BASIC APPROACHES TO TAX TREATY NEGOTIATION[1]

Introduction

Income tax treaties (technically "conventions") begin with the recitation that they are entered into between countries for the purposes of avoiding double taxation of international income flows and the prevention of fiscal evasion with respect to taxes on income and capital gains. The problem of potential international double taxation arises each time an enterprise enters into an inter-country transaction or an individual steps across an international boundary. Taxing conflicts arise in these situations when the countries involved each lay claim to an income tax on resulting income or profits. Historically, the initial measures invoked to alleviate international double taxation were unilateral in nature. Some countries employ a foreign tax credit or offset mechanism. Other countries use an exemption mechanism whereby foreign source income earned by their residents is exempted from domestic taxation. Additional countries use either the tax credit or exemption methods in different tax contexts. Both of the foregoing unilateral tax relief measures recognize the primacy of other countries source taxation structures.

Nevertheless, many countries have found it necessary to supplement unilateral measures by entering into a network of bilateral tax treaties their principal commercial partners and other countries with which their taxpayers are involved in trade or investment. A principal goal of tax treaties is agreement on common definitions of income source, residency and a sufficient nexus (permanent establishment) to subject commercial and industrial profits to source country taxation. Other important goals include reduction of source country withholding rates on passive income such as interest, dividends and royalties, elimination of double taxation, prevention of fiscal evasion with respect to taxes on income and capital gains, tax administration cooperation, and a mechanism for resolving tax disputes between the treaty partners. Tax treaties between developed and developing countries frequently take into account differing levels of economic development, fiscal administration resources and tax structure complexities.

Any tax treaty negotiator must be aware that two major model treaties are used by most countries as a starting point for tax treaty negotiations. The model treaties (which are included in the Appendix) are:

1. OECD Model Convention on Income and on Capital

2. United Nations Model Double Taxation Convention between Developed and Developing Countries

The United States employs its own U. S. Treasury Model Convention as a treaty negotiation starting point in particular with developing countries. Other countries have formally or informally published "Model" treaties setting forth the basic positions their

[1] This part of the draft Manual was prepared by Professor Jon E. Bischel.

treaty negotiators will take in an opening round of treaty discussions. The following discussion highlights the considerations involved in tax treaty negotiations and the differences in approach between the most recent drafts of the OECD and UN model treaties.

In this portion of the Manual we will state the UN Model as it presently exists and follow it with a discussion of each Article. Where we discuss another treaty or the OECD Model Treaty we have attached copies of these treaties in the Appendix.

UN MODEL

Article 1

PERSONS COVERED

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

DISCUSSION

Article 1

PERSONS COVERED

Many older negotiated treaties used the prior model treaty title of Personal Scope for Article 1. Both model treaties recently changed the title of Article 1 to Persons Covered to more accurately convey the correct scope of a tax treaty by specifying the types of persons or taxpayers to which a tax treaty applies.

The text of Article 1 in recent tax treaties states that the treaty shall apply to persons who are residents of one or both Contracting States. Subsequent treaty articles specifically define the Article 1 terms. For instance, in typical recent treaties Article 3 defines the term "person" as including an individual, company or any other body of persons. Article 4 defines the term "resident of a Contracting State" as meaning any person who is liable to taxation therein on the basis of domicile, residence, place of management or any other criterion of a similar nature.

SIGNIFICANCE: A primary purpose of tax treaties is to promote international commerce by eliminating bilateral international double taxation between treaty partners. However, the scope of a tax treaty is not limited to commercial and business activities. In broad terms Article 1 defines the outer scope of potential treaty benefits with regard to the imposition of both source and residency income taxing jurisdiction. Yet, unintended third country benefits may still potentially be derived through the use of bilateral tax

conflict with treaty provisions treaty negotiators may wish to consider the effect of other treaty and domestic anti-avoidance measures.

> **EXAMPLE:** United States treaties contain a "savings clause" which provides that the United States in determining its taxes of U.S. citizens, residents or corporations may, regardless of other treaty provisions, include all items of income taxable under U.S. revenue laws on the basis upon which the United States imposes taxes. Thus, U.S. citizens, residents and corporations may expect to benefit from a tax treaty only to the extent the foreign treaty partner makes concessions with respect to its own taxes not otherwise creditable for foreign tax credit purposes.

UN MODEL

Article 2

TAXES COVERED

UN MODEL

Article 3

GENERAL DEFINITIONS

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

- *(a) The term "person" includes an individual, a company and any other body of persons;*
- *(b) The term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes;*
- *(c) The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean respectively an enterprise carried on by a resident of a Contracting State and an enterprise carried on by a resident of the other Contracting State;*
- *(d) The term "international traffic" means any transport by a ship or aircraft operated by an enterprise that has its place of effective management in a Contracting State, except when the ship or aircraft is operated solely between places in the other Contracting State;*
- *(e) The term "competent authority" means:*
  - *(i) (in State A): ....*
  - *(ii) (in State B): ....*
- *(f) The term "national" means:*
  - *(i) any individual possessing the nationality of a Contracting State;*
  - *(ii) any legal person, partnership or association deriving its status as such from the laws in force in a Contracting State.*

2. As regards the application of the Convention by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State.

DISCUSSION

Article 3

GENERAL DEFINITIONS

The model treaties use Article 3 to group a number of general definitions required for interpretation of the terms used in a treaty. They are “person”, “company”, “enterprise of a Contracting State”, “international traffic” and “national”. In actually negotiated treaties with countries which use place of incorporation to define corporate residence (e.g. Une

Treaty negotiators should be aware that most countries do not allow domestic legislation to override treaty obligations. A few countries take the position that either in principle tax treaties may be overridden by subsequent domestic legislation, or that domestic law and treaties are of equal status. As a consequence, in the

DISCUSSION

Article 4

RESIDENT

The treaty term “resident of a Contracting State” as defined in Article 4 of the UN model treaty (which varies slightly from the OECD model) means any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of incorporation, place of management or any other criterion of a similar nature, and also includes that State and any political subdivision or local authority thereof. However, the term does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein. Moreover, it should again be emphasized that under Article 3 of the model treaties the term “person” includes not only individuals, but also a company or any other body of persons.

Most actually negotiated treaties follow the model treaties by looking first to the internal law definition of residence of each State. However, where there is a conflict in those definitions Article 4 of the model treaties lists in decreasing order of relevance a number of subsidiary criteria to be applied when an individual is a resident of both countries under their internal laws to determine which State the individual is considered to be a resident for purposes of the treaty. If none of these criteria (See Article 4(2))is determinative of the individual’s residence status determination of residence is settled by the the competent authorities ofState

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UN MODEL

Article 5

PERMANENT ESTABLISHMENT

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

2. The term "permanent establishment" includes especially:

(a) A place of management;

(b) A branch;

(c) An office;

(d) A factory;

(e) A workshop;

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

3. The term "permanent establishment" likewise encompasses:

(a) A building site, a construction, assembly or installation project or supervisory activities in connection therewith, but only if such site, project or activities last more than six months;

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

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

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

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

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

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

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

(f) *The maintenance of a fixed place of business solely for any combination of*

wholly on behalf of that enterprise, and conditions are made or imposed between that enterprise and the agent in their commercial and financial relations which differ from those which would have been made between independent enterprises, he will not be considered an agent of an independent status within the meaning of this paragraph.

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

DISCUSSION

Article 5

PERMANENT ESTABLISHMENT

Generally, each country will attempt to tax a non-resident enterprise that is engaged in the active pursuit of business in its territory when engaged with a certain degree of intensity or regularity. The differences in the rules concerning source of income, problems of allocating income to one or the other country and the undesirability or futility of taxing certain business activities of a non-recurring, preparatory or ancillary nature led to development of the permanent establishment concept. The concept provides that an enterprise of one treaty country shall be taxable in the other treaty country only if it maintains a permanent establishment. However, the lack of definitions for "business" and "enterprise" sometimes results in disagreement between taxpayers and tax administrations about whether an enterprise constitutes a permanent establishment.

SIGNIFICANCE: The definition of the term permanent establishment is central to source country taxation of business profits since under Article 7 no tax is imposed upon source country business profits unless a permanent establishment exists. (See UN Model, Article 7(1) taxing business profits attributable to a permanent establishment) Further, gain from the sale of merchandise is generally exempt from source country taxation unless such property forms part of a permanent establishment.

Paragraph 1 of Article 5 of both the models and treaties actually in force set forth the basic principle that a permanent establishment means a "fixed place of business through which the business of an enterprise is wholly or partly carried on." In paragraph 2 of the model treaties this principle is illustrated with the following non-exhaustive specific examples: a place of management, a branch, an office, workshop, and a mine, an oil or gas well, a quarry or other place of extraction of natural resources. Additional examples added by some recently negotiated treaties between developed and developing countries include an agricultural, pastoral or forestry property; a store or other sales outlet. Note, the list of examples does not necessarily signify a permanent establishment, as the

conditions of Article 5(1) must also be met for them to constitute a permanent establishment.

Under Article 5(3) of OECD based treaties construction jobs, assembly projects and building sites are considered permanent establishments, if they last more than 12 months in duration. By contrast the UN Model uses durations of more than six months. Most treaties between developed and developing countries use the more than six months criteria. Some treaties also employ the more than six month criteria in regard to the exploration for or exploitation of natural resources located in a source country, as well as use of substantial equipment in taxing state by, for or under contract with the enterprise. Other treaties provide the use of substantial equipment in the taxing state at any time shall constitute a permanent establishment even in the absence of a fixed place of business.

The UN model and some treaties (e.g. New Zealand-South Africa, Article 5(5)(a)) negotiated by developing countries use a time criteria of more then six months within any twelve-month period with regard to permanent establishments arising from the furnishing of services, including consulting services, by an enterprise through employees or other personnel engaged by the enterprise for such purpose. Under the provision the furnishing of any service may lead to taxation as a deemed service permanent establishment even if an enterprise has no fixed place of business in the taxing state as required under Article 5(1). Some developed country negotiators view the provision as at odds with treaty provisions addressing independent personal services, as well as being difficult to administer, and in certain cases having a potential adverse effect on the transfer of technology.

Under Article 5(4) of the model treaties certain preparatory and auxiliary business activities or functions will not cause a fixed place of business to be deemed a permanent establishment. They include:

(a) the use of facilities solely for the storage, display or delivery of goods or merchandise belonging to the enterprise. Generally, this limitation would include facilities used for packaging and dispatch, but not for sale. The UN Model deletes the word "delivery" on the basis that a continuous connection and hence the existence of such a supply of goods should be a permanent establishment, despite the small amount of income which would normally be attributed to such activity.

(b) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of storage, display or delivery. As previously noted the UN Model deletes the word "delivery" although the UN commentary on Article 5 states that almost 75 percent of tax treaties entered into by developing countries have included delivery of goods in their treaties.

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

(d) the maintenance of a fixed place of business solely for purchasing goods or merchandise or for collecting (not evaluating or editing) information for the enterprise,

(e) the maintenance of a fixed place of business solely for any other activity of a preparatory or ancillary nature of the enterprise. Under this subparagraph all preparatory and ancillary activities are exempted from permanent establishment taxation. Hence, the list of exceptions under subparagraphs (a) to (d) are specific examples and not intended to be exclusive. By contrast, an activity cannot be considered as preparatory or auxiliary, if it is similar to the essential and

Article 5(6) of the UN Model does not have a counterpart in the OECD Model. It provides that the collection of premiums or insurance of risks, except re-insurance transactions, in the other State by an insura

aforesaid, the profits of the enterprise may be taxed in the other State, but only so much of them as is attributable to (a) that permanent establishment; (b) sales in that other State of goods or merchandise of the same or similar kind as those sold through that permanent establishment; or (c) other business activities carried on in that other State of the same or similar kind as those effected through that permanent establishment.

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

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

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

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

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

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

DISCUSSION

Article 7

BUSINESS PROFITS

Under traditional treaty rules if an enterprise of treaty partner country A has no

regular market. The Commentary to the OECD model indicates that the profits so attributable are normally the profits shown on the books of the establishment. The tax authorities of the country in which the permanent establishment is located are, however, permitted to use the provisions of its own internal laws to rectify the accounts of the enterprise so as to properly reflect income which the establishment would have earned if it were an independent enterprise dealing with its head office at arm's length. Moreover, Article 7(4) of both model treaties provides that in so far as it has been customary for a treaty country in which a permanent establishment is located to determine profits to be attributed to the permanent establishment on the basis of an apportionment of the total profits of the enterprise to its various parts, nothing contained in Article 7(2) shall preclude the use of such apportionment method if it accords with the Article 7 principles. However, the profits attributed to a permanent establishment must be determined by using the same method year by year unless there is a good and sufficient reason to the contrary. (UN model Article 7(5), OECD model Article 7(6)).

The model treaties differ substantially regarding the difficult and complex problems of the deductions allowed to the permanent establishment. Both model treaties in Article 7(3) provide that in determining the profits of a permanent establishment, allowance shall be made for expenses, wherever incurred, for purposes of the business of the permanent establishment, including executive and general administrative expenses. However, the UN model recognizes that there are some classes of expenditures that give rise to special problems. These include interest and royalties, etc., paid by the permanent establishment to its head office in return for money loaned or patent rights licensed by the head office to the permanent establishment. Also included are commissions (except for the reimbursement of actual expenses) for specific services or for the exercise of management services by the enterprise for the benefit of the permanent establishment. In these cases, the payments are not18.855 0 (ents ar(3.2vi.855 8vB01 Tc.21.4(ernent OnuCtut deter)4(m)8ir

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

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

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

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

Article 8 (alternative B)

1. Profits from the operation of aircraft in international traffic shall be taxable only in the Contracting State in which the place of

DISCUSSION

Article 8

SHIPPING, INLAND WATERWAYS TRANSPORT AND AIR TRANSPORT

Article 8 of both model treaties limits taxation of profits from the operation of aircraft to the treaty partner country in which the effective place of management of the enterprise is situated. The OECD model applies the same approach to the taxation of profits from the operation of ships, the rationale being that shipping enterprises should not be exposed to the tax laws of the numerous countries to which their operations extend, potentially subjecting the enterprise to taxation on amounts exceeding its total income. This approach, used in treaties between developed countries as well as some treaties between developed and developing countries, creates a major exception to the taxation of business profits on the basis of the permanent establishment principle set forth in Article 7. However, some developing countries have entered into tax treaties that adopt the principle of source taxation and of sharing the revenue at an agreed percentage. This latter approach is consistent with the UN model, Article 8 (2) Alternative B. The UN model article allows taxation of shipping profits by a treaty partner in the case where shipping activities in that country are more than casual. In such cases taxable profits shall be determined on the basis of an appropriate allocation of the overall net shipping profits derived by the enterprise. The tax computed in accordance with such allocation shall then be reduced by ____per cent. (The percentage is to be established by bilateral negotiations)

Under both model treaties, Article 8(2) the place of effective management criterion is also employed to determine the exclusive right to tax the profits from the operation of boats engaged in inland waterways transport. However, if the effective place of management of either a shipping enterprise or of an inland waterways transport enterprise is aboard a ship or a boat, then the effective place of management shall be deemed to

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

(b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.

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

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

charging prevailing market prices to each other (see related discussion under Article 7). Although such profits might at first be assumed to be those shown on the books of the establishments, Article 9 of the model treaties permits a treaty partner tax authority to rectify the accounts of the enterprise when necessary.

> **EXAMPLE:** Subsidiary (S) located in Mexico sells automobile mufflers to its parent company (P) located in Germany for $40 per muffler. S also sells exactly the same muffler to an independent third party (I) for $50 per muffler. Under Article 9 of their tax treaty Mexican tax authorities may make an adjustment to S's profit from sales to P to reflect the same profit margin earned by S on its sales to I.

An allocation of additional profit to S by Mexico may give rise to economic double taxation if P has already reported and been taxed upon such profit in Germany. Article 9(2) of the model treaties provides that in these circumstances, Germany shall make an appropriate adjustment so as to relieve the double taxation. However, an adjustment is not automatically to be made by Germany simply because the profits in Mexico have been increased. The adjustment is due only if Germany considers that the figure of adjusted profits correctly reflects what the profits would have been had the transactions been at arm's length. Consequently, transfer pricing is an issue of primary importance, both to developed and developing countries, in connection with the proper international treatment of multinational corporations and their complex network of subsidiaries and branches. Thus, it is important to consider Article 9 in conjunction with Article 25 on mutual agreement procedures intended to resolve double taxation conflicts and Article 26 on exchange of information.

In 1999 the UN model inserted a new Article 9(3). It provides that Article 9(2) shall not apply where judicial administrative or other legal proceedings have resulted in a final ruling that, by giving rise to an adjustment of profits under paragraph 1, one of the enterprises is liable to penalty with respect to fraud, gross negligence or willful default. A taxpayer may be subject to both tax and non-tax penalties under the article.

UN MODEL

Article 10

DIVIDENDS

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

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

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

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

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

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

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

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

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

DISCUSSION

Article 10

DIVIDENDS

All countries impose a tax on the business profits generated within their boundaries by a corporation. In addition, profits distributed by a domestic corporation as dividends are generally subject to tax in the hands of a shareholder, either by way of a flat rate withholding tax at the time the dividends are paid or when the shareholder's total tax liability is determined, or both. As foreign shareholders are normally beyond the reach of a country, the dividends they receive are subject in most countries to a withholding tax regardless of whether resident shareholders are subject to such a form of taxation.

When the foreign shareholder is a parent corporation, owning a significant portion of the stock of the dividend-paying subsidiary corporation, the combination of the corporation tax on the subsidiary and the dividend source withholding tax may exceed the tax payable by the parent corporation on the same amount of income from operations within the country of its residence. If significant, the excess burden may constitute a barrier to capital movement and interfere with the international allocation of resources. Moreover, in the absence of a branch profits remittance withholding tax, the withholding tax on dividends tends to encourage branch rather than subsidiary operations and constitutes an obstacle to a form of organization that would afford local shareholders the opportunity to participate in the venture.

In the case of a foreign portfolio investor the dividend withholding tax may raise several concerns. Statutory withholding taxes, imposed at flat rates, are sometimes high compared with the average effective tax likely to apply to the investor in his home country, or more important to a unit trust or investment company. Moreover, capital exporting countries seek to collect some tax on the income received by their residents from foreign as well as domestic investments. If, as a result of unilateral measure to eliminate double taxation (i.e., credits or exemptions) little or no tax is collected on foreign portfolio investments, the foreign investments of their residents are of uncertain value compared with domestic investments. If a residence country tax is imposed, in addition to the tax imposed in the source country, the combined burden may constitute an undesirable barrier to capital investments.

Article 10 of both model treaties provides a framework for dealing with the foregoing issues. Under the OECD model dividends are sourced taxed at a reduced withholding rate not exceeding 15% if the beneficial owner of the dividends is not a resident of and does not have a permanent establishment in the source country. A special 5% withholding rate is imposed when the dividend is paid to a parent corporation which is the beneficial owner of at least 25 percent of the capital of the company paying the dividend. By contrast, the UN model Article 10 does not provide the maximum dividend withholding rates to be applied by the source country treaty partner, but rather leaves these

provisions of this article shall apply only to the last-mentioned amount. In such case, the excess part of the payments shall remain taxable according to the laws of each Contracting State, due regard being had to the other provisions of this Convention.

DISCUSSION

Article 11

INTEREST

On a national level interest income is not liable to double taxation, as it is taxed only at the level of the lender; or, if the payer is obliged to withhold a certain portion of the interest as a tax, the recipient can, under provisions of the national law, deduct the amount withheld from the amount of tax due from him and obtain reimbursement of any sum by which the amount withheld exceeds the amount of the tax that is finally payable. Internationally, double taxation of interest may arise from the fact that the interest income is taxed in the State in which it arises and also in the State of the residence of the beneficial recipient. Such international double taxation may considerably reduce the amount of interest income received by the beneficiary, or if the payer has agreed to bear the cost of the interest source withholding tax, will increase the financial burden on the payer.

Article 11(3) of both model treaties define the term "interest" for Article 11 purposes to mean 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 e nw[(0i118.w034 Tw[(ted by mTw[(m)

debt claim is effectively connected with the permanent establishment or fixed base or business in the source country of the same or similar kind as those effected through the permanent establishment Finally, Article 11(6) restricts application of Article 11 in the case of related parties to the amount of interest that would have been paid had the parties been operating at arm's length.

The rationale for the UN model bilateral negotiation approach is that withholding rates for interest adopted in developed/developing country tax treaties range between complete exemption and 25 per cent with some developing countries reducing interest withholding rates in order to attract foreign investment. Prospective tax treaty negotiators may wish to take the following factors into account in determination of a precise level of source country withholding rates for interest: (1) that the capital originated in the residence country, (2) a high source country interest withholding rate might cause lenders to pass all or a part of the interest withholding tax on to the source country borrowers, thereby effectively increasing source country revenue at the expense of its own residents, (3) a source country interest withholding rate higher than the foreign tax credit limit in the residence country might deter investment in the source country, (4) a lowering of the source country interest withholding rate has revenue and foreign exchange consequences for the source country, (5) the direction of interest flows from developing to developed countries, (6) the potential expenses involved in the earning of the interest income, and (7) interest paid to government agencies, financial institutions, export finance and long-term loans as the predominant treaty practice is to exempt certain governmental interest from source country taxation.

UN MODEL

Article 12

ROYALTIES

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

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

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

4. The provisions of paragraphs 1 and 2 shall not apply if the beneficial owner of the royalties, being a resident of a Contracting State, carries on business in the other Contracting State in which the royalties arise, through a permanent establishment situated therein, or performs in that other State independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with (a) such permanent establishment or fixed

by a residency state. Instead, it is incorporated in Article 12(2) which allows source country taxation of royalty income.

Both models exclude Article 12 coverage in the case of royalties received by beneficial owners in which the royalties arise, though a permanent establishment situated in the source country or the performance of independent personal services from a fixed base situated therein, and the right or property in respect of which the royalties are paid is effectively connected with the permanent establishment or base. The UN model broadens the exclusion to also include business activities referred to in paragraph 1 of Article 7 of the UN model. In such cases the provisions of Article 7 or 14, as the case may be, shall apply. Also, both models restrict the application of Article 12 in the case of related parties to the amount of royalties that would have been paid had the parties been operating at arm's length. Finally, the UN model contains Article 12(5) an innovation not found in Article 12 of the OECD model. The paragraph provides that royalties are considered income from sources in the residence country of the payer of the royalties. Where, however, the right or property for which the royalty was paid was used in a state having a place of use rule, the royalty would be deemed to arise in that state.

Article 12(3) of the UN model defines the term "royalties" to mean payments of any kind received as consideration for the use of, or the right to use, any copyright or literary, artistic or scientific work including cinematograph films, or films or tapes used for radio or television broadcasting, any patent, trademark, design or model, plan, secret formula or process, or for the use of, or the right to use, industrial, commercial or scientific equipment or for information concerning industrial, commercial or scientific experience. The OECD model Article 12(2) is almost equivalent, but eliminates from the definition of royalty: equipment rental, i.e. films or tapes used for radio or television broadcasting, and the right to use industrial, commercial or scientific equipment. No fewer than 13 of the OECD member states have entered reservations concerning OECD Article 12(2) definition of royalty. Most of the reservations reflect an adherence to the scope of inclusion under the UN model Article 12(3). Many recent actual treaties show a great degree of divergence from the OECD model. For instance, practically all treaties include remuneration for the use of, or the right to use equipment. Treaties with developing countries tend to soften the concept of royalties in relation to consulting activities or similar services, such as by including commercial or technical assistance in the enumeration of subjects capable of being licensed. Treaty negotiators continue to struggle with the concept of know-how which can be pure royalties for the use of intangible property under Article 12, pure technical assistance which generally falls under Articles 7 or 14, or a mixed contract which may need to be apportioned.

UN MODEL

Article 13

CAPITAL GAINS

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

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

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

4. Gains from the alienation of shares of the capital stock of a company, or of an interest in a partnership, trust or estate, the property of which consists directly or indirectly principally of immovable property situated in a Contracting State may be taxed in that State. In particular:

(a) Nothing contained in this paragraph shall apply to a company, partnership, trust or estate, other than a company, partnership, trust or estate engaged in the business of management of immovable properties, the property of which consists directly or indirectly principally of immovable property used by such company, partnership, trust or estate in its business activities.

(b) For the purpose of this paragraph, "principally" in relation to ownership of immovable property means the value of such immovable property exceeding fifty per cent of the aggregate value of all assets owned by the company, partnership, trust or estate.

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

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

DISCUSSION

Article 13

CAPITAL GAINS

Domestically, taxation of capital gains varies considerably from country to country based upon factors such as whether capital gains are taxed at all; the rate at which capital gains are taxed (i.e., as ordinary income or at a lower rate); the method of calculating capital gains (e.g. is basis adjusted for inflation) and the capital gains treatment of differing types of property (e.g. business versus investe 13

partnership, trust or estate. A substantial number of actually negotiated tax treaties contain a provision that reflects, but may broaden or narrow, the substance of Article 13(4) of the UN model. Recently, the OECD inserted a new Article 13(4) in its model. It provides that gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from

year of presence in the source State. If he has no fixed base or does not meet the source State presence requirement he will enjoy exemption from source State taxation. A substantial number of actually negotiated treaties contain an Article 14 type provision essentially adopting the UN position that there may be some uncertainty that the criteria for establishing a fixed based as opposed to a permanent establishment ought to be identical or whether a fixed base might be comparable to a permanent establishment yet consist of some lesser activity in certain cases.

The OECD deleted Article 14 from its model

traffic, or aboard a boat engaged in inland waterways transport, may be taxed in the Contracting State in which the place of effective management of the enterprise is situated.

DISCUSSION

Article 15

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

DISCUSSION

Article 16

DIRECTORS' FEES AND REMUNERATION OF TOP-LEVEL MANAGERIAL OFFICIALS (UN Model)

DIRECTORS' FEES (OECD Model)

Article 16 of both model treaties overrides the jurisdictional principles contained in Articles 15 (both models) and Art 14 (UN model) in the following cases. Directors' fees and other similar payments (including payments in kind and fringe benefits such as health insurance and club memberships) are not limited

2. Where income in respect of personal activities exercised by an entertainer or a sports person in his capacity as such accrues not to the entertainer or spor

jurisdiction tax approach by providing that pensions and other similar payments may also be taxed in the other Contracting State if the payment is made by a resident of that other State or a permanent establishment situated therein. The State where a permanent establishment is situated may thereby indirectly recoup the prior tax benefit it extended to the permanent establishment by allowing deductions for contributions to its pension plans.

UN MODEL

Article 19

GOVERNMENT SERVICE

1.

(a) Salaries, wages and other similar remuneration, other than a pension, paid by a Contracting State or a political subdivision or a local authority thereof to an individual in respect of services rendered to that State or subdivision or authority shall be taxable only in that State.

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

(i) is a national of that State; or

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

2.

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

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

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

DISCUSSION

Article 19

GOVERNMENT SERVICE

The provisions of Article 19 regarding taxation of government service are virtually identical in both model treaties. Under Articles 19(1)(a) and (2)(a) as a general principle remuneration for, and pensions in respect of, services rendered to a Government, or political subdivision or local authority are taxable exclusively in the paying State. In this regard Article 19 overrides Articles 15, 16 and 18. However, the following exceptions apply to the application of the foregoing general principle:

(1) Articles 19(1)(b) and 2(b) provide for exclusive taxing jurisdiction by the State where the services are performed, instead of the paying State, in the case of remuneration, and pensions in respect thereof, paid by one Contracting State to an individual in respect of services rendered in the other Contracting State if the individual is a resident of the latter State and also a national of that State or who did not become a resident of that State solely for the purpose of rendering the service. This approach is consistent with the Vienna Conventions according to which a receiving State is allowed to tax remuneration paid to certain categories of personnel of foreign diplomatic missions and consular posts who are permanent residents or nationals of that State.

(2) Under Article 19(3), Articles 15, 16, 17 and 18 shall apply if the services were rendered in connection with a business carried on by a Contracting State. This result is consistent with the principle of international law that States may not enjoy taxation

States has in the other Contracting State. In such event the provisions of Art.7 (or Art. 14 UN model), as the case may be shall apply. Art. 21(2) does not apply to immovable property, as defined in Art.6(2). The OECD Commentary states that immovable property situated in a Contracting State shall be taxable only in the first-mentioned State in which the property is situated and of which the recipient thereof is a resident.

Art. 21(3) of the UN model is an addition not found in the OECD model. It states that notwithstanding the provisions of paragraphs 1 and 2 of Art. 21, items of income of a resident of a Contracting State not otherwise dealt with in the other treaty articles and arising in the other Contracting State may also be taxed in that other State. It is intended to permit the country in which the income arises to tax such income if its law so provides while the provision of Art. 21(1) would permit taxation only in the country of residence. The concurrent application of Arts.21(1) and 21(3) may generate international double taxation subject to elimination under Art. 23.

Finally, the UN Group of Experts noted that there are very artificial devices entered into by persons seeking to take advantage of Art. 21, especially if Art. 21(3) is omitted. The issue may specifically be addressed by adding the following clause:

"The provisions of this article shall not apply if it was the main purpose or one of the main purposes of any individual concerned with the creation or assignments of the rights in respect of which income is paid to take advantage of this article by means of that creation or assignment"

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

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

DISCUSSION

Article 22

CAPITAL

Art. 22 applies to taxes on the possession or ownership of capital, not the income or gains from capital. (e.g. net wealth taxes) as well as the exclusion of taxes on estates and inheritances and on gifts and of transfer duties. The first three paragraphs of Art.22 are identical in structure to the first three paragraphs of Art. 13. Therefore, capital is taxable exclusively in the State of residence, subject to the same three exceptions found in Art. 13. They are:

(1) A resident of a Contracting State who owns immovable property refer4dt of a007 Tc-.(1-coaT10

05 Tw[(45) A resi2entCresented by immovable thr]TJperty refer4dt o 0 TD.02702 Tc.13396Tw[(451.iefor

DISCUSSION

Article 23

METHODS FOR ELIMINATION OF DOUBLE TAXATION

Double taxation may arise when a national or resident of a country derives income from foreign sources and such income is potentially subjected to both source country and residency country tax exposure. For instance, double taxation may occur where: (a) a country of residency imposes tax on its residents or nationals on a worldwide basis, (b) a resident of a country derives income from a foreign country and both countries impose a tax on the income, (c) two countries utilize different methods for determining the amount of income allocable to each country from transaction between related parties, or (d) variations exist between countries in income concepts. In such cases countries of residence may unilaterally employ exemption or credit mechanisms to eliminate the double taxation.

Both model treaties employ the same approaches to elimination of double taxation in Article 23, namely Article 23A, the exemption method and Article 23B, the credit method. The two methods contained in Article 23 are alternatives to be selected by the Contracting States. In practice, both the exemption and credit methods are used in actually negotiated treaties, although the credit method is used more extensively.

Articles 23A(1) and (2) concern the situation where income may be taxed according to the Convention in both the State of source and the State of the residence of its recipient. Article 23A(1) requires the State of residence to exempt from taxation income of its residents derived from the source Contracting State, subject to the provisions of Articles 23A(2) and (3). Article 23A(2) concerns source Contracting State investment income (dividends, interest and royalties) withholding tax. It requires the residency Contracting State to provide a deduction (offset) from its tax on the income of its resident in the amount of the source State withholding tax. Under Article 23A(3) income which is exempt from tax in the State of residence of its recipient in accordance with the Convention may nevertheless be taken into account by that State in determining the amount of tax payable on the resident's other income (exemption with progression).

Article 23B(1), as an alternative credit method, requires the State of residency to allowance a credit (offset) from

UN MODEL

Article 24

NON-DISCRIMINATION

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

2. Stateless persons who are residents of a C

DISCUSSION

Article 24

NON-DISCRIMINATION

Article 24 is identical in both model treaties. Non-discrimination clauses, such as Article 24, have historically formed the backbone of tax treaties. Under Article 24(1) each treaty country must not discriminate against nationals of the other Contracting State resident in its territory by taxing them more severely than its own nationals. Designed to assure equal tax treatment in each treaty country for its own citizens and the citizens of its treaty partner, the non-discrimination clause offers protection for the nationals of both countries from differential tax treatment by supplementing internal laws against discrimination.

Modern income tax conventions typically express the non-discrimination principle in three specific provisions, each designed to protect a distinct class of treaty partner nationals: individuals, enterprises and permanent establishments of enterprises. However, the protection specifics vary in coverage. For instance, under Articles 24(1), (2) and (5) treaty partner individuals and enterprises are protected from other or more burdensome taxation and connected requirements to which nationals or other similar enterprises, of the State concerned in the same circumstances, in particular with respect to residence in the case of individuals , are or my be subjected. By contrast, Article 24(3) shields a permanent establishment only from less favorably levied taxation. Also, Article 24(3) focuses on taxes imposed by each treaty country alone and prohibits each from levying a higher tax than on a hypothetical domestic enterprise carrying on the same activities. Finally, Article 24(4) dispense the State of source of the dividends, interest or royalties received by a permanent establishment from applying any limitation contained in treaty Articles 10,11 and 12. This provision allows the State of source, where the permanent establishment is situated to apply its withholding tax at the full rate.

UN MODEL

Article 25

MUTUAL AGREEMENT PROCEDURE

1. Where a person considers that the actions of one or both vi1J9.1,mson cone orTT2 1ece(s)-nt es7ver

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

contains two additional sentences allowing the competent authorities to develop both unilateral and bilateral measures to implement the mutual agreement procedure. They are also to consult together for the elimination of double taxation in cases not provided for in the treaty. The UN model commentary, as well as some actually negotiated treaties, specifically authorize the competent authorities to endeavor to agree in the area of allocation of income and expenses between related enterprises or units of the same business enterprise operating in both Contracting States. (E.g. U.S.- France treaty, Art. 25(2))

As advantageous as the current competent authority structure is, in practice its use may be limited. For instance, the competent authority to which a claim is made has to

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

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

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

DISCUSSION

Article 26

EXCHANGE OF INFORMATION

In order to serve the goal of preventing international double taxation without creating enhanced opportunities for tax evasion and avoidance, tax treaties include a provision to ensure the cooperation between the Contracting States, through an exchange by the competent authorities, of the supply of information necessary to apply the provisions of the treaty or to enforce the domestic laws of the Contracting States concerning the taxed covered by the treaty. (Model treaties Art. 26(1))

The information that will be made available is that which would be provided under the tax laws and normal administrative procedures of the country furnishing the information. No information that would disclose any trade, business, industrial, commercial or professional secret or trade process may be exchanged if its disclosure would be contrary to public policy (ordre public) (UN model, Art. 26(2), OECD model Art. 26(3)) The information obtained may be disclosed only to persons and authorities involved in the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes covered by the Convention.

The major categories of information being exchanged under actually negotiated treaties are as follows:

(a) information concerning items of income

(e) taxpayers' travel and residence activities

UN MODEL

Article 27

Also of significance is the historic multilateral Convention on Assistance in Tax Matters entered into by the Nordic countries. A more recent multilateral Convention is the Mutual Administrative Assistance in Tax Matters Convention which was prepared by the OECD and went into force in 1995. It has been ratified by a number of countries.

Article 29 (OECD Model ONLY)

TERRITORIAL EXTENSION

1. This Convention may be extended, either in its entirety or with any necessary modifications [to any part of the territory of (State A) or of (State B) which is specifically excluded from the application of the Convention or], to any State or territory for whose

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

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

DISCUSSION

Article 28 (UN Model)

TERMINATION

As it is desirable that a tax treaty should remain in force at least for a certain period, this Article provides that termination can only be given after a certain year to be fixed by bilateral agreement. It is up to the Contracting States to decide upon the earliest year such notice can be given or even to agree not to fix any such year.