-abuse rules in domestic law

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

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

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

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

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

778. While the interpretation of tax treaties is governed by general rules that have been codified in Articles 31 to 33 of the *Vienna Convention on the Law of Treaties*,[427] nothing prevents the application of similar judicial approaches to the interpretation of the particular provisions of tax treaties. If, for example, the courts of one country have determined that, as a matter of legal interpretation, domestic tax provisions should apply on the basis of the economic substance of certain

427 Note 27.

transactions, there is nothing that prevents a similar approach to be adopted with respect to the application of the provisions of a tax treaty to similar transactions.[428]

779. As a general rule and having regard to the principle in paragraph 763 above, therefore, the preceding analysis leads to the conclusion that there will be no conflict between tax treaties and judicial anti-abuse doctrines developed by a country's courts. For example, to the extent that the application of a judicial doctrine such as "substance over form" or "economic substance" results in a recharacterization of income or in a redetermination of the taxpayer who is considered to derive such income, the provisions of the treaty will be applied taking into account these changes.

780. Whilst rules found in domestic law (whether they are specific or general legislative anti-abuse rules, judicial doctrines or principles of interpretation) generally do not conflict with tax treaties, there is agreement that member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused.[429]

4. Specific anti-abuse rules in tax treaties

781. Some forms of treaty abuse can be addressed through specific treaty provisions. A number of such rules are already included in the UN and OECD models. Examples include the concept of "beneficial owner" in Articles 10, 11, 12, and 12A; the "special relationship" rule applicable to interest, royalties and fees for technical services in Articles 11, 12 and 12A; the rule of paragraph 4 of Article 13 on gains from the alienation of shares or comparable interests that derive more than 50 per cent of their value from immovable property situated in a country; the rule on "star-companies" in paragraph 2 of Article 17; the limitation-on-benefits rule of paragraphs 1 to 7 of Article 29 and the rule applicable to permanent establishments situated in third states in paragraph 8 of Article 29.

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

429 Paragraph 47 of the Commentary on Article 1, quoting paragraph 80 of the Commentary on Article 1 of the OECD Model.

782. Clearly, such specific treaty anti-abuse rules provide more certainty to taxpayers than broad general anti-abuse rules or doctrines. One should not, however, underestimate the risks of relying extensively on specific treaty anti-abuse rules to deal with tax treaty avoidance strategies. First, specific anti-abuse rules are often drafted only after a particular avoidance strategy has been identified and used, maybe extensively. Second, the inclusion of a specific anti-abuse provision in a treaty can weaken the case as regards the application of general anti-abuse rules or doctrines to other forms of treaty abuses. Adding specific anti-abuse rules to a tax treaty could be wrongly interpreted as suggesting that an unacceptable avoidance strategy that is similar to, but slightly different from, one dealt with by a specific anti-abuse rule included in the treaty is allowed and cannot be challenged under general anti-abuse rules. Third, in order to specifically address complex avoidance strategies, complex rules may be required. This is especially the case where these rules seek to address the issue through the application of criteria that leave little room for interpretation rather than through more flexible criteria such as the purposes of a transaction or arrangement. For these reasons, whilst the inclusion of specific anti-abuse rules in tax treaties is the most appropriate approach to deal with certain situations, it cannot, by itself, provide a comprehensive solution to treaty abuses.

5. General anti-abuse rules in tax treaties

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

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

785. Most countries that are members of the Inclusive Framework on BEPS[430] will want to include paragraph 9 of Article 29 in their treaties as their preferred approach for complying with the requirements of the Action 6 minimum standard on treaty-shopping.[431] Other countries that do not feel confident that their domestic law and approach to the interpretation of tax treaties would allow them to adequately address improper uses of their tax treaties should obviously consider the inclusion of paragraph 9 of Article 29.

6. The interpretation of tax treaty provisions

786. Another approach that has been used to counter improper uses of treaties has been to disregard abusive transactions under a proper interpretation of the relevant treaty provisions that takes account of their context, the object and purpose of the treaty as well as the obligation to interpret these provisions in good faith in accordance with Article 31 of the *Vienna Convention on the Law of Treaties*.[432] As already mentioned, a number of countries have long used a process of legal interpretation to counteract abuses of their domestic tax laws and it seems entirely appropriate to similarly interpret tax treaty provisions to counteract tax treaty abuses.

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

788. As noted in paragraph 166, the title of the UN and OECD models was amended in 2017 to include an express reference to the prevention of tax avoidance and evasion as a purpose of the treaty. At the same time, a new preamble was added to clarify that the Contracting States do not intend the provisions of the treaty to create opportunities for non-taxation or reduced taxation through tax avoidance or evasion, including through treaty-shopping (treaty-shopping being only one example of the improper use of tax treaties). Since the title and

430 Note 22.

431 Paragraph 711 above.

432 Note 27.

preamble form part of the context of treaties that are based on the UN and OECD models, they should play an important role in the interpretation of the provisions of these treaties to prevent treaty abuse.

C. The importance of proper administrative procedures and treaty interpretation

789. The Commentary[433] recognizes the role that proper administrative procedures can play in minimizing risks of improper uses of tax treaties. While anti-abuse rules are important for preventing the improper use of treaties, the application of certain anti-abuse rules may be challenging for tax administrations, especially in developing countries. Developing countries may consider developing their own procedural provisions regarding treaty application by learning from countries that have successful experience of treaty application.

790. Developing countries may be hesitant to adopt or apply general anti-abuse rules if they believe that these rules would introduce an unacceptable level of uncertainty that could hinder foreign investment in their territory. Whilst a ruling system that would allow taxpayers to quickly know whether anti-abuse rules would be applied to prospective transactions could help reduce that concern, it is important that such a system safeguards the confidentiality of transactions and, at the same time, avoids discretionary interpretations (which, in some countries, could carry risks of corruption).

791. Clearly, a strong independent judicial system will help to provide taxpayers with the assurance that anti-abuse rules are applied objectively. The Commentary stresses the importance of proper mechanisms for tax treaty interpretation,[434] noting that countries that have a weaker judicial system or where there is little judicial expertise in tax treaty interpretation may consider alternative mechanisms to ensure responsible treaty interpretations that neither discourage foreign investment nor encourage treaty abuse. Similarly, an effective application of the mutual agreement procedure will ensure that disputes concerning the application of anti-abuse rules will be resolved according to internationally accepted principles so as to maintain the integrity of tax treaties.

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433 Paragraphs 119 to 122 of the Commentary on Article 1 of the UN Model.

434 Paragraphs 120 and 121 of the Commentary on Article 1 of the UN Model.