TECHNICAL CHANGES TO BE INCLUDED IN THE NEXT UPDATE TO THE OECD MODEL TAX CONVENTION

Public discussion draft

15 November 2013 – 15 January 2014

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This public discussion draft includes proposals for changes to the Model Tax Convention resulting from the work of Working Party 1 on Tax Conventions and Related Questions[1] on a number of technical issues related to the Model Tax Convention. It is proposed that these changes be part of the next update to the OECD Model Tax Convention, which is currently scheduled to be finalised in 2014.

The changes included in this discussion draft are the following:

– Minor clarification of the French definition of "activité" and "affaires" in subparagraph 1 *h*) of Article 3
– Correction of the Commentary on Article 3 as regards the reference to the State whose laws govern the definition of company
– Update of the wording of paragraph 31 of the Commentary on Article 24
– Replacement of the word "income" in paragraphs 35-36 of the Commentary on Article 7
– Replacement of the word "ascribable" in paragraph 72 of the Commentary on Article 24
– Minor editorial corrections related to the reference to paragraph 5 of Article 13 in paragraph 23 of the Introduction
– Clarification of the meaning of the phrase "fiscal year concerned" in Article 15
– Clarification concerning the reference to exemptions for certain categories of interest that appears in paragraph 63 of the Commentary on Articles 23 A and 23 B
– Clarification concerning Article 20 and payments from the host State
– Minor editorial correction to the last part of paragraph 7.7 of the Commentary on Article 11
– Addition to the Commentary on Article 11 dealing with the application of Article 11 (Interest) to accrued interest
– Minor editorial correction to the drafting of paragraph 12 of the Commentary on Article 27
– Addition to the Commentary on Article 13 concerning the application of that Article with respect to capital gains that have accrued before that Article is included in a bilateral treaty
– Addition to the Commentary on Articles 10 and 13 concerning the application of these articles in the case of a redemption of shares
– A minor editorial correction to the alternative provision in paragraph 68 of the Commentary on Article 7

The Committee invites interested parties to send their comments on this discussion draft **before 15 January 2014**. These comments will be examined at the February 2014 meeting of the Working Party, when it is expected that the contents of the 2014 Update to the Model Tax Convention will be finalised.

Comments on this discussion draft should be sent electronically (in Word format) by email to **taxtreaties@oecd.org** and should be addressed to:

Tax Treaties, Transfer Pricing and Financial Transactions Division
OECD/CTPA

[1] Working Party 1 is the subgroup of the OECD Committee on Fiscal Affairs that deals with tax treaties.

TECHNICAL CHANGES TO BE INCLUDED IN THE NEXT UPDATE TO THE OECD MODEL TAX CONVENTION

[Proposed changes to the existing text of the Model Tax Convention appear in ~~strikethrough~~ for deletions and ***bold italics*** for additions]

A. INTRODUCTION

1. Replace the first part of paragraph 21 of the Introduction by the following:

> 21. The following are the classes of income and capital that may be taxed without any limitation in the State of source or situs:
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> — income from immovable property situated in that State (including income from agriculture or forestry), gains from the alienation of such property~~,~~ and capital representing it (Article 6 and paragraph 1 of Articles 13 and 22) ***as well as gains from the alienation of shares deriving more than 50 per cent of their value from such property (paragraph 4 of Article 13)***;
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> [*the rest of paragraph 21 remains unchanged*]

2. Replace paragraph 23 of the Introduction by the following:

> 23. Other items of income or capital may not be taxed in the State of source or situs; as a rule they are taxable only in the State of residence of the taxpayer. This applies, for example, to royalties (Article 12), gains from the alienation of shares or securities (paragraph 5 of Article 13, ***subject to the exception of paragraph 4 of Article 13***), private sector pensions (Article 18), payments received by a student for the purposes of his education or training (Article 20), and capital represented by shares or securities (paragraph 4 of Article 22). Profits from the operation of ships or aircraft in international traffic or of boats engaged in inland waterways transport, gains from the alienation of such ships, boats, or aircraft, and capital represented by them, are taxable only in the State in which the place of effective management of the enterprise is situated (Article 8 and paragraph 3 of Articles 13 and 22). Business profits that are not attributable to a permanent establishment in the State of source are taxable only in the State of residence (paragraph 1 of Article 7).

B. ARTICLES

Article 3

3. Replace the French version of subparagraph 1 *h*) of Article 3 by the following:

> *h*) les termes « activité », par rapport à une entreprise, et « affaires » comprennent l’exercice de professions libérales ~~ou~~ ***ainsi que l’exercice*** d’autres activités de caractère indépendant.

C. COMMENTARY

Commentary on Article 3

4. Replace paragraph 3 of the Commentary on Article 3 by the following:

> 3. The term "company" means in the first place any body corporate. In addition, the term covers any other taxable unit that is treated as a body corporate ***for the purposes of the tax law of the Contracting State of which it is a resident***~~according to the tax laws of the Contracting State in which it is organised~~. The definition is drafted with special regard to the Article on dividends. The term "company" has a bearing only on that Article, paragraph 7 of Article 5, and Article 16.

Commentary on Article 7

5. Replace paragraphs 35 and 36 of the Commentary on Article 7 by the following:

> 35. Paragraph 3 of Article 5 sets forth a special rule for a fixed place of business that is a building site or a construction or installation project. Such a fixed place of business is a permanent establishment only if it lasts more than twelve months. Experience has shown that these types of permanent establishments can give rise to special problems in attributing ***profits***~~income~~ to them under Article 7.
>
> 36. These problems arise chiefly where goods are provided, or services performed, by the other parts of the enterprise or a related party in connection with the building site or construction or installation project. Whilst these problems can arise with any permanent establishment, they are particularly acute for building sites and construction or installation projects. In these circumstances, it is necessary to pay close attention to the general principle that ~~income is~~***profits are*** attributable to a permanent establishment only ~~when it results from~~***with respect to*** activities carried on by the enterprise through that permanent establishment.

6. Replace paragraph 68 of the Commentary on Article 7 by the following:

> 68. Some States may prefer that the cases covered by paragraph 3 be resolved through the mutual agreement procedure (a failure to do so triggering the application of the arbitration provision of paragraph 5 of Article 25) if a State does not unilaterally agree to make a corresponding adjustment, without any deference being given to the adjusting State's preferred position as to the arm's length price or method. These States would therefore prefer a provision that would always give the possibility for a State to negotiate with the adjusting State over the arm's length price or method to be applied. States that share that view may prefer to use the following alternative version of paragraph 3:
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>> Where, in accordance with paragraph 2, a Contracting State adjusts the profits that are attributable to a permanent establishment of an enterprise of one of the Contracting States and taxes accordingly profits of the enterprise that have been charged to tax in the other State, the other Contracting State shall, to the extent necessary to eliminate double taxation ***on these profits***, make an appropriate adjustment if it agrees with the adjustment made by the first-mentioned State; if the other Contracting State does not so agree, the Contracting States shall eliminate any double taxation resulting therefrom by mutual agreement.

7. Replace paragraph 28 of the Commentary on Article 10 by the following:

28. Payments regarded as dividends may include not only distributions of profits decided by annual general meetings of shareholders, but also other benefits in money or money's worth, such as bonus shares, bonuses, profits on a liquidation ***or redemption of shares (see paragraph 31 of the Commentary on Article 13)*** and disguised distributions of profits. The reliefs provided in the Article apply so long as the State of which the paying company is a resident taxes such benefits as dividends. It is immaterial whether any such benefits are paid out of current profits made by the company or are derived, for example, from reserves, *i.e.* profits of previous financial years. Normally, distributions by a company which have the effect of reducing the membership rights, for instance, payments constituting a reimbursement of capital in any form whatever, are not regarded as dividends.

Commentary on Article 11

8. Replace paragraph 7.7 of the Commentary on Article 11 by the following:

7.7 The problem described in paragraph 7.1, which essentially arises because taxation by the State of source is typically levied on the gross amount of the interest and therefore ignores the real amount of income derived from the transaction for which the interest is paid, is particularly important in the case of financial institutions. For instance, a bank generally finances the loan which it grants with funds lent to it and, in particular, funds accepted on deposit. Since the State of source, in determining the amount of tax payable on the interest, will usually ignore the cost of funds for the bank, the amount of tax may prevent the transaction from occurring unless the amount of that tax is borne by the debtor. For that reason, many States provide that interest paid to a financial institution such as a bank will be exempt from any tax at source. States wishing to do so may agree to include the following ~~interest~~ in a paragraph providing ***for***~~from~~ exemption of certain interest from taxation in the State of source:

d) is a financial institution;

9. Replace paragraph 20 of the Commentary on Article 11 by the following:

20. As regards, more particularly, government securities, and bonds and debentures, the text specifies that premiums or prizes attaching thereto constitute interest. Generally speaking, what constitutes interest yielded by a loan security, and may properly be taxed as such in the State of source, is all that the institution issuing the loan pays over and above the amount paid by the subscriber, that is to say, the interest accruing plus any premium paid at redemption or at issue. It follows that when a bond or debenture has been issued at a premium, the excess of the amount paid by the subscriber over that repaid to him may constitute negative interest which should be deducted from ***the stated interest in determining*** the interest that is taxable. On the other hand, ***the definition of interest does not cover*** any profit or loss ***that cannot be attributed to a difference between what the issuer received and paid (e.g. a profit or loss, not representing accrued interest or original issue discount or premium,*** which a holder of ~~such~~ a security ***such as a bond or debenture*** realises by the sale thereof to another person ***or by the repayment of the principal of a security that he has acquired from a previous holder for an amount that is different from the amount received by the issuer of the security).***~~does not enter into the concept of interest.~~ Such profit or loss may, depending on the case, constitute either a business profit or a loss, a capital gain or a loss, or income falling under Article 21.

20.1 The amount that the seller of a bond will receive will typically include the interest that has accrued, but has not yet become payable, at the time of the sale of the bond. In most cases, the State of source will not attempt to tax such accrued interest at the time of the alienation and will only tax the acquirer of the bond or debenture on the full amount of the interest subsequently paid (it is generally assumed that in such a case, the price that the acquirer pays for the bond takes account of the future tax liability of the acquirer on the interest accrued for the benefit of

the seller at the time of the alienation). In certain circumstances, however, some States tax the seller of a bond on interest that has accrued at the time of the alienation (e.g. when a bond is sold to a tax-exempt entity). Such accrued interest is covered by the definition of interest and may therefore be taxed by the State of source. In that case, that State should not again tax the same amount in the hands of the acquirer of the bond when the interest subsequently becomes payable.

Commentary on Article 13

10. Replace paragraph 3 of the Commentary on Article 13 by the following:

3. The Article does not deal with the above-mentioned questions. It is left to the domestic law of each Contracting State to decide whether capital gains should be taxed and, if they are taxable, how they are to be taxed. The Article can in no way be construed as giving a State the right to tax capital gains if such right is not provided for in its domestic law. [*rest of the paragraph is moved to new paragraph 3.1*]

3.1 The Article does not specify to what kind of tax it applies. It is understood that the Article must apply to all kinds of taxes levied by a Contracting State on capital gains. The wording of Article 2 is large enough to achieve this aim and to include also special taxes on capital gains. ***Also, where the Article allows a Contracting State to tax a capital gain, this right applies to the entire gain and not only to the part thereof that has accrued after the entry into force of a treaty (subject to contrary provisions that could be agreed to during bilateral negotiations), even in the case of a new treaty that replaces a previous one that did not allow such taxation.***

11. Replace paragraph 31 of the Commentary on Article 13 by the following:

31. If shares are ~~sold~~ ***alienated*** by a shareholder ~~to the issuing company~~ in connection with the liquidation of ***the issuing*** ~~such~~ company or the ***redemption of shares or*** reduction of ~~its~~ paid-up capital ***of that company***, the difference between the ~~selling price~~***proceeds obtained by the shareholder*** and the par value of the shares may be treated in the State of which the company is a resident as a distribution of accumulated profits and not as a capital gain. The Article does not prevent the State of residence of the company from taxing such distributions at the rates provided for in Article 10: such taxation is permitted because such difference is covered by the definition of the term "dividends" contained in paragraph 3 of Article 10 and interpreted in paragraph 28 of the Commentary relating thereto***, to the extent that the domestic law of that State treats that difference as income from shares***. ***As explained in paragraphs 32.1 to 32.7 of the Commentary on Articles 23 A and 23 B, where the State of the issuing company treats the difference as a dividend, the State of residence of the shareholder is required to provide relief of double taxation even though such a difference constitutes a capital gain under its own domestic law***. The same interpretation may apply if bonds or debentures are redeemed by the debtor at a price which is higher than the par value or the value at which the bonds or debentures have been issued; in such a case, the difference may represent interest and, therefore, be subjected to a limited tax in the State of source of the interest in accordance with Article 11 (see also paragraphs 20 and 21 of the Commentary on Article 11).

12. Add the following new paragraph 4.1 to the Commentary on Article 15:

4.1 The reference to the "fiscal year concerned" must be interpreted as a reference to a fiscal year of the Contracting State in which a resident of the other Contracting State has exercised his employment and during which the relevant employment services have been rendered. Assume, for example, that the fiscal year of State S runs from 1 January to 31 December and that a resident of State R is present and performs employment services in State S between 1 August 00 and 28

February 01. For the purposes of subparagraph 2 a), any twelve month period that begins between 1 January and 31 December 00 or ends between 1 January and 31 December 01 and that includes any part of the period of employment services would be relevant. For instance, the twelve month period of 1 August 00 to 31 July 01, which begins in the fiscal year 00 and during which the person was present in State S for more than 183 days, would include the employment services rendered in that State between 1 August and 31 December 00; similarly, the twelve month period of 1 March 00 to 28 February 01, which ends in the fiscal year 01 and during which the person was present in State S for more than 183 days, would include the employment services rendered in that State between 1 January and 28 February 01. The taxation of the remuneration for the relevant services need not take place in the fiscal year concerned: as explained in paragraph 2.2 above and 12.1 below, the Article allows a State to tax the remuneration derived from employment exercised in that State in a particular year even if the remuneration for these employment services is acquired, or the tax is levied, in a different year.

Commentary on Article 20

13. Replace paragraph 4 of the Commentary on Article 20 by the following:

4. ***The Article only applies to payments arising from sources outside the State where the student or business apprentice is present solely for the purposes of education or training. Payments arising from sources within that State are covered by other Articles of the Convention: for instance, if, during his presence in the first-mentioned State, the student or business apprentice remains a resident of the other State according to Article 4, payments such as grants or scholarships that are not covered by other provisions of the Convention (such as Article 15) will be taxable only in his State of residence under paragraph 1 of Article 21.*** For the purpose of the Article, payments that are made by or on behalf of a resident of a Contracting State or that are borne by a permanent establishment which a person has in that State are not considered to arise from sources outside that State.

Commentary on Articles 23 A and 23 B

14. Replace paragraph 48 of the Commentary on Articles 23 A and 23 B by the following:

48. In the cases referred to in the previous paragraph, certain maximum percentages are laid down for tax reserved to the State of source. In such cases, the rate of tax in the State of residence will very often be higher than the rate in the State of source. The limitation of the deduction which is laid down in the second sentence of paragraph 2 and which is in accordance with the ordinary credit method is therefore of consequence only in a limited number of cases. If, in such cases, the Contracting States prefer to waive the limitation and to apply the full credit method, they can do so by deleting the second sentence of paragraph 2~~ (see also paragraph 63 below)~~.

15. Replace paragraph 63 of the Commentary on Articles 23 A and 23 B by the following:

63. The maximum deduction is normally computed as the tax on net income, i.e. on the income from State E (or S) less allowable deductions (specified or proportional) connected with such income (see paragraph 40 above). For such reason, the maximum deduction in many cases may be lower than the tax effectively paid in State E (or S). This may especially be true in the case where, for instance, a resident of State R deriving interest from State S has borrowed funds from a third person to finance the interest-producing loan. As the interest due on such borrowed money may be offset against the interest derived from State S, the amount of net income subject to tax in State R may be very small, or there may even be no net income at all. ***As explained in paragraph 7.1 of the***

Commentary on Article 11, the problem, in that case, cannot be solved by State R, since little or no tax will be levied in that State. One solution would be to exempt such interest from tax in State S, as is proposed in paragraphs 7 to 7.12 of the Commentary on Article 11. ~~This problem could be solved by using the full credit method in State R as mentioned in paragraph 48 above. Another solution would be to exempt such income from tax in State S, as it is proposed in the Commentary in respect of interest on credit sales and on loans granted by banks (cf. paragraph 15 of the Commentary on Article 11).~~

Commentary on Article 24

16. Replace paragraph 31 of the Commentary on Article 24 by the following:

31. ~~It is possible that in the future certain~~***Some*** States ~~will take exception to~~***may consider that*** the provisions of paragraph 2 ~~as being~~***are*** too liberal insofar as they entitle stateless persons who are residents of one State to claim equality of treatment not only in the other State but also in their State of residence and thus benefit in particular in the latter from the provisions of double taxation conventions concluded by it with third States. ~~If such~~ States wish***ing***~~ed~~ to avoid this latter consequence~~, they would have~~***are free*** to modify paragraph 2 as follows:

> Stateless persons who are residents 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.

17. Replace paragraph 72 of the Commentary on Article 24 by the following:

72. In addition to the typical triangular case considered here, other triangular cases arise, particularly that in which the State of the enterprise is also the State from which the income ~~ascribable~~ ***attributed*** to the permanent establishment in the other State originates (see also paragraph 5 of the Commentary on Article 21).

Commentary on Article 27

18. Replace paragraph 12 of the Commentary on Article 27 by the following:

12. Similarly, some Contracting States may wish to limit the types of tax to which the provisions of the Article will apply or to clarify the scope of application of these provisions by including in the definition a detailed list of the taxes. States wishing to do so are free to adopt bilaterally the following definition:

> The term "revenue claim" as used in this Article means an~~y~~ amount owed in respect of the following taxes imposed by the Contracting States***, insofar as the taxation thereunder is not contrary to this Convention or any other instrument to which the Contracting States are parties,*** as well as with interest, administrative penalties and costs of collection or conservancy related to such amount:
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> *a*) (in State A): …
>
> *b*) (in State B): …